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The review provides a detailed analysis of main trends in Russia's economy in 2010. The paper contains 6 big sections that highlight single aspects of Russia's economic development: the socio-political context; the monetary and credit spheres; financial sphere; the real sector; social sphere; institutional challenges. The paper employs a huge mass of statistical data that forms the basis of original computation and numerous charts.

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Section 1. The Socio-Political Context

1.1. Economic policies in 2010: a quest for innovations¹

1.1.1. The global economic crisis in 2010

While the end of 2009 and the beginning of 2010 was the time of optimistic expectations and hopes that the global crisis would be soon overcome, early 2011 is characterized by restraint and a reluctant acceptance of the fact that economic difficulties may indeed last for a relatively long period of time. In late 2009 the world gave a sigh of relief after having realized that the worst had not happened and a global economic catastrophe had been avoided, that the financial system had survived and economic growth rebounded, and unemployment had not become disastrously rampant. There was then a widespread and increasingly growing hope that the crisis would soon be over, and the stable positive dynamics of socio-economy development typical of the previous decade would rapidly resume.

By contrast, our estimates were rather more moderate². We affirmed that the crisis which began in 2008 was a systemic one, and that it would be over after a structural transformation of the world economy, including the formation of a new model of economy regulation and a new model of world economic links and international currency relations. We predicted that such a transformation would take a relatively long period of time, and involve the working-out and materialization of economic development institutions and mechanisms. We expected that this would be a time of instability and fluctuations that could be described as a *turbulent decade*.

The year 2010 confirmed the correctness of our conclusion – with regard to both the world economy and Russia. Economic growth has indeed rebounded, although its rate is now significantly lower than it used to be before the crisis (with the exception of Germany). However, an end of a period of recession does not necessarily mean that a crisis is really a thing of the past, because in the current case the onset of the crisis took place long before the beginning of the recession. The economic growth achieved over the past year resulted, in the main, from the governments' efforts – that is, from a rise in budget expenditures. In the USA, the policy of large-scale money injections is being pursued on an unprecedented scale, and the vagueness of its medium- and long-term prospects has given rise to doubts as to the stability of the global monetary system. Despite its recent revival, private demand has so far failed to become the main locomotive of the economy, which also raises difficult questions about the prospects of the macroeconomic stability of the world's leading countries. However, the situation on many developing markets is rather more optimistic; economic growth, rise in employment, and capital inflow are factors that have a cumulative positive effect there.

The financial crisis in a number of Eurozone countries entered an acute phase when Greece and Iceland applied for international assistance (from the IMF and the EU). A number of

¹ The author wishes to express his sincere gratitude to O. V. Kochetkova, A. V. Moiseev and S. G. Sinelnikov-Murylev for their considerable assistance in the preparing of this section of the review.

² See *Russian Economy in 2009: Trends and Outlooks*. Moscow: IET, 2010; Mau V., *Global'nyi krizis: opyt proshlogo i vyzovy budushchego* [Global Crisis: The Experience of the Past and the Challenges of the Future] // *Ekonomicheskaja Politika* (Economic Policies). 2009. No 4; Mau V., *Ekonomicheskaja politika 2009 goda: mezhdru krizisom i modernizatsiei* [The Economic Policy of 2009: Between Crisis and Modernization] // *Voprosy Ekonomiki*. 2010. No 2.

other EU economies (Spain, Portugal, Italy) continue to be under threat, though, which casts doubt on the prospects of the euro as a single European currency. From a macroeconomic point of view, the current crisis in Europe has been increasingly resembling the 1980s crisis in Latin America, when many countries of that region fell into the insolvency trap because of their uncontrolled borrowing. Moreover, at that time the brink of bankruptcy was approached not only by the borrower countries but also by their creditors – the largest American banks. That crisis was eventually overcome through the systemic and interdetermined efforts of both the borrowers and creditors, when the former took obligations to radically change their economic policies, and the latter agreed to write off part of the debt (and sometimes a significant part of it)¹.

The struggle against the crisis in developed countries has been carried on in two major directions. The USA, as the owner of the main reserve currency and the ‘debt creator’ for the rest of the world, chose the way of an unprecedentedly soft monetary policy by issuing dollars to finance its state budget. In other words, the USA embarked on a policy which directly contradicted its own traditional recommendations offered to countries hit by a financial crisis. (However, it should be acknowledged that a country that issues a world reserve currency could indeed afford, with considerable justification, to pursue some unorthodox budgetary and monetary policies.) In fact, the USA continues to adhere to the high-demand policy by stimulating expenditure on the part of both the state budget and households.

By contrast, European countries on the whole embarked on a policy of budget tightening. This is typical of both the relatively stable Germany and the crisis-ridden Portugal or Greece. Such policies include state budget expenditure cuts (and, correspondingly, budget deficit cuts) and the simultaneous introduction of tax incentives for businesses. Thus, under this scenario, the emphasis is shifted to supply-side economics.

It is now safe to say that 2010 marked the end of the first phase of the crisis (the phase of preventing the economic collapse) and the beginning of the second phase – the phase of working out a new model of socio-economic development. On the completion of the first phase, the world economy found itself to have been weakened and not yet renovated (*Table 1*). The leading countries and their institutions responsible for economic and monetary policies have learned how to take coordinated anti-crisis actions. Now they are facing the task of jointly working out a growth model focused on stable and sufficiently dynamic growth that would be primarily based on private demand and not on state expenditures.

One of the major results of the year was the seemingly final repudiation of the illusion as to the possibilities and prospects of state regulation of economy. The shock of the first phase of the crisis made it popular to accuse the liberal economic model of being a vehicle of state economic regulation and to call for a return to the ideology and practices of the Big State, meaning active government interference in the management of national economies. It became fashionable to juxtapose the vulgar interpretation of economic liberalism (neo-liberalism or supply-side economics) and the newly revived vulgar interpretation of Keynesianism (demand-side economics). However, it soon became clear that the crisis could be equally attributed to a *lack* of state regulation and the *inability* of the State to provide adequate economic regulation. And it became clear that the crisis should be responded to not by increasing state

¹ For an interesting comparative analysis of the current crisis in a number of European countries and the Latin American crisis of the 1980s, see: Rathbone J.P., *Eurozone can learn grim Latin lessons* // Financial Times. 2010. Dec. 22.

interference in the economy (let alone in production), but by working out new instruments of state regulation. Such instruments should be globally coordinated and primarily focused on financial market regulation.

Table 1

Growth rate of GDP volume (percentage change on previous year)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010*	For reference: 2010 as compared to 2007
Russia	10.0	5.1	4.7	7.3	7.2	6.4	8.2	8.5	5.2	-7.9	3.8	0.6
USA	4.1	1.1	1.8	2.5	3.6	3.1	2.7	1.9	0.0	-2.6	2.7	0.0
Canada	5.2	1.8	2.9	1.9	3.1	3.0	2.8	2.2	0.5	-2.5	3.0	1.0
UK	3.9	2.5	2.1	2.8	3.0	2.2	2.8	2.7	-0.1	-5.0	1.8	-3.4
France	4.1	1.8	1.1	1.1	2.3	2.0	2.4	2.3	0.1	-2.5	1.6	-0.9
Germany	3.5	1.4	0.0	-0.2	0.7	0.9	3.6	2.8	0.7	-4.7	3.5	-0.6
Greece	4.5	4.2	3.4	5.9	4.4	2.3	4.5	4.3	1.3	-2.3	-3.9	-4.9
Spain	5.0	3.6	2.7	3.1	3.3	3.6	4.0	3.6	0.9	-3.7	-0.2	-3.1
Japan	2.9	0.2	0.3	1.4	2.7	1.9	2.0	2.4	-1.2	-5.2	3.7	-2.9
Mexico	6.0	-0.9	0.1	1.4	4.0	3.2	4.9	3.3	1.5	-6.6	5.0	-0.4
China	8.4	8.3	9.1	10.1	10.1	11.3	12.7	14.2	9.6	9.1	10.3	31.9
Euro area	4.0	1.9	0.9	0.8	1.9	1.8	3.1	2.8	0.3	-4.1	1.7	-2.1
Total OECD	4.2	1.2	1.7	2.0	3.2	2.8	3.1	2.7	0.3	-3.4	2.8	-0.3

* Preliminary estimate.

Source: OECD.

In order to resolve the difficult economic problems faced by the world (and first of all by developed countries) it is necessary to introduce deep structural reforms, to overcome the disbalances accumulated in the world, and to develop a new growth model. 2010 was the year when an active discourse on this new model was started on the global arena, and a special term – *New Normal* – for defining the subject of that discourse was coined in the USA¹.

Among the issues to be tackled are the ratios and relationships between Western and Eastern economies (first of all, the USA and China) and between Northern and Southern ones (especially within the framework of the EU). If these issues are to be resolved, it is necessary to rectify the world's macroeconomic disbalances (and first of all those affecting the international balance of payments).

An adequate model of global financial regulation should be developed, because it has now become clear to everyone that the biggest threat to global stability comes from the financial sphere. And it is equally apparent that, in conditions of globalization, financial flows cannot be regulated exclusively under national jurisdictions.

The powerful social sectors of developed countries (including Russia) should be restructured, starting with their pension and health care systems that were established and took shape in conditions of the Industrial Era. These system have proved to be inefficient in face of post-industrial challenges (both demographic and purely economic ones).

¹ See Yudaeva K., *New Normal dlia Rossii* [A New Normal for Russia] // Ekonomicheskaja Politika [Economic Policies]. 2010. No 6.

A new international currency system should be formed, and it should be clearly understood which currencies should play the role of world ones. Meanwhile, when resolving this issue, it would be necessary to avoid currency wars and a currency-devaluation race – something that very nearly happened in the autumn of 2010, when the world was teetering on the brink.

The to provide adequate solutions to all those problems will be a time-consuming process. It must be admitted that more time will have to be spent on intellectual comprehension of the adopted decisions and on mapping up some alternative action plans than on the actual decision-making. It is precisely these issues that will become the focal points during the new phase of the crisis – the phase that began in 2010 and will continue throughout 2011.

1.1.2. Russia's economic policy between crisis and modernization

In 2010, Russia in the main continued its economic policies pursued over the previous year. However, this time the emphasis was made not on the bailing out of some individual economic agents (enterprises or banks), but on the maintenance of general economic and social stability. Banks and firms began to repay their debts to the State. At the same time, there was a resumption of growth in the size of external debt of big businesses (unlike the situation observed in previous years, credits were predominantly drawn by non-financial enterprises).

Russia once again experienced economic growth, although its rate was much lower than in 2000 – 2010. As in the previous years, Russia's growth rate was higher than in developed countries but lower than in the other BRIC countries – China, India and Brazil. To be fair, the severe slump at the peak of the crisis (9 % of GDP and almost 15 % in industry) made the issue of economic recovery much more urgent than before. The task of making Russia one of the five world leaders in GDP volume by the year 2020 also became much more difficult.

Below, we will focus our attention on the most grave problems that were influencing the economic development of Russia during last year. Accordingly, these problems will necessarily become the focal points of Russia's economic policy both at present and in the nearest future.

First. We are faced with a considerable aggravation of the financial (budgetary) situation. After nearly a decade, Russia once again has to deal with budget deficit. After the 1989-98 financial crisis which culminated in the 1998 default, the RF Government started to treat budgetary issues with extreme caution. As a result, it succeeded in achieving a balanced budget. Among the factors conducive to this achievement, there was a steady rise in oil prices. For some time, a balanced budget was the symbol of post-communist Russia and almost a rallying point for the new elite. By the time of the onset of the crisis, the intensive repayment of the external debt had made Russia one of the least indebted countries of the world. Certainly, there existed certain political forces in Russia that insisted on an increase in budget expenditures, but their political influence was negligible.

Now the situation has changed. The country experienced a budget deficit in 2009, but no catastrophe took place. The elite understood that it could gain access to far greater profits than those generated by advances in labor productivity and a favorable external market environment. As a result, there has emerged a paradoxical situation: we have a budget deficit despite the average annual price of oil having climbed to almost 80 USD per barrel, while several years ago, when oil was traded at 30 USD per barrel, the federal budget was implemented with a surplus.

From a formal point of view, the situation by no means looks alarming. State debt levels remain low, and the country has ample room for borrowing – both in rubles and foreign cur-

rencies. In comparison with developed countries, Russia's budget deficit of 3.5 – 4 % of GDP is not very high. However, if we eliminate the rent component of the federal budget, the budget deficit will stand at about 13 % of GDP. Which means that the country depends extremely heavily on the fluctuations of world prices for energy carriers – that is, on the factors that are completely beyond Russia's control.

The situation is quite comparable with that of the early 1980s. At that time, the Soviet system seemed to be absolutely stable, and the USSR economy was slowly but steadily growing (at an annual rate of 2 – 3 %). State debt levels were not high. Proceeds from the sale of energy carriers were spent on covering budget expenditures (first of all, military expenditures, purchases of foodstuffs and consumer goods, and purchases of imported equipment for the purposes of further development of the oil and gas sector). That model was considered to possess a long-term – if not altogether permanent – potential for stability, and in accordance with their knowledge of the world's historical experience with oil prices the Soviet authorities were confident that the price of oil could only be on the rise. However, when oil prices demonstrated a six-fold plunge, it took only five years for the cherished stability to turn into a complete financial disaster. The same risks are still very real today. The only difference is that, unlike in the early 1980s, we are now well aware of the fact that oil prices are capable of moving in both directions.

Second. After the rate of inflation dropped in 2009 and in the first half of 2010, the CPI resumed its growth and reached 8.8 % by the end of the year. In other words, Russia's inflation rate remains one of the highest in the G-20. It is comparable only with the rates of inflation in India and Turkey (*Table 2*).

Table 2

Consumer Price Index, as a percentage of the previous year

	2007	2008	2009	2010
Russia, <i>according to OECD</i>	9.0	14.1	11.7	...
Russia, <i>according to Rosstat</i>	11.9	13.3	8.8	8.8
G7	2.2	3.	-0.1	...
Turkey	8.8	10.4	6.3	8.6
India	6.4	8.3	10.9	
China	4.8	5.9	-0.7	4.6 (RBC)
Brazil	3.6	5.7	4.9	5.0
Spain	2.8	4.1	-0.3	1.8
Greece	2.9	4.2	1.2	4.7
USA	2.9	3.8	-0.4	1.6
UK	2.3	3.6	2.2	3.3
Canada	2.1	2.4	0.3	
France	1.5	2.8	0.1	1.5

Sources: OECD, IMF, RBC, Rosstat.

To some extent, this is an absolutely natural process following a resumption of economic growth. Although the dynamics of prices began to decelerate at the peak of the economic slump, the Russian economy continued to be highly inflationary – the bottom point of the slump saw the rate of annual inflation dropping to 8.8 %. As the recession abated, it was from that lowest point that Russia's inflation resumed its climb.

However, Russia's inflation is also fed from two other – so to say, negative – sources. One of them is the factor created by the drought and the extremely poor harvest of cereals, which reflects on the whole index of agricultural production. The second source is the factor of budgetary policy, because the current very strong rise in expenditure cannot but boost prices.

The current wave of inflation has also had some monetary sources, for the budget deficit was financed from the Reserve Fund and by foreign currency interventions during the capital-inflow period at the beginning of the year. Some contributions to the rise in inflation also came from the inflationary expectations inevitably produced by an expansionary budgetary policy.

Given the current situation in Russia, a rise in inflation has created more problems for this country than for its developed counterparts. In developed countries, inflation would have become a factor (and indicator) of a rebound in production, and even the subsequent tightening of monetary policy would have been limited to only a few percentage points. In Russia, inflation must inevitably raise interest rates to double digits, thus creating a serious obstacle to economic growth.

In this situation, it was only reasonable to expect that Russian firms would considerably increase borrowing on external markets that offered cheaper loans. Such expectations indeed proved to be well-substantiated. In 2010, foreign borrowing began to climb, especially on the part of non-financial institutions (unlike in the pre-crisis period).

Third. Russia has been hit by massive capital outflow. In this respect, the situation in Russia is totally different from that existing in the other BRIC countries, because Brazil, India and China are experiencing strong capital inflows. In both cases there emerges the issue of advisability of restricting the freedom of capital movement, although the purposes of such restrictions would be diametrically opposed to each other – to reduce the impetus for capital inflow for the purpose of lowering the level of volatility in one case (e.g., Brazil has already introduced a Tobin tax), or to do this for the purpose of preventing a dangerous capital outflow in the other.

Capital outflow from Russia was taking place despite that fact that the Russian stock market was one of fastest growing stock markets in the world. However, its small size (the inflow of portfolio investments constitutes only a small part of capital flows), small depth and extremely high volatility (it can fluctuate many-fold) have made big international investors lose interest in it. To make matters worse, the amount of direct investments registered last year was negligibly small.

Apparently, the current capital outflow from Russia has several causes. One of the reasons is the general uncertainty concerning the forthcoming Russian elections. Another reason is persistently high corruption, when part of the funds spent by budgets of all levels of government remains in the hands of ‘officials’ who prefer to transfer their loot to safer havens (as is confirmed by the relatively small money transfers abroad typical of the past year). As far as the latter tendency is concerned, it can be said that corruption is visibly evolving from being a microeconomic phenomenon into a macroeconomic factor.

At the same time, the current account balance rapidly has been decreasing due to a considerable rise in imports caused by a rise in the social expenditures of the budget. High effective demand transforms into demand for cheap goods. Currently, Russia is importing most of such goods. It has become clear that a 1999-like situation – when growth in nominal payments to the population turns into growth in demand for domestically produced goods (import substitution) – can be possible only in the event of a radical devaluation of the national currency (many-fold, as in 1998, and not by a few percent only (as it is done now))¹.

¹ In this regard, in November 2010 A. Uliukaev stated that, if the policies aimed at boosting social expenditures were to be continued, this could result in the emergence of a structural deficit of the current account that would

This brings us to the following general conclusion: last year has clearly demonstrated that Russia is no longer the cheap country that it used to be in the 1990s and early 2000s. This applies to the value of assets, the value of goods, and the value of services. Both the crisis and the relatively stable exchange rate of the ruble maintained in crisis conditions had a considerable impact on the risk/return ratio due to the persistence of high risks and a fall in profitability, because other developing countries have proved to be more reliable than Russia, while offering a comparable level of profitability. As regards the price/quality ratio, Russian domestically produced consumer goods, as a rule, have also been failing to adequately compete with imports. These circumstances have caused capital outflow from Russia, and so put a downward pressure on the current account balance.

The fear of the current account balance becoming negative is not groundless. But such a course of events is not inevitable, because the rise in demand for imports has resulted in weakening of the ruble – which, in its turn, can become an import-restriction factor. This will depend both on the actions of the monetary authorities and on the fiscal policy of Russia. The Central Bank is capable of influencing the exchange rate of the ruble by gradually weakening it in order to restrain the inflow of imports. It is true that such policies would be contrary to the aim of inflation targeting, and so would once again prove that the issues of domestic production remain more important for the Central Bank than those of the achievement of price and currency stability.

The prospects for the balance of payments also depend on the character of Russia's budgetary policy. Unrestrained budgetary expansion (especially in the part of social allocations) can become a factor of steady demand for imports, and so lead to the emergence of a double deficit (of both the budget and the current account balance).

Fourth. By the end of 2010, the situation on the labor market had become considerably better than what was expected at the beginning of the year. By December 2010, the total number of unemployed persons (calculated under the ILO methodology) had dropped by 0.7 million to 5.7 million, while the number of officially registered unemployed persons had dropped by 183.1 thousand to 1.9 million. It can be said that the jobless recovery phenomenon (which means that the growth in employment was abnormally weak during the recovery given the growth in output) has failed to materialize in Russia. From the point of view of social and political stability, such a situation can only be greeted warmly. However, it has two possible explanations which actually prevent us from assessing the recovery of the labor market with unreserved enthusiasm.

Firstly, the phenomenon of jobless recovery is the reverse side and indicator of a structural transformation of the economy. It means growth in structural unemployment, i.e., the emergence of new jobs and a lack of persons qualified to fill these jobs. In other words, jobless recovery is a mandatory factor of a comprehensive modernization of the economy which determines its exit from a crisis. The absence of this phenomenon requires a specific discussion of the issue of whether or not modernization is present at the exit phase of the crisis. A similar effect on the economy can be produced by political pressure exerted on businesses and the regions urging them to maximize employment.

Secondly, given the specific demographic situation in contemporary Russia, the fact that the growth in employment is not lagging behind the recovery of the economy may be sugges-

be almost impossible to control through monitoring the ruble's exchange rate. (See *Gaidarovskie Chteniia* [The Gaidar Readings]. 13 October 2010. <http://www.iet.ru/images/READINGS/ulukaev.pdf>)

tive of a higher rate of retirement, which would mean that unemployment in Russia drops not only due to a rise in employment but also due to a reduction in the size of the potential workforce (able-bodied persons of working age).

These two explanations do not contradict each other, and, most likely, both of them had some practical influence on the course of events in 2010. Certainly, from the point of view of social stability, such a course of events was useful. However, from the point of view of the need to achieve the goals of modernization, the situation on the labor market has so far been impervious to unambiguous interpretations.

Fifth. Russia has made several important steps towards international integration – both along the lines of the Customs Union and the Common Economic Space initiatives, and also with regard to the issues of Russia's accession to the WTO. Considerable progress has been achieved in both directions. And in both cases the top issues are not economic or technical, but purely political ones. Will Russia become a member of the WTO, and will the institutes of integration work in the post-Soviet space? The answers to these questions depend on the decisions that are being made by the political leaders of the countries involved in the aforesaid processes. For Russia, both processes are important instruments for the stimulation of competition between commodity producers and jurisdictions¹.

In an attempt to combine anti-crisis measures with modernization, the Russian government, in the past two years, began to introduce some new elements in its economic policy that were considerably different from those typical of 2000-08.

First of all, it was *a new macroeconomic reality* – a stubborn budget deficit and persistent growth in government borrowing. The rise of these phenomena was facilitated by the existence of huge reserves and a low level of state debt on the eve of the crisis.

Another political novelty (stemming from the previous one) was the government's *U-turn towards heavier taxation*. Throughout almost all of its post-communist history, since the imposition of a fundamentally new tax system in 1992, Russia was only cutting taxes (unlike the excises on carbohydrates, tobacco and alcoholic beverages). A number of decisive measures designed to reduce taxes were implemented in 2000 – 2001. It should be taken into account that one of the important – although not declared – reasons for reducing taxes was the government's desire to set them at a level and under a model that could be truly administered by the state – that is, to set the tax rates as close as possible to the effective level.

Now the trend has changed. Recently, there occurred a significant rise in social allocations (first of all, those to the Pension Fund) and in taxes on carbohydrates. The fiscal logic of these moves is sufficiently clear – with budget expenditure being increased it is practically inevitable that taxes will go up as well. According to Russia's minister of finance, tax increases should be continued for the time being. However, it is also apparent that the imposition of heavier taxes on labor de-stimulates structural modernization, because tax hikes are most painful for labor-intensive industries, while raw-materials industries are less responsive to them.

In a bid to mitigate the negative impact of the rise in taxes, the authorities have begun to more actively resort to *discrete (pinpointed) measures of economic policy*. The most vivid example of this trend is the establishment of the *Skolkovo* innovation zone, whose residents are granted an unprecedented range of tax and administrative benefits – from a very low rate of

¹ For the competition of jurisdictions, see Shuvalov I., *Rossia na puti modernizatsii* (Russia on the Way to Modernization) // *Ekonomicheskaja Politika*. 2010. No 1.

social contributions to the introduction of their own (detached from the general system) law-enforcement, tax and customs bodies. In effect, the Skolkovo initiative is an effort to create a center for innovation and growth administered in a manner befitting a contemporary post-industrial society. This experiment is very important, because its outcome will have some far-reaching consequences for the economic and social life of Russia.

In fact, the government has embarked on a course of singling out and selectively assisting ‘national champions’ – individual industries and sectors that, for one or other reason, are considered to be promising. Actually, this trend had begun well before the crisis, with the establishment of the State Nanotechnologies Corporation *Rosnanotech*, when the government came to believe that nanotechnologies were the crucial determinant of scientific and technological progress ‘that should be bolstered at all costs’¹. Those initial steps were followed, already under crisis conditions, by the creation of the Commission for Modernization and Technological Development of Russia’s Economy headed by Dmitry Medvedev. At its very first meeting in the autumn of 2009, the Commission singled out five priority areas for science and technology development (energy effectiveness and energy saving, including development of new types of fuel; space technologies, first of all in the field of telecommunications; medical technologies; strategic information technologies, including supercomputer and software development). In March 2010, the Government Commission on High Technology and Innovation was established under the chairmanship of Vladimir Putin. These two commissions were designed to address general issues of innovative development and modernization, and to supervise the implementation of pinpointed projects – ‘national champions’.

The same logic can be applied to the recently initiated transformation of the model of special economic zones (SEZ). Initially, SEZs were interpreted as the growth points established by way of a competitive tendering process designed to define an optimum region for business and innovation activities. On the contrary, the present trend is to establish special economic zones ‘by decree’ – that is, to create them at a place considered to be feasible from the point of view of forming one or other technological cluster. One of the examples of this approach is the proposed *Titanium Valley* special economic zone in Sverdlovsk Oblast.

In late 2010, in order to compensate small businesses for the rise in social taxes, the government, being well aware of the fact that some businesses would go into the shadow, took the decision that for the next two years insurance contributions to the Pension Fund should be reduced from 26 % to 18 % for small enterprises and individual entrepreneurs engaged in production and rendering of social service to the population.

Finally, in 2010, the issue of privatization was again put on the front burner. The government adopted a large-scale program of privatization that envisaged the sale of stakes in enterprises with minority shareholding by the State, as well as minority stakes in some of the biggest state-owned companies decisively controlled by the State, such as *Rosneft*, *RZhd*, *Rusgidro*, *Sberbank*, *VTB*, and a number of other giants. Apparently, the objectives of this privatization initiative are to attract strategic investors (and so to obtain investment resources and improve corporate governance), and also to increase budget revenues. In the present cir-

¹ There were apparent similarities between that course and *The Plan for the Electrification of Russia* (GOERLO). Decades ago, Lenin said that ‘Communism is Soviet power plus the electrification of the whole country’. In other words, electrification, coupled with political stability, was perceived as a key factor of the political and economic breakthrough that was being attempted by a country recovering from a revolution.

cumstances, the former objective should be regarded as a crucial one, although only time will show whether or not it can actually be achieved in practice¹.

1.1.3. A quest for a new growth model

One of the illusions usually cherished at the beginning of a structural crisis is the expectation that the good old days will return – that the turmoil will be overcome and the old growth model will be restored. Such a strategy is erroneous, though. A crisis like the present one necessitates the formation of a new model of economic development. Only after this requirement has been met, a recovery from crisis can begin. At the stage of exiting the crisis, the advantage will be on the side of the countries capable of building that model and then most consistently and resolutely implementing it in practice. So, the specific role of a structural crisis is to stimulate the building of a new growth model and to provide individual countries with the chance to achieve a breakthrough in their development.

At present, Russia has to make a choice between two alternative strategies of socio-economic development. This choice must be made by the country's political elite in the nearest future.

The first strategy envisages the development of the existing growth model and its adaptation to challenges as they come. Under this arrangement, the State represents the main source of growth – in the triple role of the provider of key financial resources, the neutralizer of market anarchy, and the holder of the key institutions that are necessary for economic growth. The State designates priorities and concentrates the political and economic resources that are necessary for achieving them, builds the financial system on the basis of state-owned banks and exchanges, and directly manages key production companies (controls the 'commanding heights'). Under this system, state demand not only for goods and services but also for institutions turns out to be system-forming. Household demand for goods and services also depends to a great extent on the State.

The second strategy envisages a rise in the importance of private sources of growth (private firms and households). They should gradually squeeze the State out of the business sphere. The State should create maximally favorable conditions for the functioning of private economic agents, and stimulate their interest in development, i.e., stimulate the supply of goods and services.

This dichotomy is well known, for it is frequently encountered in economic history and economic history. It had emerged long before the current global crisis. The choice between demand-side economics and supply-side economics forms the basis of the century-long discursive contest between the Keynesian and neoclassical models of economic growth.

This issue is even more pressing in developing countries (or in the countries pursuing catch-up modernization). In his analysis of the developmental experiences of Germany and Russia in the late 19th and early 20th centuries, Alexander Gerschenkron has shown that, in

¹ In principle, privatization can pursue three goals: political, economic and fiscal. The first goal consists in strengthening the existing political regime through widening its social base. The second consists in attracting efficient owners and in improving the quality of economic growth. The third consists in increasing state budget revenues. In the situation of the 1990s, just as it happened in every major revolution of the past, the first goal was absolutely predominant. In conditions of political stability, the economic goal comes to the fore, although the other two goals also play their part, being quite congruent with each other. (For more details, see Mau V. *Ekonomika i revoliutsiia: uroki istorii* [Economics and Revolution: Lessons from History] // *Voprosy Ekonomiki*. 2001. No 1.

conditions of catching-up development, the State should take upon itself the responsibility to compensate for market uncertainty, and especially for the weakness of the nascent market institutions¹. However, the subsequent course of events has indicated that such an excessive state interference in economic matters can cost society dearly – both in economic and political terms. The Big State ossifies and, at some point, becomes an obstacle to modern economic growth. The overcoming of this obstacle always requires a large expenditure of resources and, sometimes, a heavy loss of life.

The existing growth model – demand-side economics

The major elements of this model are as follows: the high levels of social and political stability as the key aim of the government; the continually growing prices for hydrocarbons; budget expenditure growth as the principal source of demand; a gradual increase in taxation; the continuing existence of a potential for inflation; the increasing role of narrowly targeted decisions, and the reluctance to set up the ‘rules of the game’.

The existing growth model which emerged in the 2000s is based on the presence of significant, cheap and untapped financial resources that owe their existence not to labor productivity growth but to a favorable external market situation. In fact, Russia has had a version of this model since the 1970s, and its popularity is almost as high as it was in the first decade of its existence. The rapidly rising expenditures of the state budget make it necessary for Russia to further accelerate the climb in prices for energy resources in order not to end up with a massive budget deficit.

Under the existing model, the State is the most important source of demand. The major part of demand is coming from the medium and low-income strata of the population (pensioners, unemployed persons, civil servants, military personnel, and workers of state corporations). An important role is played by the funding of the power structures in the part of arms purchases and the upkeep of military personnel. (However, in this regard, 2010 was a watershed year for Russia, given the Russian military’s announcement of big military purchases from NATO countries.)

Another important sphere of state-generated demand is investments in infrastructure. However, being well aware of the high levels of corruption in this sector, the government has become much more circumspect about investing in infrastructure than in the social sphere.

It is not easy for a government to decide whether the priority for investment should be infrastructure or the social sphere. Social expenditures are oriented to a more competitive market, and they are really capable of generating a rise in consumption. The infrastructure sectors are more heavily monopolized, and investments therein result in a rise in prices (or tariffs) rather than in a rise in demand for the relevant goods and services.

At the same time, social expenditures considerably boost inflation and increase demand for cheap imports. The experiences of the past few years indicate that a rise in demand for cheap commodities and services is satisfied not by the domestic producer but through imports from cheap labor countries (first of all, from Asia)². This circumstance considerably reduces the potential impetus of budget expenditures.

¹ Gerschenkron A. *Economic Backwardness in Historical Perspective: A Book of Essays*. Cambridge, Mass.: The Belknap Press of Harvard University Press, 1962.

² According to Aleksey Vedevev’s estimates, 75 % of growth in domestic demand resulted in inflation and a rise in imports, and only 25 % stimulated domestic output. (A. Vedevev et al., *Na puti k deshevym den’gam* [On the Way

To a certain extent, this demand could be compensated for by means of exchange-rate policy, that is, by restraining the process of the ruble's strengthening. However, the monetary authorities have a very narrow scope for action in this direction, especially given the current high level of prices for hydrocarbons.

Yet another problem associated with social expenditures is their irreversibility. Once social obligations have been assumed, they can be safely repudiated only in conditions of a severe political and economic crisis. The insufficiency of budget revenues will not be accepted as an excuse by the population. From this point of view, expenditures on infrastructure are much more politicized, and therefore are easier to give up.

Under this model, the priority of social stability will prompt the government to pursue conservative policies in the labor market – the policies aimed at preventing the release of excess workers, and therefore obstructing structural innovation. To be condoned by the authorities, the release of excessive labor should be done very cautiously and under the control of the State. This approach can be very fruitful, as is exemplified by the 2010 experience of *AvtoVAZ*. However, this example cannot be replicated on a massive scale.

If structural reforms are abandoned, the maintenance of macroeconomic and social stability will require a steady rise in taxation – that is, a revision of the policies pursued in the past 15 years.

Finally, an economy based on state-generated demand is, in principle, more prone to the preservation and protection of monopolies. In response, the monopolies will indeed ensure economic and political stability, but at a price. The price will be a lower quality of goods and services, and a higher rate of inflation.

The predominance of state-generated demand will lower the need of economic agents in bringing down the inflation rate, because state investments will then become more important than private investments – but it is the private investor who is more interested in the inflation rate being lower as a stimulus for bringing down interest rates.

Apparently, the State will increase the pinpointedness of its decisions by creating incentives for some categories of investors and producers that will compensate them for tax hikes, high interest rates and high administrative barriers.

Growth for the sake of structural modernization – supply-side economics

Modernization should put the main emphasis on the quality of growth rather than on its rate. This approach necessitates the creation of a new growth model based on stimulation of the supply of goods and services, i.e., on ensuring adequate conditions for successful functioning and development of economic agents.

This model has the following three major elements.

Firstly, a steady decrease (instead of an increase) in the budget burden as a percentage of GDP, i.e., a decrease in both budget expenditure and taxes. Practically all successful examples of catch-up development in the post-industrial world took place in countries with budget loads that were smaller than those in the most advanced countries. (This is the principal difference between contemporary catch-up development and catch-up development in the industrial epoch of the 19th and 20th centuries. It is especially important to prevent a rise in taxes on labor: instead, such taxes should be gradually reduced;

to Cheap Money]. *Tsentr strategicheskikh issledovaniy Banka Moskvyy* [The Center for Strategic Research of the Bank of Moscow]. 2010. June.).

secondly, the restoration of the macroeconomic balance, i.e., the budget deficit decreases, while budget expenditures become more rational and efficient;

thirdly, currency policy should be investment friendly. This means that the ruble should be transformed, step by step, into a regional reserve currency. As the efficiency of domestic output stimulation by means of restraining the strengthening of the national currency considerably decreases, it is necessary to start inflation targeting, which will make it possible to keep interest rates at a level acceptable to investors;

fourthly, maintenance of economic openness as the most important condition for stimulating domestic competition, development of the Customs Union and the common economic space, accession to the WTO and the OECD, and, later on, movement toward the creation of a common economic space with the EU that can be considered to be a strategic goal of the country's external economic policy. All this does not exclude the implementation of measures designed to boost non-primary exports on a day-to-day basis;

fifthly, neutralization of opportunistic incomes, which means a return to the initial ideological and practical design of the Stabilization Fund which was formed in order to accumulate revenues from the sale of hydrocarbons at a time when their price exceeded the cut-off price set for a number of years;

sixthly, a profound reformation of every branch of the social sector, first of all the pension and medical care systems, which should be brought into line with the demographic and financial realities of the post-industrial time; strengthening of the private and individual principles of the functioning of these branches, and bringing their development to conformity with the formation of sources of long-term investments;

seventhly, a consistent implementation of privatization with the emphasis being put not on fiscal tasks but on social and political objectives, such as the formation of a broad stratum of non-oligarchic owners of means of production (medium-sized and big businesses), the formation of a middle stratum, and the attraction of strategic investors. This type of privatization would generate demand for modernization, macro-economic resurgence and the above-mentioned structural reforms. (This is exactly what happened in the 1990s, when the beginning of privatization opened the way for macroeconomic and political stabilization.)

Of course, the above conclusions are not meant to minimize the importance of reforms in the political and law-enforcement spheres, which are designed to protect property rights, develop competition, and overcome corruption, i.e., to provide solutions to the acute problems that have been so widely discussed in recent years.

1.1.4. The key challenge: structural modernization in conditions of a rent-based economy

Figures for 2010 indicate that the resurgence of economic growth has failed to become synonymous with an exit from the economic crisis. The economic situation remains unstable and highly dependent on state-generated demand. The necessity to maintain a high level of expenditure despite the impossibility of a significant increase in taxes suggests a rise in borrowing as the only possible solution. In its turn, borrowing creates a number of immediate and long-term problems for the governments of all countries, because all those debts will have to be repaid. Moreover, their repayment will become a major drain on the state budget for years to come.

The governments of the leading countries of the world are faced with a hard choice, which is of a fundamental importance for the prospects of global economic development. They are

to choose between the tightening of budgetary policy and the continuation of budget incentives. The first approach will conduce to macroeconomic resurgence in the future, but can cause recession in the immediate term. That will be very unpleasant, both in economic and political terms, and can threaten the ruling parties with the loss of their mandate. The second approach will maintain the current level of economic growth. However, it is fraught with the danger of the emergence of some serious problems that will take at least a decade to overcome.

Both approaches are based on the experiences of the previous two great crises. An attempt to tighten budgetary policy in the mid-1930s resulted in the resurgence of a recession, which was brought to an end only by the Second World War. On the other hand, an attempt at growth stimulation in the 1970s caused a fall into the trap of stagflation, which the economy was able to disentangle itself from no sooner than the early 1980s – after passing once again through a deep recession.

The austerity vs stimulus discussion among economists and politicians is gaining momentum. Not surprisingly, both parties are actively appealing to the memory of John Maynard Keynes who, indeed, put forth the idea of economic stimulus but never recommended that it be used on a scale as massive as that in the 1970s, when Richard Nixon declared himself a ‘Keynesian’ and pursued state intervention policies under the guise of Keynesianism.

Given all the importance of this discussion, it fails to precisely reflect the essence of the current problem. Its main shortcoming is the discussants’ attempt to find a solution in the old logic of business as usual, i.e., an attempt to revive the pre-crisis rules of the game and to blissfully continue pre-crisis economic policies. For them, the only question is in finding the best way to weather the current storm by sacrificing either growth or financial stability.

In essence, this polemic replicates on a national level the logic of the behavior of large enterprises – you should bide time, receive and restructure credits, and then it will be business as usual.

The key problem of such an approach is the actual abandonment of the modernization component of anti-crisis policy. Waiting for growth to recover on the micro or macro level makes governments prone to maximally safeguard stability and to condone nothing that could undermine their electoral prospects.

However, the problem is much deeper than that. A systemic crisis always has a strong modernization component. The crisis – or, better to say, the process of its overcoming – implies the potential achievement of new levels of competitiveness and promises some new economic and technological solutions.

The overcoming of a crisis does not reflect on growth figures, like its beginning did not coincide with the beginning of recession. The case in point is the emergence of a new quality of growth, a new growth model, and a new model of socio-economic regulation, this time apparently on a global scale. To achieve these ends, governments should pursue a conservative budgetary policy that would stimulate innovation instead of helping traditional enterprises to preserve their market share and profits.

In other words, the choice between austerity and stimulus is not reduced to the question of whether preference should be given to an expansionist or conservative budgetary policy. The case in point is what signal should be sent to economic agents – to remain as they are, or to modernize. However socially and politically problematic they might be, tough budget constraints create conditions for innovation, while soft budget constraints that can mitigate many

current problems will lead to a severe structural crisis in the future. In the mid-1980s, the Soviet Union gave preference to stimuli, and the consequences of that choice are well known.

In contemporary Russia, the situation is aggravated by the country's half-century-long dependence on the inflow of cheap money. Resource dependence is extremely dangerous, because it leads to a gradual degradation of social (political and economic) institutions and the education system, thus creating barriers to modernization. This resource dependence is quantitatively different from the raw-material character of the Russian economy of bygone days, when agricultural products accounted for the lion's share of Russia's exports. The core issue of how this dependence can be neutralized – thus stimulating demand for modernization – must clearly become the focal point of the ongoing political and economic discourse.

Section 2. Monetary-Credit and Budgetary Spheres

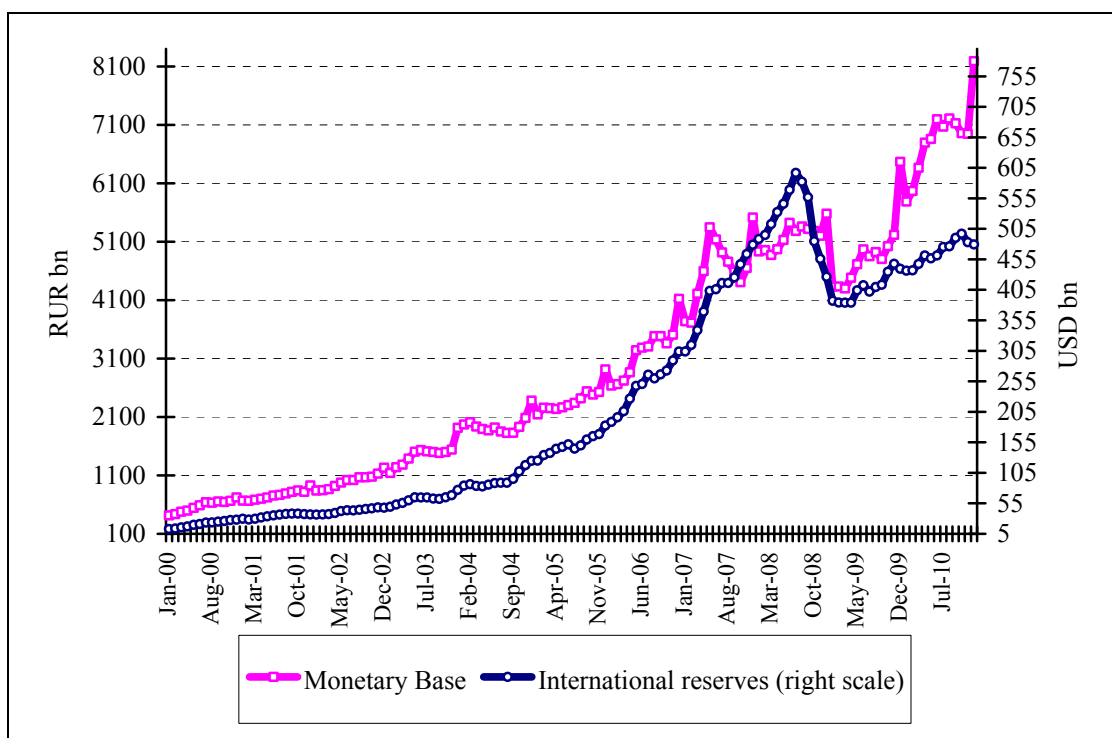
2.1. The Monetary and Credit Policy

A major trend in the monetary and credit sphere of the Russian Federation in 2010 was the cutting-down of support to anti-crisis Russian financial system by the Bank of Russia in the course of the gradual recovery of the Russian economy. Herewith, the resumption of monetary supply growth by monetizing the total balance of payments, as well as a significant negative shock of aggregate supply in summer (as a result of the drought) again caused an acceleration of inflation in autumn. Reduced dependence of the banks of the RF Central Bank and the sustained net flow of currency to the country once again bring the Bank of Russia at a choice between reducing inflation and managing the exchange rate. At the same time, representatives of the Central Bank of Russia declare the inflation reduction as their priority goal.

2.1.1. The Monetary Market

During 2010, there was again observed a substantial increase in the RF international reserves (*Fig. 1*). The main factor of growth were relatively high prices for Russia main exports, primarily oil, gas and metals. Furthermore, the reduction for the year Euro against the USD in the global currency markets brought about a decline in the dollar value of the reserves denominated in Euro. As a result, there was a trade surplus of the Russian Federation, and the national international reserves were growing, as the Bank of Russia bought foreign currency to slow down the growth of the nominal exchange rate.

By the end of the volume of international reserves amounted to 479.4 billion dollars, while at the beginning of the year they accounted for 439.5 billion dollars, i.e., during the year reserves grew by 9.1%. The volume of the RF international reserves remains sufficiently large by international standards: they are in the third place in the world in absolute value after the reserves of China and Japan. However, the experience of winter 2008/2009 showed that the sharp deterioration in external economic conditions and massive capital outflows, even such large reserves can be quickly spent in case of maintenance of the RF Central Bank rate. In addition, the rapid growth of imports, while maintaining net capital outflows from Russia caused by the persistence of high economic and political risks of investments in Russia, as well as the need to service a large external debt, reducing the supply of currency in Russia. Therefore, with the stable energy prices in 2011, international reserves will probably grow more slowly than in 2010.



Source: RF Central Bank.

Fig. 1. The Dynamics of the Monetary Base and Foreign Reserves in 2000-2010

As one can see from *Fig. 1*, after the crisis, the monetary base was growing at progressive rate as compared to international reserves. An important source of monetary supply growth in 2010, in addition to the operations of the Central Bank of Russia in the foreign exchange market was the use of the Reserve Fund to finance the budget deficit. During 2010, the accounts of the Ministry of Finance of Russia declined by 1.7 trillion rubles. In fact, the monetization of fiscal deficits causes expansion of monetary supply to Russia

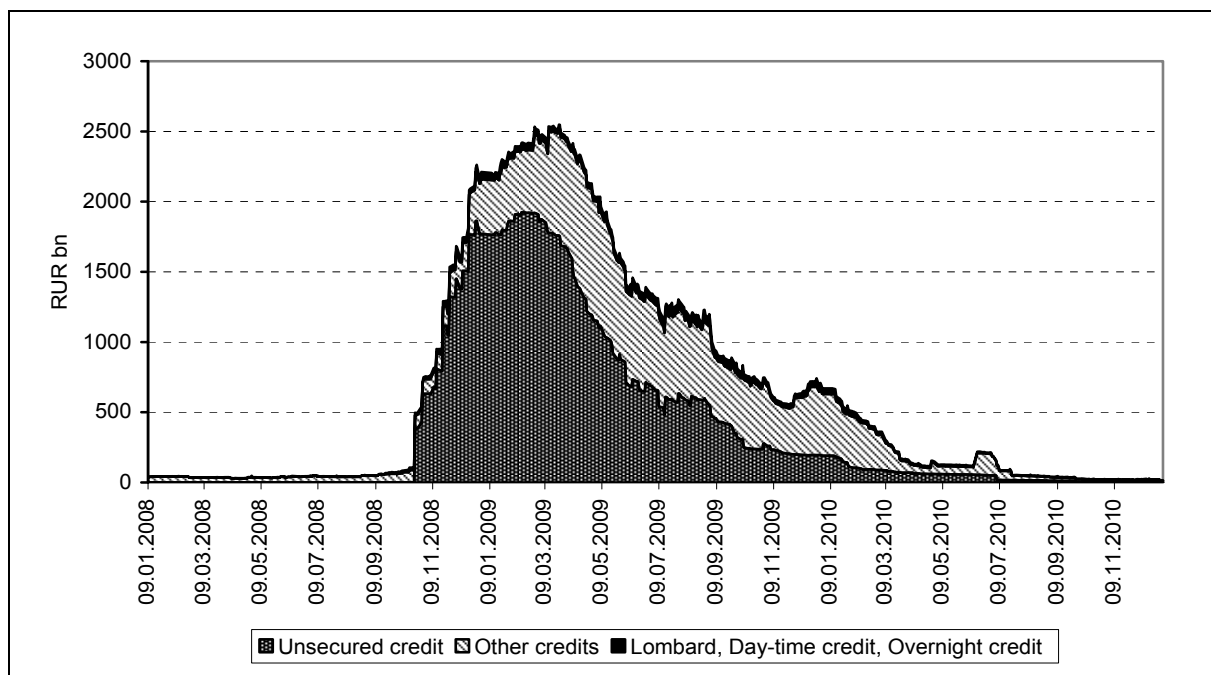
Herewith, the constraint of the growth of the monetary base at the beginning of the year was the reduction of the net debt of credit institutions to the RF Central Bank (see *Table. 1* and *Fig. 2*). However, already in summer of 2010 credit to the banks on the part of the RF Central Bank has been reduced to the pre-crisis level and further had no significant effect on the balance sheet of monetary regulation. Therefore, in case of continued balance of payments and budget deficit of 2011, one can expect a significantly higher rate of growth of money supply, which increases the risk of inflation.

Table 1

Bank of Russia Balance, 2009–2010

	01.01.2009		01.01.2010		01.12.2010	
	RUR. bn.	% assets/ liabilities	RUR. bn.	% assets/ liabilities	RUR. bn.	% assets/ liabilities
Funds placed with non-residents and foreign issuers' securities	12091.1	71.3	12383.3	80.3	13752.2	85.8
Credits and deposits	3871.3	22.8	1705.8	11.1	551.4	3.4
Precious metals	450.3	2.7	764.6	5.0	1172.0	7.3
Securities	441	2.6	465.9	3.0	446.6	2.8
Other assets	110	0.6	100.3	0.7	105.1	0.7
Assets, total	16963.7	100	15420	100	16027	100
Cash in circulation	4378.2	25.8	4629.9	30	5153.0	32.2
Cash on accounts with the Bank of Russia	10237.6	60.4	7979.7	51.7	6978.7	43.5
<i>Including the government of Russia</i>	7093.9	41.8	4980.2	32.3	4434.2	27.7
<i>Those of resident-credit institutions</i>	2010.1	11.8	1731.3	11.2	934.2	5.8
Cash in settlements	16.1	0.1	8.4	0.1	44.8	0.3
Securities issued	12.5	0.1	283.1	1.8	870.8	5.4
Other liabilities	319.2	1.9	168.3	1.1	818.8	5.1
Capita	1902.4	11.2	2099.1	13.6	2161.1	13.5
Profit by the reported year	97.8	0.6	251.4	1.6	0	0.0
Profit by the reported year	16963.7	100	15420	100	16027.3	100

Source: the Bank of Russia.



Source: the Bank of Russia.

Fig. 2. Debts of credit institutions under the loans of the Bank of Russia in 2009-2010.¹

¹ "Other" credits include loans secured by the Bank of Russia under promissory notes, rights of claim under loan agreements with organizations or guarantees of credit institutions.

Dynamics of the assets of the Central Bank of Russia has led to the expansion of the monetary base during 2010 the monetary base (in wide terms¹) increased by 1.7 trillion rubles - up to 8.2 trillion rubles (26.6%) (*Table 2*). Recall that in 2009, this figure rose by 15.9%. Cash in circulation, with the account of credit institutions' cash balances accounted on January 1, 2011 amounted to 5.8 trillion rubles (25.1% as compared with January 1, 2010), the correspondent accounts of credit institutions with the Bank of Russia - 1 trillion rubles (10.5%), compulsory reserves - 188 billion rubles (+24.4%), deposits of credit institutions with the Bank of Russia - 633.2 billion rubles (+24.4%), the value of Bank of Russia bonds with credit institutions - 588.9 billion rubles (grown in 2010 by 2.1 times).

Table 2

The Dynamic of the Monetary Base in Broad Terms in 2010 (RUR. Bn.)

	01.01.2010	01.04.2010	01.07.2010	01.10.2010	01.01.2011
<i>Monetary base (in broad terms)</i>	6467.3	6 363.90	7 195.00	7 126.00	8190.3
Including:					
Cash in circulation, with account of credit organizations' cash balances	4622.9	4 411.20	4 828.10	5 024.50	5785.2
Credit organizations' corresponding accounts with the Bank of Russia	900.3	579.5	603.6	590	994.7
Compulsory reserves	151.4	167.7	175.5	182.2	188.4
Credit organizations' deposits with the Bank of Russia	509	469.6	637	519.4	633.2
The bonds of the Bank of Russia held by credit organizations	283.7	735.9	950.8	810	588.9

Source: the Bank of Russia

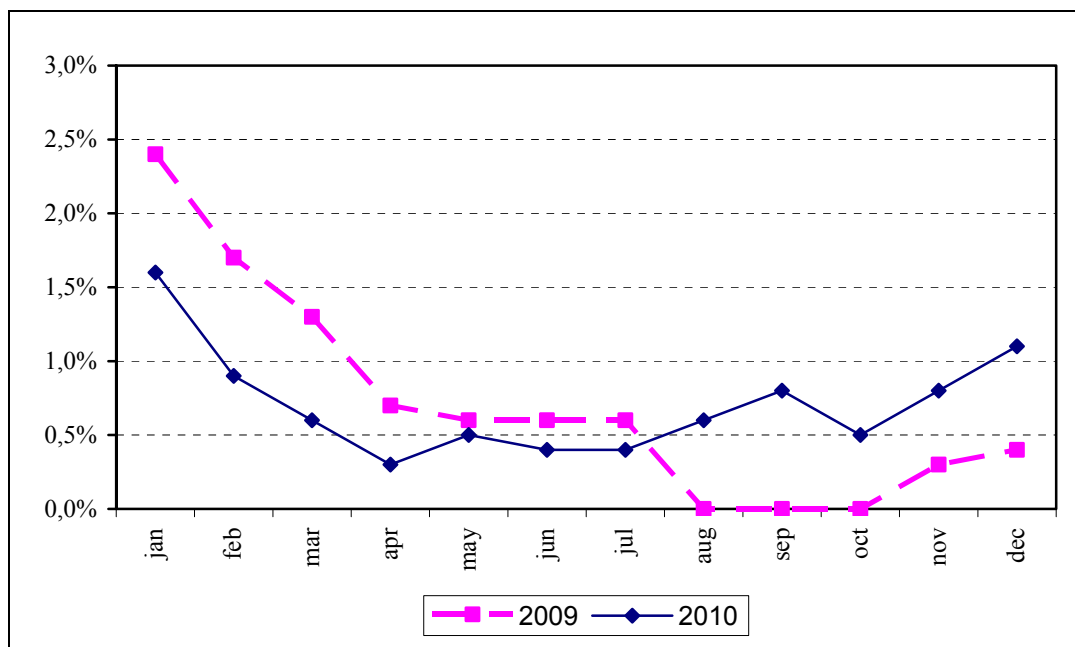
Monetary supply M2 in national terms has increased over the 2010 by 28.5% and amounted on January 1, 2011 to RUR 20173.5 bn or 45.3% of GDP (on January 1, 2010 monetary aggregate M₂ amounted to RUR15,697.7 billion (40.5% of GDP). Consequently, in 2010, the monetization of the Russian GDP was growing due to a rapid increase in the monetary base and expanded lending to the economy from commercial banks. In the conditions of high uncertainty about the RF future prospects of economic development, the monetary growth in the medium term will be largely determined by foreign economic situation, as well as the volume of the budget deficit, on the one hand, and speed economic recovery and credit activity of the banking sector on the other hand.

2.1.2. Inflationary Processes

One of the important consequences of the 2008-2009 economic crisis for the Russian economy as a significant slowdown of inflation due to the decline in aggregate demand and due to the reduced monetary supply (within September 2008 - February 2009 M₂ monetary supply decreased by 17.3%). In the first half of 2010 inflation continued to reduce, but in the

¹ According to the RF Central Bank methodology, the monetary base in wide terms characterizes the Bank of Russia's monetary and credit liabilities denominated in the national currency, which determine growth in money supply. The monetary base in wide terms comprises cash the RF Central Bank issued in circulation (with account of credit institutions' cash balances), balances of the compulsory reserves accounts which credit organizations deposit with the Bank of Russia, monies on correspondent accounts (including averaged balances of compulsory reserves) and deposit accounts the credit organizations have with the Bank of Russia, their investments in the Bank of Russia's bonds, backup funds by forex transactions deposited with the RF Central Bank, as well as the Bank of Russia's other liabilities bywith respect to operations with credit organizations in the currency of the Russian Federation.

beginning of the year conditions were created for the acceleration of inflation in the form of rapid monetary supply growth (see previous section) (*Fig. 3*). A drought, which hit Russia in summer of 2010, has made practically inevitable the acceleration of inflation in autumn. Let us consider inflation in 2010 in more detail.



Source: Russian State Statistical Service.

Fig. 3. The Dynamics of CPI of the RF in 2009–2010

In January - December 2010 food prices grew on average across the country by 12.9% (versus 6.1% in 2009) (Table 3). The main contribution to the growth of food prices has made a rise in cereals and beans (+58.8%), fruit and vegetables (+45.6%), sunflower oil (+ 27.6%), butter (+23.3%) and sugar (+22.5%). The rapid increase in food prices has made the most significant contribution to the CPI growth in 2010. Prices for commercial services have grown in 2010 by 8.1% (against 11.6% in 2009). During January - December the utmost growth in prices were observed in housing and utilities (+13%) for passenger transport services (+8.7%), services of cultural organizations (+8.6%) for medical services (+8.4%). Non-food products have increased in price in 2010 by 5% on average (against 9.7% in 2009). During the year the utmost growth took place in the price of tobacco products (+19.5%) for knitwear (+7.8%), clothing and underwear (+7.1%) and motor gasoline (+6.5%) . The rate of increase basic consumer price index for 2010 made 6.6% (against 8.3% for the same period of the last year). Therefore, the main factors of inflation dynamics in 2010 were the effect of a low base in 2009, on the one hand¹ and monetary supply growth against the background of a slow recovery of economic activity and aggregate supply shock in the summer - on the other hand.

From the *Table 3* one can see that the major component of inflation in 2007-2010 was the growth in food prices, the expenses for which are the substantial share of household expenditures. At the same time, in 2010 food expenses growth was twice faster than in 2009. The

¹ In early 2009 accelerated inflation was recorded in Russia.

main reason for this was the summer drought. Such a conclusion can be drawn basing on the fact that a significant acceleration of growth in food prices began in the fall, while the growth in price was faster for the products, affected by the drought. At the same time, we would like to note that the rapid rise in food prices in 2010 took place all over in the world, but the CPI in the most developed countries remained at a low level. This may indicate either the great possibilities of Russian companies to raise prices due to low competition, and the effects of faster growth in monetary supply in late 2009 - early 2010, as well as the mature high inflationary expectations.

In the sector of commercial services sector one should note the continued growth in prices for housing services. At the same time, in 2010 housing services rose much less than in 2009, whereas in 2008-2009 accelerated pace of appreciation of service were observed. A further slowdown in price increases for housing and communal services in view of the alignment of their prices for population and industrial enterprises, as well as reducing the level of subsidy rates for utility services from the state will decrease the contribution of higher prices of housing services in inflationary pressures.

Non-food products in 2010 rose in price more slowly. Herewith, a rapid increase in tobacco prices was due to primarily an increase excise taxes on them, and the price for knitwear, clothing and underwear - rise in price for cotton due to low yield.

Table 3

**The Annual Price Rise Rates for Some Kinds of Goods and Services
in 2007–2010 (as% December/ to December of the preceding year)**

	2007	2008	2009	2010	2007–2010
CPI	11.9	13.3	8.8	8.8	50.1
<i>Food stuffs</i>	15.6	16.5	6.1	12.9	61.3
<i>Grits and beans</i>	24.7	25.8	-2.5	58.8	142.9
<i>Butter</i>	40.3	10.5	7.9	23.3	106.3
<i>Sunflower- oil</i>	52.3	22.1	-19.8	27.6	90.3
Pasta	23.6	33.8	1.6	4.7	75.9
Milk and dairy products	30.4	12.2	2.3	16.7	74.7
Bread and bakery	22.4	25.9	2.4	7.6	69.8
Meat and poultry	8.4	22.2	5.0	5.3	46.5
Fish and seafood	9.0	15.1	10.6	4.8	45.4
Non-food goods	6.5	8.0	9.7	5.0	32.5
Construction materials	16.2	11.3	2.1	4.6	38.1
Gasoline	8.5	1.2	8.0	6.5	26.3
Services	13.3	15.9	11.6	8.1	58.4
Housing and utilities	14.0	16.4	19.6	13.0	79.3
Preschool education services	11.8	20.7	16.2	7.7	68.9
Sanatorium and rehabilitation services	15.6	21.2	9.5	5.4	61.7
Passenger transportation services	13.6	22.5	6.5	8.7	61.1
Cultural institutions' services	14.5	15.5	11.3	8.6	59.8

Source: Russian Statistical Service.

In conclusion, let us compare the consumer price rise rates in the RF with those in other CIS Countries (*Table 4*).

Table 4

**Consumer Price Indices in the CIS Countries in 2000–2010, %
versus Relevant Period of Preceding year**

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010*
Azerbaijan	2	2	3	2	7	10	8	17	21	1	5,2
Armenia	-1	3	1	5	7	1	3	4	9	3	7,8
Belarus	169	61	43	28	18	10	7	8	15	13	7
Kazakhstan	13	8	6	6	7	8	9	11	17	7	7
Kyrgyzstan	19	7	2	3	4	4	6	10	25	7	4,9
Moldova	31	10	5	12	12	12	13	12	13	0	7,2
Russia	20	22	16	14	11	13	10	9	14	12	6,4
Tajikistan	24	37	10	17	7	8	12	21	20	6	5,6
Ukraine	28	12	1	5	9	14	9	13	25	16	9,3

*Data for January-September.

Source: The CIS Intergovernmental Statistics Committee (<http://www.cisstat.org/>).

Inflationary processes in the CIS countries in the recovery period after the economic crisis were determined mainly by two groups of factors. On the one hand, in many countries, the crisis led to depreciation of the national currency, which in early 2009 contributed to higher prices by raising import prices and inflationary expectations. In early 2010, there was an effect of a low base, stimulated some moderation in inflation. In addition, economic recovery in the most CIS countries is still rather slow, which imposes constraints on inflation from aggregate demand.

On the other hand, in 2009-2010 the monetary supply was growing. In addition, the resumption of increasing consumer demand also increases the inflationary pressure. As a result, the combination of the above factors determines the rate of price growth in the CIS countries.

In the Russian context recovery in prices for the Russian main export goods (despite the outflow of private capital), a negative supply shock, as well as financing the budget deficit at the expense of the Reserve Fund have caused inflation in the second half of the year. Due to the low inflation in the first half of 2010, in general, CPI remained at the level of 2009. However, in case of continuation of these trends, inflation up to 2011 may not show further decrease and remain at 8-9%.

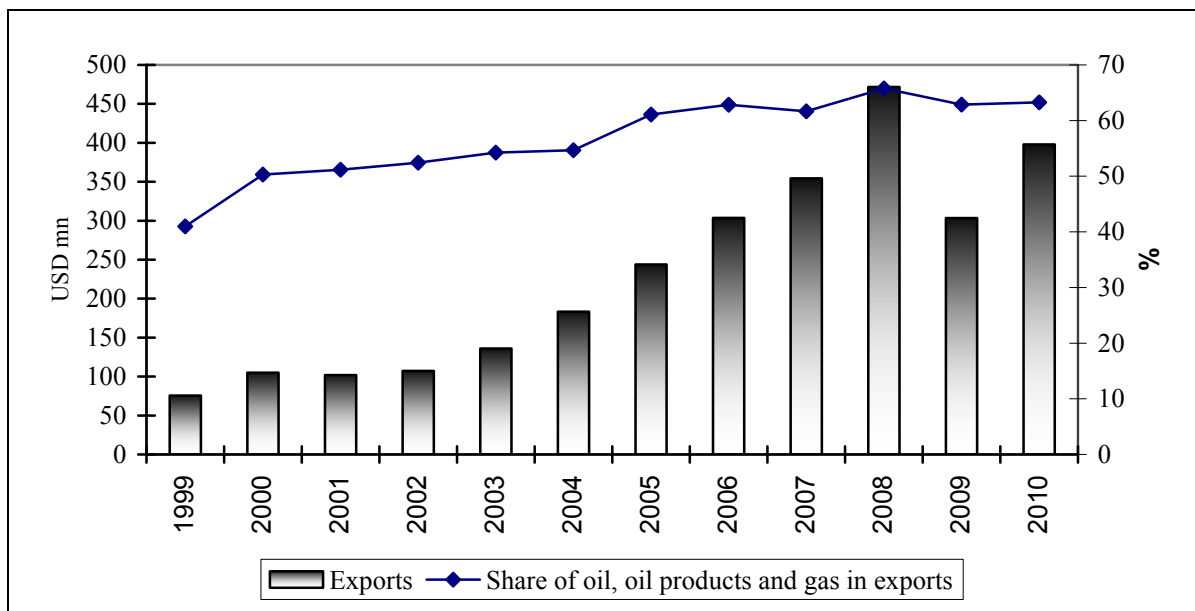
2.1.3. The State of the Balance of Payments¹ and Foreign Currency Market

Balance of payments stability of the Russian Federation in 2010 was ensured at the expense of exports, especially fuel and energy complex products. Global economic recovery after the crisis, as well as the preservation of mitigated monetary and credit policy in the US and the EU have inspired growth in commodity prices, resulting in the growth of fuel and energy exports from Russia by the year-end by 32% as compared with the previous year. At the same time, the outflow of capital from the country within the year was much greater than expected by the Government and the Bank of Russia, which reflects the high risks of investing in the Russian economy. In view of combination of the above factors, the balance of payments appears to be quite stable, but in the medium term such stability of the balance of payments would be in danger as a result of the rapid growth of imports in Russia compared to

¹ The analysis of the balance of payments was conducted on the basis of the RF Central Bank's preliminary data: http://cbr.ru/statistics/credit_statistics/print.asp?file=bal_of_payments_est.htm

exports from the country, and continued growth of the balance of account deficit of operations with capital and financial instruments.

According to the published by the Bank of Russia preliminary assessment of the balance of payments of the Russian Federation in 2010, positive current account balance amounted to 72.6 billion dollars, i.e., increased by 47,1% as compared with 2009 (*Table 5*). Herewith, trade balance surplus grew by 33.7% (from 111.6 billion to 149.2 billion dollars), while exports of goods increased by 31.2% (from 303.4 billion to 398 billion US dollars), and imports of goods increased by 29.7% (from 191.8 billion to 248.8 billion dollars). The share of exports of oil and natural gas amounted to 63.3% in the total value of exports, having increased by 0.4 percentage points as compared with 2009 (*Fig. 4*). Therefore, as in previous years, the main factor determining the scope of the balance of current account, was the balance of trade, which, in turn, largely depends on the changes of energy prices and other major Russian export commodities in the global markets. The data presented in *Fig. 5*, shows that the relationship between oil prices and the trade balance of Russia, observed in 2002-2009, was demonstrated within 2010 as well.



Source: RF Central Bank .

Fig. 4. The Dynamics of Commodities Export and the Share of Fuel and Energy Complex Products in 1999-2010

Deficit in the balance of services reached 27.3 billion dollars and increased (in absolute value) compared with 2009 by 37.3%. Exports of services amounted to 44.1 billion dollars, an increase against the previous year by 2.6 billion dollars (+6.1%). Imports of services for 2010 has increased by 16.2% and reached 71.4 billion dollars. Balance of labor compensations in 2010 has increased in absolute value and amounted to -9.2 billion dollars (in 2009 it made -8.6 billion dollars). Deficit of balance of investment revenue in 2010 as compared with 2009 increased by 6.9% and reached 36 billion dollars. Investment gains due rose from 30.7 billion to 32.8 billion dollars, which is based on a significant decline in non-financial companies revenues (from 15.1 billion to 20 billion dollars). The rise of income receivable was due to

the global economic recovery and growth of investment abroad. Increased revenues receivable by non-financial enterprises from 46.6 billion to 56.4 billion dollars has identified the growth of general income receivable from 61.5 billion to 68.8 billion dollars.

The balance of current transfers¹ in 2010 accounted for -4.1 bn US dollars, having decreased by 8.8% as compared with 2009.

Table 5

**Main Items of the Balance of Payments and the Dynamic of External Debt
in 2008–2010 (USD bn.)**

Balance Item	2008					2009					2010				
	I Q.	II Q.	III Q.	IV Q.	Year	I Q.	II Q.	III Q.	IV Q.	Year	I Q.	II Q.	III Q.	IV Q.*	Year*
Current account	38.7	26.8	29.6	8.5	103.7	9.7	8.2	15.4	16.1	49.4	33.3	19	6	14.3	72.6
Capital and financial instruments account ²	-20.5	35.2	-15.9	-130	-131.3	-32.4	3.1	-27	12.1	-44.3	-11.2	8.1	-6	-21.4	-30.5
Change in forex reserves («+» – “decline of reserves”, «-» – growth in reserves)	-12.1	-64.9	-8.9	124.8	38.9	30.5	-14.2	9.1	-28.8	-3.4	-16.6	-26.1	-2.7	8.6	-36.8
Net mistakes and omissions	-6.1	2.9	-4.7	-3.3	-11.3	-7.8	2.9	2.6	0.6	-1.7	-5.5	-1.1	2.7	-1.5	-5.4
Change in external debt of RF («+» – growth in debt, «-» – decrease of debt)	19.1	51.5	6.3	-60.3	16.6	-34.2	19.6	7.9	-6.7	-13.3	-3.5	-7.3	19.1	7.4	15.7
Change in the external public debt of RF	0.2	-1.5	-2.0	-3.7	-7.1	-2.4	4.1	9.4	2.5	13.7	-2.4	3.8	-0.3	-0.2	0.9
Change in the external debt of the private sector in RF	19.0	53.0	8.4	-56.6	23.7	-31.8	15.5	-1.5	-9.2	-27.0	-1.1	-11.1	19.4	7.6	14.9

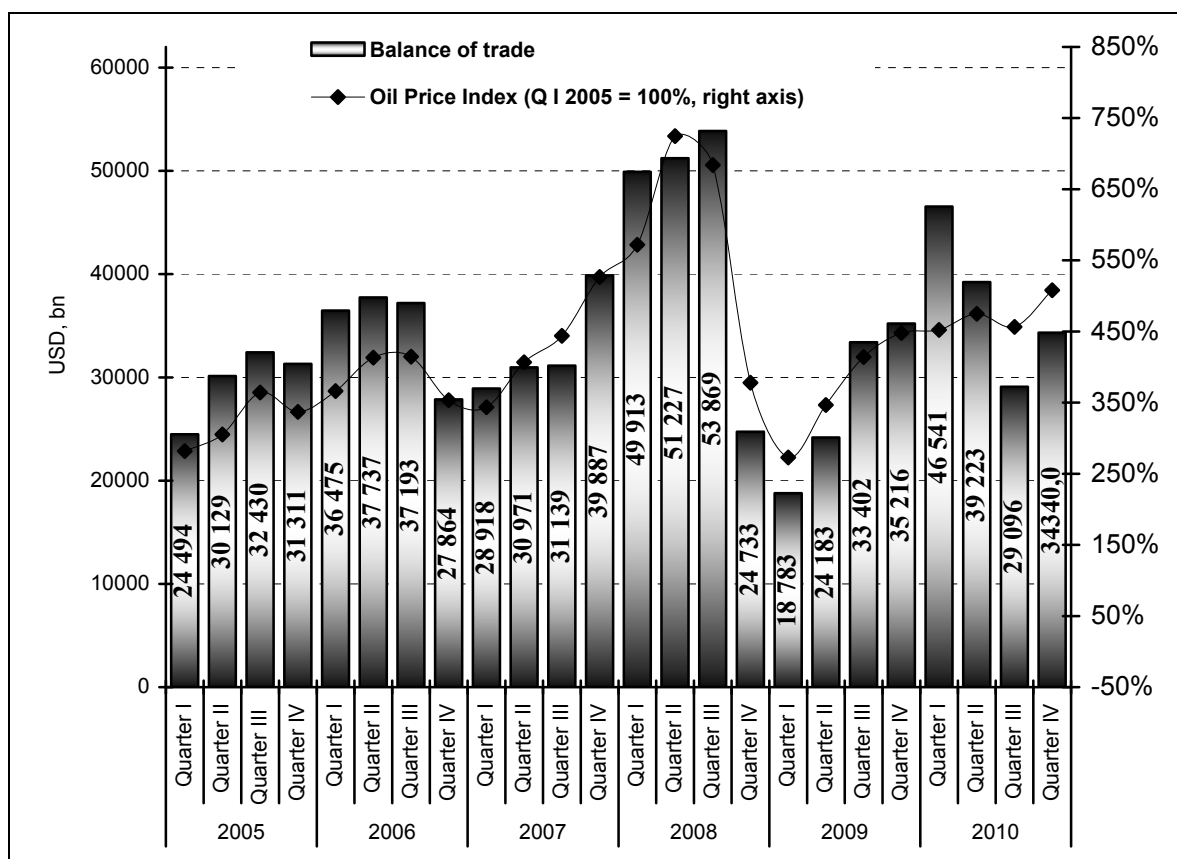
* Preliminary estimates.

Source: The Bank of Russia.

Thus, it was high prices for major Russian exports that were behind a huge positive balance of current accounts of the Russian balance of payments in 2010. Let us note that at the end of the year, the debt of has resumed its growth again (see *Table 5*). As to foreign debt, it has changed slightly for the year, having increased only by 0.9 billion dollars. In the medium term, one can expect recovery rates of external debt growth, both, in private and public sector of economy, due to the lack and high cost of financial resources domestically, as well as the continuing budget deficit.

¹ According to the RF Central bank, the current transfers bolster the level of disposable income and consumption of the recipient’s goods and services and decrease the donor’s disposable income and possibilities for consumption, for instance, humanitarian aid in the form of consumer goods and services. The current transfers are reflected in current accounts. Transfers other than current are conceived of as capital ones. They lead to a change in the volume of the donor or recipient’s assets or liabilities and are reflected in capital accounts. In the event the donor and the recipient are non-residents to each other, the capital transfer engenders changes in the level of national wealth of the economies they represent. Examples of capital transfers are a free-of-cost transfer of property rights for capital assets or debt forgiveness.

² Less foreign currency reserves.



Source: the RF Central Bank, IEP estimates.

Fig. 5. RF Balance of Trade and the World Oil Price Index in 2005-2010

In 2010, the balance of operations with capital account and financial instruments has significantly declined in absolute terms, amounting to USD -30.5 billion. The balance of capital transfers in 2010, amounted to USD 0.2 billion. Therefore, in 2010 the deficit of financial account amounted to USD -30.7 billion.

Increase of liabilities of the Russian economic agents against foreign economic agents as per the year results totaled to 36.6 billion dollars, which is 5.5 times more than in the previous year (6.6 billion dollars).

Like in 2009, the federal administrative bodies likewise became net payers in relation to non-residents. Their external liabilities have grown by USD 3.6 bn, resulting from repayment of Russia's external public debt.

Their external liabilities rose by 3.6 billion dollars, which resulted from sales of the newly issued debt securities of the Government of Russia by non-residents. The balance of external liabilities across the RF Subjects remained unchanged. Reduction of monetary regulation authorities' commitments in 2010 reached 2.1 billion dollars.

The resumption of the global economy growth after the financial crisis, demonstrated, among other things, in gradual recovery of the global capital markets and the growing interest of investors to risk by maintaining low interest rates in developed countries has resulted in the fact that the banking sector of the Russian Federation obligations to non-residents once again began to grow, increasing within the year to 18.1 billion dollars. At the same time, invest-

ments of economic agents of other countries in the non-financial sector of Russia accounted to only 16.4 billion dollars as compared with 34.4 billion dollars in 2009. Therefore, non-resident investments in non-financial sector of 2010 decreased compared to 2009, despite the resumption of economic growth in Russia. Consequently, foreign investors consider investing in Russia quite risky at the current level of profitability. Direct investments in non-financial sector accounted for USD 28.6 billion over 2010, as compared with 30.3 billion dollars in 2009, and the growth of portfolio investments has expressly declined by 1.6 billion dollars, as compared with the growth of 2 billion dollars a year earlier. The volume of non-financial sector under the debt on loans to non-residents declined in 2010 by USD 10 billion as a result of earlier received credits redemption.

Foreign assets of residents (liabilities of foreign economic agents to the Russian ones) increased within 2010 by 67.2 billion dollars (against 39 billion dollars within 2009).

Herewith, foreign assets of the federal government and monetary-credit regulation authorities have practically unchanged, and banks rose by 6.7 billion dollars.

Export of capital from the sector non-financial enterprises and households, as compared with 2009, has decreased by 1.2% and amounted to 60.3 billion dollars. Herewith, it is important to note that significant changes have occurred in the dynamics of the article "cash in foreign currency", which indicates, that in 2010 the export of foreign currency from Russia amounted to 14.4 billion dollars as compared with 4.1 billion dollars in 2009. Therefore, due to the stability of the national currency and foreign currency savings of population, converted into rubles, made during the fall of the ruble in winter of 2008/2009, the public and non-financial sector reduced their investments in foreign currency.

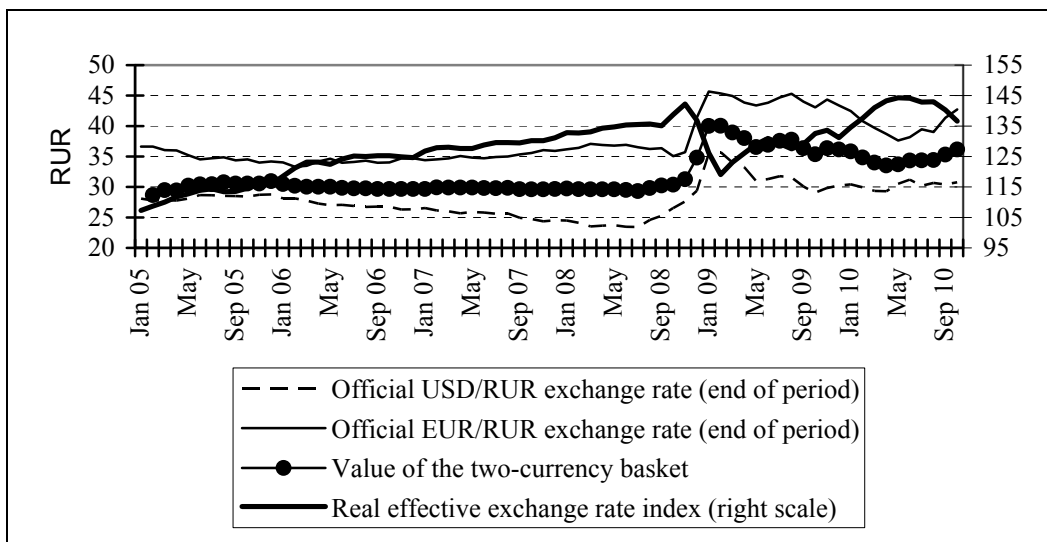
The situation in the foreign exchange market of the Russian Federation in 2010 was determined by the inflow of currency into the country via the current account operations, the outflow of capital account and financial instruments and the actions of the RF Central Bank. Herewith, a key factor in the dynamics of the course was the dynamics in the imports of the Russian Federation. With minor changes in exports, nearly constant increase in imports caused a reduction in current account balance of payments, which, when private capital outflows from the country became the only channel of foreign currency inflow to the Russian Federation. As a result, with a relatively large current account balance (see above), in January - April there was strengthening of the ruble in nominal terms (in real terms the ruble was strengthening in January - May). Then, till the year end, ruble was continuously depreciating, both in nominal and real terms. Only a renewed rise in oil prices late in the year, which came close to the level of USD 100 per barrel, caused the ruble strengthening in nominal and in real terms as of December results.

In general, as a result of January - December, the real effective exchange rate of RUR rose by 9.6% and almost reached pre-crisis level of the mid-2008 (see *Fig. 6*)¹. The official dollar rate against ruble in 2010 increased by 24 kopecks: by the end of December, the dollar made 30.48 rubles as compared with 30.24 rubles on December 31, 2009. Herewith, ruble strengthened against the two-currency basket²: the value of the two-currency basket has declined over the same period by 1 rub. 25 kopecks: from 36.16 rubles. up to 34.91 rubles. Within the year, there was a gradual strengthening of the US dollar to Euro at the background of the situation

¹ The level of January 2002 is accepted as 100 per cent.

² Two-currency basket is the RF Central Bank operational indicator in its foreign currency policy. Currently the share of EURO in the currency basket makes 45 per cent, USD – 55 per cent.

improvement in the US economy and worsening of the debt problems in the EU. As a result, the Euro rate against the ruble at the end of December amounted to 40.33 rubles.



Source: the RF Central Bank, IEP estimates.

Fig. 6 Indicators of RUR Exchange Rate between January 2005 and December 2010

Thus, in 2010 due to favorable foreign economic situation, strengthening of the ruble was continued. We would like to recall that the rise in energy sources prices in the 2000-s before the crisis also led to a rapid increase in the surplus current account balance of payments in Russia and inspired ruble strengthening. To prevent nominal RUR strengthening, the RF Central Bank was buying foreign currency and increased monetary offer. Even the formation of the Stabilization Fund in 2004, which often helped to sterilize intervention of the Central Bank interventions in the foreign exchange market, did not allow to stop the real ruble strengthening, observed up to the crisis in 2008. Herewith, the main reason of ruble strengthening restriction to the Russian authorities was the reluctance to allow the loss of the national companies' competitiveness. However, with the significant monetization of the trade balance and the lack of opportunity for the sterilization, the inflation in Russia still remained high, despite the rising monetary demand. A rise in prices, in turn, resulted in a real strengthening of the ruble (See in the insert the description of a similar situation in the foreign exchange market in China).

The issue of the Bank of Russia interest rate policy efficacy is still open. It is not excluded that in the absence of the Bank of Russia interference in the functioning of the foreign currency market ruble would be much stronger in nominal terms, but due to lower inflation the dynamics of the real exchange rate would be only slightly different from the current one. Restraining of the ruble, even in view of a partial sterilization, has inspired a rapid growth in monetary supply and inflation, still remaining at the high level in terms of the world standards. Herewith, an important role in expanding the monetary supply has played a capital inflow in 2006-2007, which, in contrast to foreign currency exchange inflows from trade operations could not be sterilized in the Stabilization Fund, which was formed through taxes. One should note, that a possibility of further sterilization, including through the emission of the RF Central Bank bonds and the accumulation of even a larger scale of the government accounts

with the RF Central Bank (i.e., in the Reserve Fund), also raises doubts as to the economic and political reasons.

At first sight, the current situation is similar. However, we believe that an important difference lies in the instability of the global economic recovery. In the event of new problems or tightening of monetary and credit policy in the US and the EU (as the economy recovers), energy prices may fall down, which will inevitably result in an outflow of capital from Russia and create conditions for the weakening of the ruble. In our opinion, under conditions of high uncertainty about the future situation in the global and Russian economies, the Bank of Russia, one should not actively intervene in the domestic foreign exchange market and should focus on reducing inflation.

The dynamics of the National Currency of China

We would like to note that the problem of yuan exchange rate, which is recently under discussion, is relevant to our country as well, because Russia, like China, is heavily dependent on commodity exports. Herewith, the sharp devaluation of the ruble after the 1998 crisis along with rising energy prices and a recovery growth has caused the process of import substitution, which was an important factor in rapid economic growth in Russia in the early 2000's. It is considered that China also supports the competitiveness of their exports by an undervalued yuan.

However, as we have seen above, during the 2000-s and until the crisis ruble was strengthening in real terms, whereas it can be seen in Figs. 7 and 8, that the real effective exchange rate of the yuan over the past 10 years has not changed. With control over the nominal exchange rate by the People's Bank of China, a stable real effective exchange rate means similar inflation in the USA (the main trading partner of China) and China.

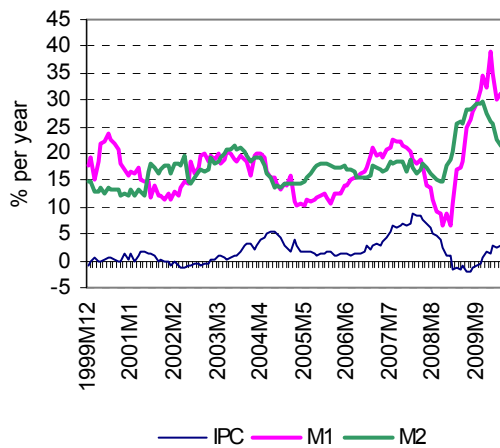


Fig. 7. The monetary instruments growth rate and CPI in China in 1999–2010 (% to the relevant period of preceding year¹)

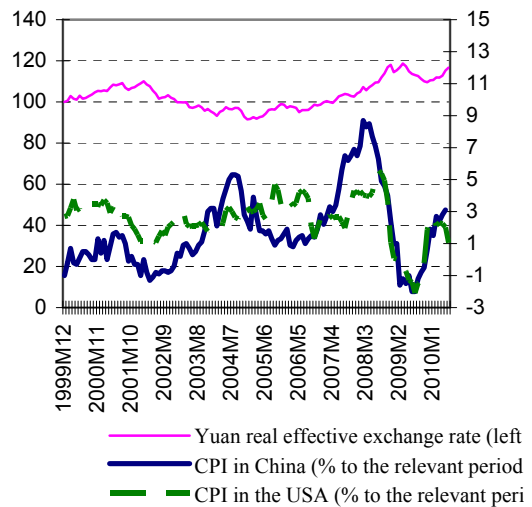


Fig. 8. Yuan real effective exchange rate (01.1999=100) и CPI in China and US in 1999–2010.

Achievement of a moderate level of inflation in China was made possible by a large sterilization through purchased by the Central Bank reserves, accumulated not only in the government accounts in the People's Bank of China, but also (to a much larger scale) by selling bonds of the Central Bank to credit institutions (see Figs. 9 and 10). Such policy, coupled with the rapid economic growth, as well as restrictions in capital inflows, limiting further inflow of foreign currency to China, has allowed the Chinese authorities to curb monetary supply growth and inflation.

¹ The same period last year.

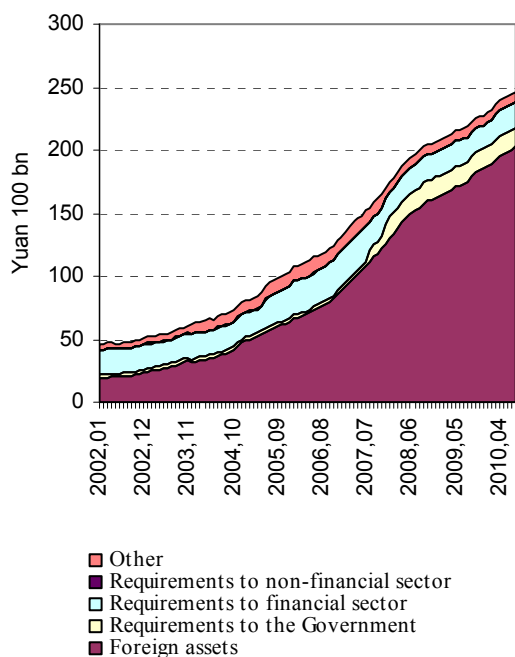


Fig. 9. People's Bank of China assets dynamics in 2002–2010

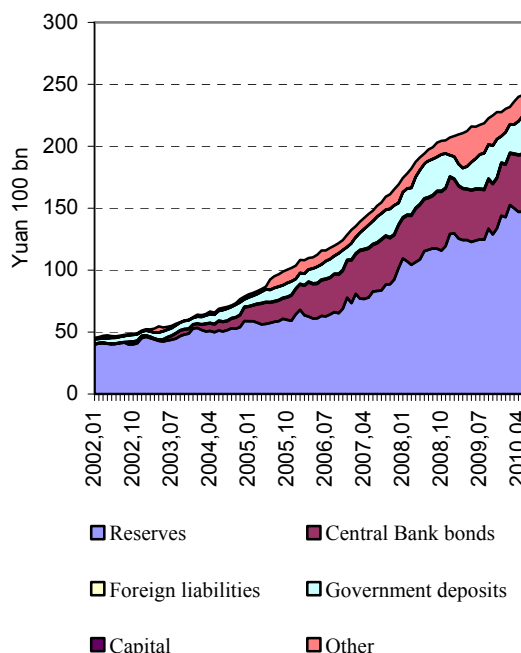


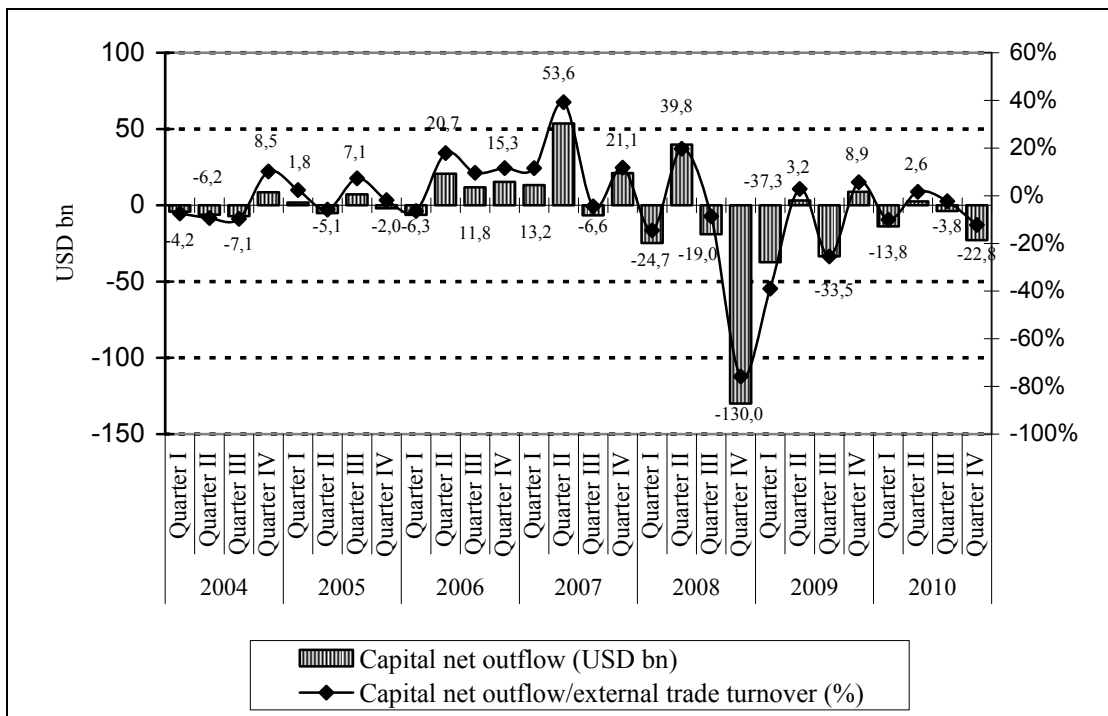
Fig. 10. People's Bank of China liabilities dynamics in 2002–2010

One of the major trends in the dynamics of balance of payments in 2010 was the dynamics of net capital outflows from non-financial sector, which reached USD 37.9 billion as of the year results (in 2009, due to the crisis, the outflow amounted to USD 58.7 billion) (See Fig. 11). After the outflow of capital in the I quarter in the amount of USD 13.8 billion, in II quarter the inflow (USD 2.6 billion) was recorded. However, in the second half of the year the outflow of capital has accelerated (USD 3.8 billion and 22.8 billion in the III and IV quarters, respectively). At first glance, it might seem that the outflow of capital is gradually decreasing at the background of the Russian economy recovery from the crisis.

However, a comparative analysis shows that while private capital inflows were growing to many developing countries, where investors were ready to run the risk and where low interest rates were sustained, private capital is still flowing away from Russia. The reasons for this situation, apparently, is the maintained strong economic and political risks of investments in the RF with the level of profitability comparable to other developing countries.

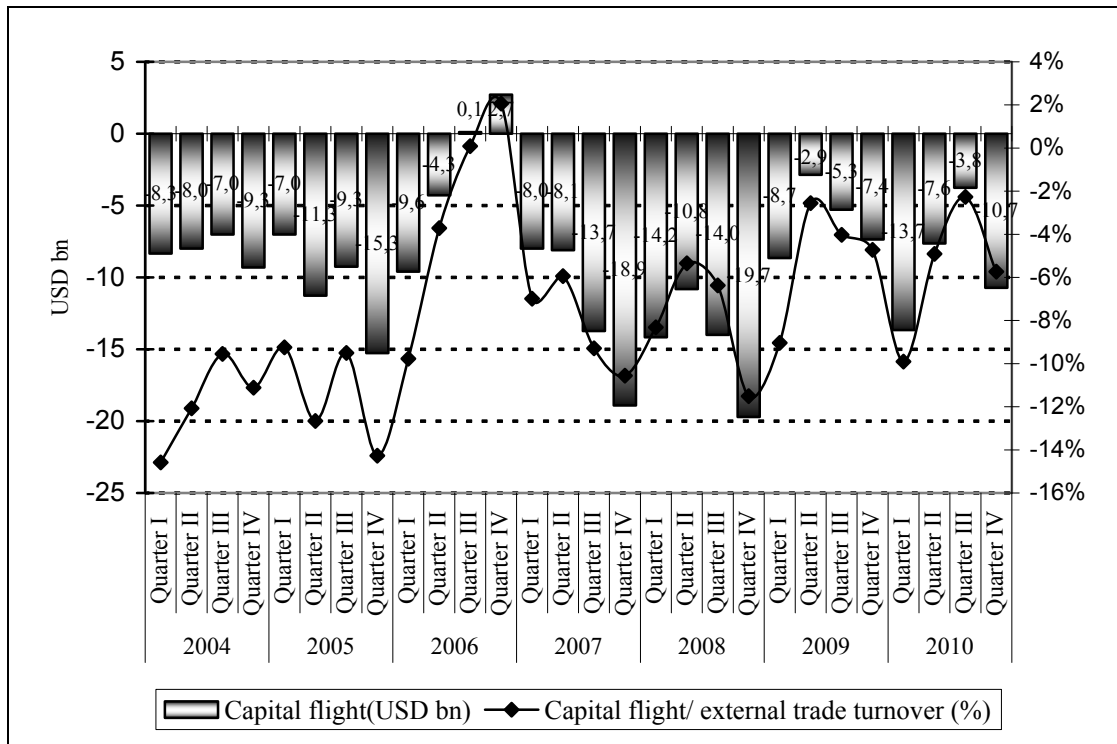
Another evidence of the unfortunate situation with the inflow of capital is acceleration of the so-called capital flight¹ in 2010. As a result of capital flight in 2010 (Fig. 12) reached, according to our estimates, 35.8 billion dollars, which is by 11.6 billion dollars more than in 2009. In 2010, respectively, an increase was recorded in the share of capital flight in foreign trade turnover from 4.9% in 2009 to 5.5%.

¹ We estimate the capital flight by the methodology of the IMF, which represents the sum of "commercial loans and advances", "delayed receivable export revenue and receivable goods and services on the account of remittances under import contracts" and "net errors and omissions".



Source: the RF Central Bank, IEP estimates.

Fig. 11. Capital net outflow dynamics in 2004–2010.



Source: the RF Central Bank, IEP estimates.

Fig. 12. Capital flight dynamics in 2004–2010.

Summarizing the analysis of the balance of payments, we should note that the decline in energy prices during the crisis has demonstrated the vulnerability of the domestic balance of payments. Restoration of oil prices in 2009-2010 helped to stabilize the balance of payments. However, with improvement of the Russian economy, imports began to recover. In addition, if during the III quarter of 2009 - II quarter of 2010 the restoration of imports was slower than exports, in the second half of 2010 the growth rate of imports has nearly twice exceeded the growth rate of exports. As a result, despite the continued rise in oil prices, late in the year, at the background of accelerating capital flight, in order to stabilize the balance of payments, it was needed to reduce Russia's international reserves amounting by 8.6 billion dollars. In the case of preservation of this trend, declining in the current account balance will continue, which will create downward pressure on the ruble.

As for balance of capital operations account and financial instruments, the capital flows apparently will remain quite volatile. However, with other terms being equal (especially in the case of stability in energy prices), in the absence of efforts on the part of the Russian government to reduce the risks of investments in Russia, one can hardly expect private capital inflows into the country as per 2011 results.

2.1.4. Main Measures in the Monetary and Credit Policy Area

Measures taken by the Bank of Russia in order to ensure the stability of the financial system can be divided into two groups: the interest rate policy and other measures.

If we talk about *interest rate policy* of the RF Central Bank in 2010, then in the first half of the Bank of Russia continued the policy of 2009 addressed to mitigate the monetary and credit policy. In particular, in January – May, the RF Central Bank reduced interest rates four times. During this period, the refinancing rate (together with the rates on Bank of Russia) was reduced from 8.75 to 7.75% per annum. The reason for such action of the RF Central Bank was that lending to the real sector of the economy has been dramatically slowed down with the reducing inflation. Slowing inflation enabled the Bank of Russia to reduce the cost of resources provided to commercial banks, slightly amending the interest rate in real terms, as nominal rates were maintained at the level of inflation. The reasons to reduce the rates, published in the RF CB press release, were in all cases approximately the same. In particular, among the reasons for lower rates there were mentioned the decline in inflation and the need to promote the recovery of the unstable economic growth.

However, as we noted earlier, the summer slowdown in inflation has stopped, and in autumn it was accelerated. Herewith, already on June 30 the Bank of Russia decided to terminate interest rate reductions. We believe that the termination of interest rate reductions was a timely decision. Moreover, the acceleration of inflation in late 2010, it is expedient to raise the issue of tightening monetary policy, as the current low interest rates at the background of excessive liquidity in the banking system encourages credit institutions to take additional risks, despite the fact that the economic situation in Russia is still far from favorable. In addition, a soft monetary policy is not helpful in inflation curbing, which acceleration is based on both, non-monetary and monetary factors. We believe that this low inflation at the level of no more than 4-5% per year should be an important factor in the growth of savings and investments in the Russian economy.

We should also note that during the crisis, interest rates of the Central Bank first began to work as a tool of monetary policy. This proved to be the result of increasing share of credits, provided by the Bank of Russia in the form of liabilities to commercial organizations, to

whom the crisis resources, available to the RF Central Bank, were practically the only source of relatively inexpensive funds. However, by mid-2010, commercial banks have returned to the Bank of Russia nearly all borrowed funds. ☒ Therefore, the possibility of the RF Central Bank to take the situation in the monetary market under control with interest rate policy once again declined. In this situation, to reduce inflation, the Bank of Russia should reduce its intervention in the foreign exchange market, smoothing only the exchange rate volatility, but not increasing (or decreasing) the volume of international reserves, thereby affecting the monetary supply. We should also note, that the sterilization of the Central Bank intervention in the foreign exchange market also provokes problems (see an insert), a detailed discussion of which is beyond the scope of this review.

The Problems of the effectiveness of the Central Bank Sterilized Interventions

The basic macroeconomic models suggest the ineffectiveness of sterilized interventions of the Central Bank¹ (i.e., the interventions in which the operations of the Central Bank in the foreign currency market do not lead to a change in the monetary base) to control the exchange rate, since such interventions domestic interest rates do not change, and according to the classical model of the formation of the exchange rate in the foreign exchange market rate also remains unchanged². However, there are entire classes of models, which showed that sterilized intervention can influence the foreign currency market. Herewith, there are two main channels of influence - the portfolio balance channel and the channel of expectations (or signaling channel).

Portfolio balance channel is usually considered in the model determining the exchange rate on the market based on comparing the economic agents profitability of investments in domestic and foreign financial assets (with the expected exchange rate changes). The differential yield is the inflow of capital to the country, which is more attractive in terms of asset returns, that leads to a strengthening of the national currency. However, in contrast to classical models of the countries, in which the assets of different countries are perfect substitutes, when considering the portfolio balances, it is assumed that economic agents pay attention to other characteristics of assets, other than returns. For example, sterilized intervention of the Central Bank in developing countries, aimed at preventing the national currency strengthening and at purchasing foreign currency in the market, may become effective due to the fact that investors consider the assets of developing countries as more risky than the assets of the developed countries.

The channel of expectations (or information channel, signaling channel) consists in the fact that sterilized intervention, without causing changes in the monetary supply, is still able to exert significant influence on the expectations of economic agents, as an intervention enables market participants to have information about the current (and future) behavior of the Central Bank. In other words, as the behavior of the players in the foreign exchange market is largely determined by their expectations about future dynamics in exchange rates, changes in expectations can significantly adjust the behavior of investors. In particular, if the national Central Bank holds sterilized interventions to support the national currency and market players believe in its ability to keep the exchange rate, then its actions may be successful, despite the fact that the interventions did not affect the monetary supply.

Other measures of monetary and credit policy, implemented by the Bank of Russia in 2010, include the following basic steps.

1. On March 19 the Bank of Russia reported that since May 1 limits for credit risk established for credit institutions to provide loans without collateral will be lowered. In other words, the Bank of Russia has reduced the maximum amount of loans granted to credit insti-

¹ See, for instance: Krugman P., Obstfeld M. International Economics: Theory and Policy. 8th ed. 2009.

² See: Sarno L., Taylor M.P. Official Intervention in the Foreign Exchange Market: Is It Effective and, If So, How Does It Work? // Journal of Economic Literature Vol. XXXIX. September 2001.

tutions. This step was aimed at cutting down the anti-crisis measures to support the banking sector.

We would like to note, that at the background of the economic situation stabilization in the country the indebtedness of lending institutions under the loans without collateral has decreased as it is. The majority of credit institutions have tried to reimburse the unsecured loans because of their high cost and the opportunity to attract market financing on better terms. Thus, we can assume that most of the remaining debt belongs to the banks that are still in a difficult situation. With the account to consolidation in the Russian banking sector, the measures taken will contribute to force out inefficient banks from the market.

2. On June 3, The Bank of Russia reported on the approval of Bank of Russia regulation № 2459-U of 03.06.2010, "On the Specifics of credit risk on some outstanding credits, loans and similar debts". In accordance with that Regulation, the Bank of Russia is slowly returning to the pre-crisis requirements to in the credit risk assessment. The mitigated reserve requirements to the loans, imposed during the crisis, were aimed at supporting Russian banks and allowed them to form a smaller volume of reserves in a crisis situation. Currently, the state of the banking sector has improved, and it allows the regulator to tighten the requirements to credit risk assessment, bringing them in line with general regulations.

3. On June 7, the Bank of Russia has informed on improving its information policy : from the above date the RF Central Bank started to disclose the information not only on the aggregate amount of intervention in the foreign exchange market, but also on the amount of so-called targeted interventions. We would like to recall, that the volume of targeted interventions are not considered by the Bank of Russia for adjusting the boundaries of floating exchange rate threshold, and are regulated by the situation with the Russian main exports in the world market. In fact, while maintaining oil prices at the current or higher level, the target interventions are the main channels for the formation of the monetary supply in the Russian Federation (like it was before the crisis).

Subtracting targeted interventions from the total amount of interventions, one can get the value of interventions, committed in excess of the established volume. Herewith, the Bank of Russia in its statement officially informed about the rules of such interventions: in case of the volume excess over the planned interventions in the value of USD 700 million, adjustment of the permissible threshold of the two-currency basket is made by 5 kopecs.

We believe that increasing the information transparency of the Bank of Russia is welcome. Such measures increase the confidence of economic agents to monetary policy the Bank of Russia, and help to increase its effectiveness. However, the establishment of clear rules of the exchange rate policy of the Bank of Russia is not quite justified in terms of high dependence of the Russian economy on foreign economic conditions, as the predictability of Bank of Russia in the foreign exchange market can create the preconditions for increasing the volatility of the exchange rate. For example, increasing the inflow of foreign currency to Russia the players of the foreign exchange market will know that the Bank of Russia will buy a certain amount of currency, and then increase the ruble rate. At the same opportunities to gain on ruble strengthening will rise in comparison with the situation in which the Bank of Russia are less predictable. It is reasonable to transfer to a free floating exchange rate of the ruble coupled with the smoothing of a sharp exchange rate fluctuations.

4. From October 13 the Bank of Russia has symmetrically extended operating range of valid value the two-currency basket from RUR 3 to 4 and reduced the amount of accumulated interventions, leading to the shift in the operational threshold by 5 kopeks, from UDF 700

million to 650 million. In addition, the RF Central Bank has revoked the fixed threshold for the allowable fluctuations of the two-currency basket (RUR 26 and 41), which were established on January 23, 2009.

Thus step of the RF Central Bank has demonstrated its commitment to stop intervention in the foreign exchange market situation and the transition to a regime of free floating of the ruble rate. At the same time, the Bank of Russia intends to continue to mitigate the significant ruble fluctuations. We would to note, that this step can be generally welcomed, as the maintenance of the ruble, coupled with the transition to inflation targeting (see the insert), as well as the free movement of capital is a difficult challenge. We believe that in future the Bank of Russia should further reduce the scale of its operations in the foreign exchange market. In this case, the RF CENTRAL BANK in a volatile export prices will inevitably be present in the foreign exchange market, smoothing out fluctuations. Herewith, the RF CENTRAL BANK will inevitably interfere in the foreign exchange market in a stable situation there. There is concern that in case of a sustained trend towards the strengthening or weakening of the national currency, the Bank of Russia may revert to targeted exchange rate, which would nullify its actions on the transition to inflation targeting with the help of interest rates.

Inflation Targeting

Inflation targeting is a relatively new regime of monetary policy, which nevertheless is now widespread in the world. For the first time about the transition to a direct inflation targeting was informed by New Zealand in 1990, later the regime was adopted by the monetary authorities in Canada, Britain, Sweden, Finland, Australia, Spain, Israel, the Czech Republic and Chile. In Russia, some elements of inflation targeting were declared by the RF CENTRAL BANK in 1996.

In most cases, the transition to inflation targeting was the answer to those difficulties the country faced in conducting monetary policy with exchange rate monetary instruments targeting. For several years, inflation targeting was used exclusively in developed countries, but at the end of 1990 it started to be applied by developing countries and countries with economies in transition.

Inflation targeting involves several elements. These include:

- 1) public announcement of medium-term target inflation indicators;*
- 2) the institutional choice of price stability as the primary long-term goal of monetary policy;*
- 3) the communication strategy that pays less attention to the intermediate goals;*
- 4) greater transparency in the execution of monetary policy and plans of the monetary authorities;*
- 5) increasing the responsibility of the central bank in achievement the target inflation indicators.*

Inflation targeting has several important advantages. Firstly, like the targeting of monetary aggregates, it allows the monetary authorities to focus on internal problems of the economy. Since the authorities of monetary and credit regulation in this case do not establish rigid relationship between the dynamics of monetary aggregates and the rate of price growth, inflation targeting enables more flexible reaction to changes in the macroeconomic situation. Secondly, inflation targeting is more obvious and understandable to the public than the exchange rate targeting. Setting specific targets of inflation indicators increases the responsibility of the central bank for its performance and helps to solve the problem of inconsistency in monetary policy.

However, it should also be noted that the inflation targeting regime is often criticized. First, inflationary processes are not always under complete control of the monetary and credit regulation authorities. In periods of economic shocks (financial crisis, external price shocks), non-monetary factors play an important role in the dynamics of inflation and the instruments of control, available to monetary authorities, may be insufficient to achieve targeted levels of inflation. This disadvantage is particularly important for developing countries and economies in transition, where after reaching the medium and low inflation rates, the impact of the exchange rate, structural changes in the economy and prices, external shocks, etc. increases dramatically.

Second, inflation targeting implicitly assumes that the monetary authorities focus on one of the macroeconomic targets (on inflation), not paying much attention to the dynamics of other target variables (in the first place, employment and production output growth).

Third, there is a fairly long lag between the actions of monetary authorities and the change in price growth. If during periods of stable economic development that does not matter, under conditions of economic shocks (when government actions are the most important), inflation targeting leads to the need of the monetary authorities to address the problem of intermediary optimization with rigidly defined local conditions, and herewith, they have to take into regard the consequences of their previous decisions.

5. On October 18, the RF Central Bank reported on the recovery from January 1, 2011 of the approaches to the formation of a list of the Bank of Russia, which were in force until February 2009. We would like to recall, that the companies included in this list, enjoy the majority of the Central Bank credits, granted to commercial banks.

Like before the crisis, the List of the Bank of Russia will include organizations, whose rating of the long-term creditability in foreign currency under the assessment of at least one of the foreign rating agencies is at the level not less than “B-” by rating agencies Standard & Poor's or Fitch Ratings or “B3” under classification rating agency Moody's Investors Service. In addition, the Bank of Russia will excluded from the listing the entities, included in the list of strategic organizations, approved by the Governmental Commission on Sustainable Development of the Russian economy. Herewith, the liabilities of systemically important institutions, which will serve as loans to the Bank of Russia as of January 1, 2011, will remain in the pledge before their maturity.

Thus, the Bank of Russia took another step on the “exit” from the crisis management measures to support the banking system, increasing quality requirements for collateral under the loans granted to them, which can be considered correct and timely measure. At the same time, due to a small number of systemically important institutions included in the List and at the same time having to use a significant amount of debt liabilities, this move will hardly have a serious impact on the Russian economy.

6. In early November, the RF Central Bank has submitted to the RF State Duma the “General Directions of monetary policy in 2011 and for 2012 and 2013”. In that document the Bank of Russia has clearly outlined its major task for 2011-2013, which should be inflation curbing within 5-7% per year. Herewith, the RF Central Bank does not set quantitative indicators in the dynamics of the ruble rate and declared the continuation of the movement toward a free exchange rate, while smoothing the volatility of the exchange rate. In our view, such a formulation of the purposes of the Bank of Russia allows it to conduct monetary policy more effectively without trying to simultaneously achieve two largely conflicting goals: reducing inflation and maintaining exchange rate. At the same time, it is obvious that in the medium term the Bank of Russia will be unable to restrain from interfere in the exchange rate (in addition to smoothing volatility), due to the high dependence of the Russian economy from external economic situation. Herewith, the intervention of the RF Central Bank is likely to increase in periods of abrupt changes in supply and demand in the foreign exchange market. We believe that namely in such periods the willingness of the Bank of Russia to the free exchange rate regime will be tested in practice.

Among other monetary and credit policy indicators in the medium term are the follows:

- enhancing the role of the RF Central Bank interest rate policy in reducing inflation and inflationary expectations (the narrowing interest rate corridor) within the framework of this purpose, the RF Central Bank plans to gradually reduce the difference in interest rates on credits provided to banks and resources attracted from them, in case of significant volumes of transactions between the Bank Russia and banks and the restriction of the corridor will more accurately affect the interest rates in the RF;

- cutting down counter-crisis measures;
- consolidation and capitalization of the banking sector;
- taking into account the situation on financial markets when conducting monetary and credit policy, the question is, in particular, about the decision to change monetary policy, taking into account the dynamics of not only inflation, but also prices in financial markets;
- increased transparency and improvement of monetary and credit policy analysis.

With regard to the macroeconomic forecast, included in the “Guidelines”, the growth of the monetary base in narrow definition in 2011, according to the forecast the RF Central Bank will make 7.7-19.4%. International reserves at the end of 2011 could reach from 478 to 576 billion dollars. The forecast is based on three versions, with an intermediate variant, based on the price of oil in 2011 at the level of 75 dollars per barrel, which is consistent with macroeconomic forecast of the Russian government. In general, the forecast of the Bank of Russia, in our opinion, is fairly realistic and roughly coincides with the IEP assessments. Implementation of the Central Bank estimates in terms of monetary growth will largely depend on the dynamics of capital flows. In the version of "Guidelines", submitted to the RF States index of private capital outflows from Russia for 2010wqszxd has been increased from 9 to 22 billion dollars, which demonstrates once again the volatility and poor predictability of this index, as its outlook has changed several times in During the year, and actual results for the year several times differed from the forecast of the Bank of Russia, given at the beginning of the year.

2.2. National budget

2.2.1. Assumptions of the 2010 budget policy

An international crisis of 2008 – 2009, ever growing debt challenges in Greece, Spain, Ireland and Portugal in 2010 prompted the Government of the Russian Federation to revise the approach to the policy of irresponsible build-up of government expenses and obligations. A trend to curb budget expenses emerged back in 2010 while the budget was corrected and has continued while a budget was shaped for the next three year- period.

We have to confess, however, that our national budget system remains in an extremely unstable condition and strongly depends on the world market prices on energy carriers. Regardless of the planned cuts in expenses expressed in GDP per cent shares, the level of these expenses is still very high exceeding that of 2008. In this situation, a budget crisis objective possibility should be accounted for as early as possible; to prevent such a crisis, to sustain the balance of the national financial system in a long-term perspective must become an inherent condition of formulating a present-day budget policy. Otherwise a future Russia can as well repeat its experience of the 1998 crisis should external economic parameters change unexpectedly.

A main cause of the 1998 financial crisis was inability of any of the Russian governments during three years after the USSR had collapsed to approve and execute a realistic budget: government expenses exceeded government revenues from year to year manifesting a sustained trend. Impossibility to cover the expenditures by the tax revenues led to monetary financing (up to 1995) and growing borrowings at the internal and external financial markets thus making the national economy vulnerable and sensitive to internal and external shocks.

Restructuring expenses including their serious reduction should have become a key factor in budget balancing. The RF Government being fully aware of political and social implica-

tions of such a decision made punctured attempts to streamline expenses of the federal and local budgets; in June-July 1998, Cabinet led by S. Kirienko developed a special program in this area that was duly approved.¹ However, these actions were targeted at streamlining of some expenditures only; they looked like attempts to identify and remove inefficient expenditures while the problem was much more complicated: the government had to refuse implementing a considerable portion of its commitments that were impossible to be executed without a dangerous build-up of government debts; the government also had to seriously reform the budget funding system. No such action was done. As a result of the Government hesitancy to cut down the expenditure obligations, a financial crisis developed, and the national budget system collapsed.

The following years up to 2008 went by in a favorable external market situation; it helped improving budget revenues and running a considerable budget surplus (see *Table. 6*).

Table 6

Implementing budget revenues and expenditures at all the government levels in 1999–2009 , in GDP %

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Federal budget											
Revenues	12,7	15,5	17,8	20,3	19,5	20,1	23,7	23,3	23,4	22,5	18,9
Expenditures	14,0	14,2	14,8	18,9	17,8	15,8	16,3	15,9	18,0	18,3	24,9
Deficit (-)/Surplus (+)	-1,3	1,4	3,0	1,4	1,7	4,3	7,4	7,4	5,4	4,2	-6,0
Consolidated budgets of the RF subjects											
Revenues	13,4	14,1	14,5	15,1	14,6	14,1	13,9	14,1	14,6	15,0	15,3
Expenditures	13,3	13,4	14,5	15,5	14,9	13,9	13,6	13,6	14,4	15,1	16,1
Deficit (-)/Surplus (+)	0,1	0,7	0,0	-0,4	-0,3	0,2	0,3	0,5	0,2	-0,1	-0,8
Budget of the enlarged government											
Revenues	33,8	38,3	38,4	37,8	37,1	37,5	39,7	39,6	39,8	38,6	35,1
Expenditures	35,3	34,3	35,2	36,3	36,0	32,9	31,6	31,2	33,8	33,8	41,4
Deficit (-)/Surplus (+)	-1,5	4,0	3,2	1,5	1,1	4,6	8,1	8,4	6,0	4,8	-6,3

Source: Federal Treasury, IEP estimates.

Consolidated expenditures continued growing till 2003 inclusively against the sustained growth of the budget revenues; after 2003, they reduced by 4-5 p.p. of GDP. There were two reasons behind such correction of the budget policy.

First of all, any further step up of the budget expenditures would have been against the task of financial stability assurance in the country by curbing inflation. The task of sustaining macroeconomic stability and further de-regulation of economic relations within the administrative

¹ Federal Government resolution No 600 “On approval of the program of government expenditures saving” passed on June 17, 1998 in pursuance of Decree of the President of the Russian Federation of May 26, 1998 No 597 “On measures to ensure government expenditures saving” was targeted to cut down inefficient social benefits, state investments and subsidies to certain sectors. According to the assumptions of the program developers, the implementation of the program would have decreased budget expenditures by RUR 41.9 billion (1.6% of GDP). To resolve this issue, Hother governmental resolutions were adopted, among them: RF Government resolution of May 12, 1998 No 438 “On measures to strengthen financial discipline”, Decree of the President of the Russian Federation of May 14, 1998 No 554 “On measures to strengthen financial discipline and implementation of the Budget laws of the Russian Federation”, Resolution of the RF Government of July 17, 1998 No 970-r and others.

reform could not be implemented because of the previous budget policy. To reduce inflation to 4%-5.5% per year and to maintain stability and predictability of the Ruble exchange rate, a well-thought budget policy was required together with restrained growth of federal budget expenditures (not exceeding 16.5 - 17 p.p. of GDP); besides such policy was to be combined with slower growth rates of tariffs on gas, electricity, railway transportations, utilities (within 5% - 8% per year) that were controlled by the government.

Secondly, there was an acute need in inventory and reduction of the created, in the previous years, enormous burden of social obligations that could never be realized or that inadequately reflected the then social, economic and demographic situations; this manifested in development of tougher requirements to budget allocations, implementation of an end-result oriented budgeting process and attempts to optimize the network of budget funded institutions.

In 2004 there was a major cut in budget expenditures when the share of federal budget expenditures (as a % share of GDP) fell down by 2 percent points. Such major reduction occurred in a situation when the decision to pursue a conservative budget policy (establishment of a Stabilization Fund, among others) coincided in time with a sharp and unexpected improvement of the external economic environment.

Table 7

Federal budget in 1998 – 2009: actual and forecasted parameters

	GDP, in current prices, in RUR bln		Federal budget expenditures, in RUR bln		Federal budget expenditures as a % share of GDP		Inflation, in %		Urals price/barrel, in USD	
	forecast	actual	forecast	actual	forecast	actual	forecast	actual	forecast	actual
1998	2 840	2 629,6	499,9	379,4	17,6	14,4	5,7	84,4	16,0	17,0
1999	4 000	4 823,2	575,0	677,2	14,4	14,0	30	36,5	12,0	20,0
2000	5 350	7 305,6	855,0	1 034,9	16,0	14,2	18	20,2	16,4	27,5
2001	7 750	8 943,6	1 193,4	1 324,1	15,4	14,8	12	18,6	21,2	24,0
2002	10 950	10 830,5	1 947,3	2 046,0	17,8	18,9	12	15,1	23,5	23,7
2003	13 050	13 243,2	2 345,6	2 354,9	18,0	17,8	10–12	12	21,5	27,0
2004	15 300	17 048,1	2 659,4	2 695,6	17,4	15,8	10	11,7	22,0	34,5
2005	18 720	21 625,4	3 047,9	3 514,3	16,3	16,3	7,5–8,5	10,9	28,0	50,8
2006	24 380	26 903,5	4 270,1	4 281,3	17,5	15,9	7–8,5	9	40,0	61,2
2007	31 220	33 258,1	5 463,4	5 983,0	17,5	18,0	6,5–8,0	11,9	61,0	68,4
2008	35 000	41 444,7	6 570,2	7 566,6	18,8	18,3	7	13,3	53,0	89,0
2009	51 475	39 063,6	9 024,6	9 636,8	17,5	24,7	8,5	8,8	95,0	59,4

Source: Ministry of Finance of Russia, Federal Service of State Statistics

One can see from *Table 7*, that in 2004 the revenues of the federal budget were estimated following the macroeconomic forecast estimates that were based on the average annual price of Urals crude for the last 10 years (1994–2004) – 22 USD/barrel. At the same time, the expenditures of the federal budget were estimated from the crude price of 20 USD/barrel. In reality the 2004 price of crude reached its maximum for the previous 30 years hitting an average annual of 34.2 USD/barrel. As a result, the Stabilization Fund that began functioning in January 1, 2004, was considerably replenished reaching RUR 522.3 bln (or 3.1% of GDP) following the 2004 year results.

Another important factor causing the expenditure reduction (as a % of GDP) was an understated forecast of inflation which initially was planned at 10%. In reality the inflation rate was 11.7%. Thus the expenditures reduced both in real terms and as a per cent of GDP.

Due to the understated forecast of the crude price and inflation, budget expenditures in % of GDP could be restrained for the entire period of the 2000's. But beginning from 2007, due to abnormally high prices on crude and the mitigated budget policy, the curbing effect of the conservative macro-economic forecasts could not further prevent a budget expenditures growth (in % of GDP).

The budget policy has been relaxing since 2007; this was related to adoption by the government of additional social obligations to the national community, also within the framework of implementation of national projects of priority; and to the approval of new investment programs connected with the election of President. The year of 2007 actually made a start of a "soft" budget policy when the growth of expenditures at all the budget levels in Russia outpaced the growth rates of budget revenues; as a result the budget surplus of the enlarged government reduced for the first time in the last five years, regardless of favorable internal and external environment.

In 2008, the dynamic trend of the main parameters of the Russia's budget system strikingly differed from those in the previous year. Based on the 2007 year end results, all budget expenditures and revenues grew considerably vs the same indicators of 2006, however, in 2008 changes were multidirectional: in the context of emerging economic crisis and fall of prices on energy carriers, the federal budget revenues reduced by 0.9 % of GDP; simultaneously the revenues of the consolidated budgets of the RF subjects increased by 0.4 % of GDP. This may suggest that a crisis mostly hit financial stability of the federal budget, leading to reduction of oil and gas revenues and indirect taxes revenues.

While the financial crisis was hitting economies of many countries, functioning of the Russian economy radically changed in the 2H of 2008. This period was characterized mainly by relatively low prices and demand on Russian exported goods, by a sharp fall in output and unemployment growth. By the beginning of 2009, the Russian economy entered a recession period, with devaluation of the national currency (Ruble) and cuts in investment programs. Such aggravation of the economy affected the national budget system: given considerable reduction of revenues in the budgets of all the levels and the growth of expenditure obligations, in 2009 the budget of the enlarged government showed a deficit for the first time in the last decade (see *Table 6*). The imbalance of the budget system and the lengthy world crisis created risks of expanding the scale of debt borrowings in the near future.

The largest fall of revenues and growth of expenditures was observed at the federal level which relied largely on market revenues. The revenues of the federal budget reduced by 23 p.p. in real terms while the expenditures increased almost by 25 p.p.; in 2008 the budget surplus of 4.1p.p. of GDP was replaced by a deficit at 5.9 p.p. of GDP in 2009.

The Federal Government managed to implement, under a very tight schedule, a wide range of anti-crisis actions, unprecedented both in terms of a number of forms and directions of the government impact on the economy and the volume of tapped resources. If in the fall of 2008, the measures of "pin-point" responses were implemented under extremely tight time restrictions and by using mainly "manual management tools", by March 2009 a comprehensive Program of Anti-Crisis Actions of the RF Government for 2009 was developed.

To finance the priority areas of this Anti-Crisis Program, changes in the Federal Budget Law were to be made. As a result, the budget acquired a clear recessional character: the ear-

lier approved budget allocations were cut down by 2.4% of GDP; and 4.1% of GDP including the released funds were allocated mainly to support financial stability and maintain strategic sectors and enterprises, and to a lesser extent, to support vulnerable groups of the population. The anti-crisis actions were funded both from the federal budget and off-budget sources which share was estimated at 2/3 of the respective expenditures.

The 2008 anti-crisis package, according to our estimates, valued RUR1.1 trillion (2.7% of GDP) and included mainly investments to support the financial system. In 2009, RUR2.4 trillion (6.2% of GDP) of the budget and off-budget funds were allocated to support the anti-crisis actions.

In Russia, the macroeconomic risks of the Anti-Crisis Program were partially mitigated by using the Reserve Fund: about RUR3 trillion (7.7% of GDP) of the Reserve Fund were allocated to balance the federal budget. There are three aspects specifically related to the “reserve” nature of these allocations.

Firstly, the use of the Reserve Fund to liquidate the budget deficit was a standard issuance of money by the RF Central Bank since practically such transaction means moving the Central Bank liabilities from the special account of the RF Government and including them in the monetary base (using the current account of the Government). Such transaction could not have been considered an emission if the Russia’s Bank simultaneously sold the currency received during the period of the Reserve Fund accruals; however the international reserves of the Russia’s Bank having reduced to minimal in January 2009 continued growing steadily in future. If the formation of the Reserve Fund were not accompanied by the reduction of the monetary base (its funds would have been accrued not at the Government accounts in the Central Bank but at the accounts of commercial banks), then its reserves and spending would not be associated with the emission. Thus, in terms of the monetary policy, the Fund is not a reserve but a separate channel of money inputs into the national economy.

Secondly, the described emission effect in using deposits from a budget account is observed every time when the government spends money in the current Treasury system that keeps its budget accounts in the Bank of Russia. Within this system, the funds received at a budget account are drawn outside the monetary stock. The monetary stock is fluctuating constantly during a year. There is a sharp growth of monetary aggregates in December when the budget implements its expenditure items, or there is a reduction of the monetary base in the last days of a month when taxes are remitted to the budget.

However, in view of the adopted budget period which is a budget year, in terms of the budget policy, only the final impact of budget transactions on the monetary stock is normally considered. If to extend the term of budget planning to up, e.g. five years, then the use of the Reserve Fund money will stop being a pure emission since the accrued funds during such period can be viewed as temporally drawn from (similar to fluctuations of the monetary base caused by a time asymmetry of implementation of the revenue and expenditure budget items) and returned to the national economy.

Thirdly, in the budget and debt policies perspective, the Reserve Fund deposits can be absolutely considered as a reserve of the RF Government since its availability helps financing the budget shortage with no market borrowings and with no increase of the government debts. This can be done by emission and simultaneous “sterilization” of the monetary stock at the expense of currency interventions and using external reserves accumulated as a counter-part of the Reserve Fund. The practices of such countries as the EU countries, the USA, Japan, Great Britain and others show that it is the growth of the national debt used to finance anti-

recession actions that becomes a key issue at the stage of economic recovery. Therefore the Reserve Fund in Russia is a factor that prevents debt burden to increase and to carry the current budget expenditure load over to the next period (generations).

Simultaneously with the growth of expenditures, tax benefits of anti-crisis nature were adopted: a Profit Tax rate was reduced, a new procedure for non-linear depreciation introduced, a bonus depreciation increased, MET non-taxable price exemption increased, etc. In 2009, the “tax package” overall cost was about 1.5 p.p. of GDP.

The list of the budget anti-crisis actions taken in Russia in 2008 – 2009 is very like similar international programs: unemployment benefits, support of the retired, assistance to strategic enterprises in various sectors of economy, financial rehabilitation of banks, support to small and mid-size businesses. The actions differed by scope of allocations dependent on emergency and scale of problems faced by the governments.

In general, the anti-crisis policy in Russia was quite successful though with some deficiencies:

- in implementation of the Anti-Crisis program decisions were often delayed;
- the actions of government support had low transparency, in particular, there were no fixed rules of allocations among the enterprises;
- at the initial stage of the crises, insufficient focus was made on giving support to the community, thus reducing effectiveness of the government measures;
- cash execution of the expenditure obligations was irregular and therefore impeding efficient and timely spend of the budget allocations.

Main developments of the budget policy in the 2000'es

In the 2000'es, regular efforts were taken in Russia to assure stability of the budget system, efficiency of budget allocations and their spending. The budget policy of that period was characterized by the following:

In 1998, Budget Code was adopted and made effective since January 1, 2000, manifesting a considerable success in the area of the budget reform. The new law established legal foundations of the budget system of the Russian Federation, the position of the subjects of the budget legal relations, the procedure for regulating inter-budget relations, the foundations of the budget process in the Russian Federation, and accountability for violation of the RF budget laws.

The Reserve Fund was established in 2004 as a tool of accumulating some of the revenues generated by customs duties imposed on oil and from the Mineral Extraction Tax (oil) when the Urals price exceeded the base price¹. The purpose of the Reserve Fund was to assure the balance of the federal budget in cases where the oil price was lower than the base price and to neutralize extra liquidity by offsetting interventions of the Central Bank caused by increase of external reserves. Thus the expenditure obligations were maintained at a predictable and stable level and did not depend on uncontrolled external situation. As a result of growing prices on oil in 2004–2007, the Stabilization Fund could accumulate sufficient funds that allowed

¹ Since 01.01.2004, the base price was established at \$20/bbl for Urals (Federal Law No 184-FZ of 23.12.2003, while since January 1, 2006 this threshold price was raised to \$27 (Federal Law of 12.10.2005 No 127-FZ). Regardless of that the oil prices continued growing, further increase of the “cut-off price” likewise the use of funds of the Stabilization Fund inside the country was stopped due to a risk of inflation and larger dependency of the budget on external economic environment.

the Fund to perform a priority task of maintaining stability of the Russian state finance and in addition to early repay some of the national external debts. Moreover, due to the application of the Stabilization Fund tool, the budget policy of 2004–2007 acquired features of a counter-cycle. The Stabilization Fund starting February 2008 was split into Reserve Fund and National Welfare Fund. In 2009 – 2010 it was the Reserve Fund that functioned as a main source of financing the federal budget deficit;

In 2003–2004, the introduction of results-oriented budgeting (ROB) began as a tool to improve quality of managing budget funds and allowing distribution of budget funds not by the budget items but by strategic targets and tactical objectives aimed at reaching certain end results. As complex management procedures and processes including target programming and results-oriented budgeting were implemented in the environment where such fundamental budget issues as reforming of the budget network, improvement of incentives at the bottom level to use budget funds more efficiently remained unsettled, no breakthrough in the effective management of the budget funds could be expected. A low quality of the institutional environment considerably discredited the very idea of ROB in Russia regardless of its good potential. As a result, the application of the programmed and targeted planning was actually limited to planning, analysis and monitoring for assessment of efficient use of the budget funds while those mechanisms were designed to become inherent elements of the budget process substantiating the needs of the ministries and departments declared in the Budget Law.

Improvement of the legal foundations for procurement to meet federal and municipal demands was prompted by Federal Law No 94-FZ effective of July 21, 2005 “On placement of orders for supplies of goods, execution of works and rendering services for federal and municipal needs” and a number of amendments thereto. The new procurement system had a lot of advantages vs the previous one: application of direct legal regulation of the procedures for placing orders at all the levels of the budget system, limitation of corruption risks by narrowing the area of application of non-competing procedures (close bids, placement of orders with a sole supplier), introduction of more transparent ways of order placement (auctions, procurement at commodity exchanges, etc.) At the same time these innovations having failed to ensure a considerable reduction of the corruption scope, created certain problems for “fair” providers.

A review of the applicable international experience shows that the government needs in goods, works and services are satisfied more efficiently and adequately if all procedures of a process cycle of a government order (planning, formation and placement) are built into unified institutional environment, aligned with common for all the procedures milestones and streamlined in terms of structure and element composition. At present, however, the Russian legislation does not provide for a unified approach to regulation of the entire cycle of the government order placement. Thus, at the planning stage, the budget legislation is called to ensure targeted and effective spending of the budget funds. Regulation of the implementation of government contracts is limited to the application of general provisions of the Civil Code, and no specific regulation tools are actually applied. Though the stage of placing a government order is most effectively regulated as a result of on-going refinement of FZ-94, the following issues are not settled yet: carry-over of the budget funds allocated to payment for government contracts from the current to a future budget period, broader independence in spending of the saved budget funds generated by effective procurements, application of price monitoring data to justify the start-up procurement prices, prospects of centralization of state procurements,

improvement of the procedure for setting prices in construction sector, possibility to engage specialized companies to perform control over contract compliance, in terms of targeted spending of funds, effective work organization, implementation of technologies (banks and engineering companies), methods of procurement of highly specialized services (R&D and pilot), etc.

Implementation of national projects of priority (NPP) as an alternative way of programmed governance of budget expenditures. A new approach to resolve the task of improvement of the Russian community life quality was demonstrated in development of four national projects of priority in the areas of education, healthcare, housing and agribusiness industry. Within each such project problems, objectives and actions were formulated. A specific focus was made on development trends of education and healthcare as these sectors have provided traditionally a wide range access to their services for the citizens and have always been extremely significant in terms of investments into human capital.

A review of the implementation results of NPP shows that the project target indicators have been delivered and over-delivered. However, these deliverables have not been supported by any institutional reform and therefore limited to additional budget allocations to alleviate acute problems in the key social sectors.

As there were no system approach to project shaping, the list of areas and actions of government support had to be extended every year thus leading to additional budget expenditures (to finance new “bottlenecks”, e.g. schools were connected to Internet, later the Internet traffic was paid for, since municipal budgets had no such expenditure items). Besides, the implementation of the national projects created additional expenditure obligations for the regional authorities. It is the regional authorities that are accountable mainly for the areas identified as national priorities. Therefore the national projects being included in the regional scope of competences created for the regions the so called hidden non-financed expenditure mandates:

- in the projects “Education” and “Healthcare” additional benefits and increase of salaries of certain categories of budget employees took place while labor remuneration in the education and healthcare sectors in general have been maintained at the levels planned by the government. Thus a gap in individual revenues was created, and some of the human resources moved to jobs that were highly paid for. The regional authorities had to respond by unplanned increase of salaries of other employees in the education and healthcare sectors.
- as the national projects of priority were implemented, it was found that they did not provide funds for maintenance of high-tech medical equipment, retraining of employees so that they could work with such high-tech equipment, etc.

The process of establishment of development institutions in order to create a unified national innovation system for development began in 2005. For several years, several dozens of organizations were established in Russia with the aim to incentivize investments and transfer to an innovative-performance model of the Russian economy, among them: Bank of Development and External Economic Activity, Investment Foundation of the Russian Federation, OJSC Special Economic Zones, Russian Venture Company, Russian Corporation of NanoTechnologies and other institutions. Each of them enjoyed a sizable support from the federal budget. Budget allocations were granted to organizations called development institutions, mainly in the form of contributions to their charter capital. Development institutions are granted such forms of private business support as loans, insurance of export risks, acquisition

of securities of legal entities, participation in their capital and in concession agreements, and direct subsidizing.

The development institutions in spite of the considerable government support have not become catalysts of investment growth of the Russian economy, partially because there were no effective interface system for the institutions, their competences were vague, the applied tools were not aligned with those of established budget support, and the institutions did not have access to main sector strategic documents, etc.

Transition to a mid-term budget planning. In 2007, the 2008 – 2010 federal budget for 2008 – 2010 was formed (for a three-year period) for the first time in the contemporary Russia history. This development indeed was designed to improve predictability of the mid-term budget and fiscal policy of the RF Government, to enhance financial assurance of the adopted expenditure obligations for a three-year term and also to improve requirements to the budget quality and accountability for mistakes made in planning. According to the Budget Law, budget allocations were approved separately for each year of the three-year period, and chief executives of the budget were granted the right of re-allocation of funds in the course of the federal budget implementation between the current and future years. However, early 2009, as a result of rather high mid-term uncertainties caused by further recession in the world and in the Russian economy, the Federal Government elected not to follow the new practice of 3Y budgeting in 2010-2012. This decision was justified in the then economic environment, and the return to budgeting on a one-year basis was considered a temporary measure, therefore in 2010 the RF Government returned to federal budgeting on a three-year basis.

Thus the review of most important measures to improve the budget policy performed in the 2000'es shows that most of them remained on paper. The results-oriented budgeting was not developed up to a level of becoming a tool of effective management of expenditures; the system of the development institutions can hardly be described as completely developed, the reform of the budget network was slow, etc. A lot of issues remain unattended and unsettled; they can form an urgent agenda to be dealt with in the near future.

We can assume that these insignificant results have been a consequence of mistakes made in selection of priorities of the budget reform. Since early 2000'es, complicated management tools (the results-oriented budgeting, targeted programming) have been implemented to improve the budget process; they proved to be quite effective in such countries as Great Britain, the USA, New Zealand, Australia; however they were hardly used in the countries with weak institutional environment. In a country where such fundamental issues of the budget sphere as restructuring of the budget network, creation of incentives for more efficient use of the budget funds at the bottom level, and improvement of a government order remain unresolved, it is difficult to expect a fast breakthrough in the quality of budget management.

2.2.2. Budget policy at the stage of recovery

In the context of improving macro-economic situation, with a stable growth of oil world prices in 2010, common trends for all budget levels have been: revenue growth, reduction of expenditures vs the previous year and consequently reduction of the budget deficit (see. *Table. 8*). In particular, the budget expenditures of the enlarged government fell down by 2.5 p.p. of GDP, of the federal budget by 2.p.p. of GDP, of the consolidated budget of the RF subjects by 1.2 p.p. of GDP. At the same time, with re-calculation into real prices, the saving of the budget funds looks quite modest vs 2009 figures and fluctuates within 2-5% range –

thus we can hardly speak of the efficiency of the announced intentions to implement the “responsible” budget policy.

In 2010, the revenues of the budget system changed insignificantly vs the similar parameters of the previous year. Thus the budget revenues of the enlarged government grew by 0.3 p.p. of GDP (equivalent to a 4.8% surplus). This is mainly a result of the change of the procedure of remitting revenues from insurance contributions¹ the federal budget revenues made 18.7% of GDP in 2010 – this is by 0.2 pp. of GDP lower than in 2009.

Table 8

Implementation of revenues and expenditures of the budgets of all power levels in 2010

	2010		Change vs 2009				pp of GDP
	in bln RUR	in % of GDP	nominal value		real value		
			bln of RUR.	%	bln of RUR	%	
Federal budget							
Revenues	8303,8	18,7	966,1	13,2	208,9	2,6	-0,2
<i>Incl. from oil & gas sector</i>	3830,7	8,6	846,7	28,4	538,8	16,4	0,9
Expenditures	10115,6	22,7	455,6	4,7	-541,2	-5,1	-2,2
Deficit (-) / Surplus (+)	-1811,8	-4,1	510,5		750,1		2,0
Consolidated budgets of the RF subjects							
Revenues	6537,0	14,7	610,3	10,3	-1,2	0,0	-0,6
Expenditures	6636,9	14,9	381,2	6,1	-264,3	-3,8	-1,2
Deficit (-) / Surplus (+)	-100,0	-0,2	229,1		263,1		0,6
Budget of the enlarged government							
Revenues	15715,9	35,3	2116,2	15,6	712,9	4,8	0,3
Expenditures	17301,0	38,9	1252,7	7,8	-403,3	-2,3	-2,5
Deficit (-) / Surplus (+)	-1585,1	-3,6	863,5		1116,2		2,8
<i>For reference:</i>	44491,4						
<i>GDP, in bln RUR.</i>							

Source: Ministry of Finance of the Russian Federation, IEP calculations

It should be noted that *the tax burden* in 2010 exceeded that of 2009 by 1.6 pp of GDP reaching 32.4% of GDP. Such increase was substantiated mainly by the positive trend of the tax revenues (see Table 9). Thus in 2010, Profits Tax, MET and indirect taxes dominated in their effect on the budget revenues of the enlarged government.

The revenues from the oil & gas sector that secure about one fourth of all the national budget revenues, have fluctuated depending on the world prices trends and demands for the goods of the fuel and energy complex. The main reason of the oil & gas sector revenues growth was the increase of the world prices on oil vs the similar period of 2009 (\$75.9 against \$56.7 \$/bbl), accompanied with monthly indexation of the export duties from \$253,6 per a ton in March up to \$303.8 per a ton in December. As a result of the growth of physical volumes of production and export of hydrocarbons and the growth of world prices on energy carriers, the surplus of oil & gas revenues was 0.9 pp. of GDP vs 2009. A non-zero beneficial export duty on the supplies of oil from the East Siberia fields², implemented in July 2010, positively affected the situation; the duty rate is re-calculated monthly depending on the world market prices and the demands for oil on the world markets.

¹ If in 2009 UST revenues were partially remitted to the federal budget and then to the RF Pension Fund, since 2010 insurance contributions have been directed to off-budget funds.

² The beneficial rate applies to 22 fields of the East Siberia.

Table 9

**Main taxes revenues to the budget of the enlarged government
of the Russian Federation in 2007 – 2010 in % of GDP**

	2006	2007	2008	2009	2010	2010 change vs 2009		Tax elasticity for GDP in 2010, by times
						in % of GDP	in 2010 prices, in %	
Tax load	35,9	36,1	35,7	30,8	32,4	1,6	9,3	2,4
Profits Tax	6,2	6,6	6,1	3,3	4,0	0,7	27,2	6,9
Personal Income Tax	3,5	3,8	4,0	4,3	4,0	-0,3	-2,6	-0,6
Uniform Social Tax/ /insurance con- tributions*	4,8	5,1	5,1	5,5	5,1	-0,3	-2,6	-0,7
VAT	5,6	6,9	5,1	5,3	5,6	0,3	10,5	2,6
Excises	1	1	0,8	0,9	1,1	0,2	23,1	5,8
MET	4,1	3,6	4,1	2,7	3,2	0,4	21,0	5,3
Customs duties and fees	8,6	7,3	8,6	6,8	7,1	0,3	9,2	2,3

* since 2010, UST has been converted to insurance contributions remitted to off-budget funds directly.

Source: RF Ministry of Finance, Rosstat, IEP calculations.

The following factors were suppressive for the oil and gas revenues trend in 2010: firstly, the slowdown of oil production growth rates in 2H 2010 vs 2009 and secondly, strengthening of the ruble currency which reduced revenues from external trade in the ruble equivalent.

The Profits Tax and indirect taxes, among other main oil and gas revenue sources, demonstrated a more pronounced trend to increase revenues both in % of GDP and in real prices; the Personal Income Tax revenues and revenues from insurance contributions, however, reduced by 0.3% of GDP.

In particular, the Profits Tax revenues by the year end reached 0.4% of GDP which is by 0.7% higher vs 2009. In real prices, the growth was 27.2% - this is the highest value among the considered taxes. Such positive growth of the Profits Tax revenues was mainly prompted by a better financial situation in the real sector. Thus, for 11 months of 2010, the consolidated financial effect of organizations (without small businesses, banks, insurance companies and budget-funded agencies) reached RUR 5.54 trillion (in current prices); this by 49.6% exceeds the value of this indicator for the respective period in 2009; the share of lossmaking enterprises reduced to 29.7% against 32.0% in 2009.

In 2010, the budget revenues from VAT grew by 0.3% vs 2009 at the expense of the tax imposed on the imported goods only. The VAT revenues from the goods sold inside the Russian Federation in real prices increased by 2.4% only while in the case of imports taxation – by 21.4%. Therefore in 2010, in the VAT revenue structure a continuation of the trend (since 2006) to reduce the share of the internal VAT has been observed in favor of the VAT revenues from the imported goods (if in 2004 the ratio between the revenues from the taxation of the internal sales and the taxation of the imported goods was 70:30, in 2010 such ratio was 53:47). It is explained by two factors mainly: the internal demand has shifted towards consumption of the imported goods (the share of imports in GDP increased from 12.8% in 2004 to 16.9% in 2010) and the legislation regulating internal VAT administration has changed recently; according to our conservative estimates¹, both factors resulted in annual under-receipt of budget revenues in the amount of at least 1.5% of GDP.

¹ Quality of VAT administration in OECD countries and in Russia/A. Knobel. S. Sinelnikov_murylev, I. Sokolov – M. Journal “Applied Econometrics” No 4 (20), 2010.

In 2010, a considerable growth of *excise* revenues to the budget of the enlarged government by 0.2% of GDP vs the respective value of 2009 was recorded. The reason behind such growth was a sizable increase of the rates on alcohol products, on beer specifically (by 3 times), and indexing for inflation of other groups of excisable goods. If in the 2000's, the growth rates of the tax base were behind the real GDP growth for all the excisable goods besides the alcohol products, since 2010 this trend has become pronounced for the alcohol products as well, which production volume reduced by 2.9% vs 2009 in physical terms.

The revenues from the *Personal Income Tax* (PIT) to the budget of the enlarged government reduced to 4.0% of GDP; this is by 0.3% of GDP lower than the 2009 value. In absolute terms the revenues grew by 7.5% only vs the previous year making RUR1,790.5 billion. In real prices the PIT revenues reduced by 2.6% vs the respective values of 2009. Such reduction of the PIT revenues occurred following the reduction of the taxable base (in GDP shares): in 2010 the growth rates of monetary revenues of the population (less social payouts) were lower than the rates of rehabilitation of the national economy; as a result, their share in GDP decreased by 4.6% of GDP for nine months of 2010 vs the respective period of 2009.

Since 2010, UST has been converted to insurance contributions administered by state off-budget funds¹. Before 2010, insurance contributions were paid on the insured and cumulative portion of the state pension and administered by the Federal Tax Service of Russia. These contributions were not a portion of UST, however the UST obligations were reduced by the amount of the paid insurance contributions (the UST portion subject to payment to the federal budget). In 2010, the summary rate of the insurance contributions was maintained at the level of the UST base rate of 26% of the payroll budget, however it was the taxable base that changed. Thus, if before 2010, the UTS was imposed at the regressive scale, and the base rate applied to the annual wage not exceeding RUR280,000, in 2010 the rate of 26% applied to the wage of RUR415,000, and any wage above that level was exempt from insurance contributions (actually two rates were applied: 26% and 0%).

It is important to note that Federal Law No 212-FZ of 24.07.2009 stipulated annual indexing of the marginal base for insurance contributions in line with the growth of the average wage in the Russian Federation². The changes described above should be taken into consideration by comparing the UST dynamics (including the insurance contributions) with the revenues from the insurance contributions in 2010. As *Table 9* suggests, the collection of the insurance contributions made about 0.3% of GDP vs the previous year. It is partially related to the reduction of the payroll fund in GDP by 2.5% of GDP.

Note that more important changes associated with insurance contributions have been effected since January 1, 2011, namely, the increase of the overall rate from 26% to 34%. According to our estimates, this action does not ensure the balance of the pension system of Russia in a long-term period, and there is a considerable negative influence on the pace of economic growth; this may enlarge a scale of tax evasion by the business (the share of the "shade wages" would increase).

With an insignificant growth of revenues to the budget of the enlarged government in GDP shares, in 2010 the budget expenditures reduced vs GDP (by 2.5 pp of GDP) but actually did

¹ Federal Law of July 24, 2009 No212-FZ On insurance contributions to the Pension Fund of the Russian Federation, Social Insurance Fund of the Russian Federation, Federal Fund of Compulsory Medical Insurance and Territorial Funds of Compulsory Medical Insurance".

² By Resolution of the RF Government of November 27, 2010, No 933, the taxable base limit was set at RUR463,000 for 2011.

not change in real terms; this conforms to the earlier accepted concept of their growth restraint (*Table. 10*).

Table 10

Implementation of the expenditure obligations of the budget of the enlarged government in 2009 – 2010, in % of GDP

	2010		2009		Change	
	RUR, billion.	% of GDP	RUR, billion.	% of GDP	in pp. of GDP	%, real assessment
Expenditures, total	17301,0	38,9	16048,3	41,4	-2,5	-2,3
<i>including</i>						
General government issues	1438,9	3,2	1313,8	3,4	-0,2	-0,7
incl. servicing federal and municipal debts	261,0	0,6	236,3	0,6	0,0	0,1
National defense	1279,7	2,9	1191,2	3,1	-0,2	-2,6
National security and law enforcement	1339,4	3,0	1245,9	3,2	-0,2	-2,5
National economy	2323,9	5,2	2782,1	7,2	-1,9	-24,3
Housing and utilities	1071,5	2,4	1006,1	2,6	-0,2	-3,5
Protection of natural environment	28,3	0,1	29,6	0,1	0,0	-13,2
Education	1893,9	4,3	1783,5	4,6	-0,3	-3,7
Culture, cinematography, mass media	353,4	0,8	324,4	0,8	0,0	-1,2
Healthcare and sports	1708,7	3,8	1653,0	4,3	-0,4	-6,3
Social policy	5863,2	13,2	4718,8	12,2	1,0	12,6

Source: RF Treasury, IEP calculations

The reduction of the government expenditures was mostly related to such budget items as “National economy” (by 1.9 pp. of GDP), “Healthcare and sports” (by 0.4 pp. of GDP) and “Education” (by 0.3 pp. of GDP). The only item of the budget of the enlarged government which enjoyed increase of funding was “Social policy”; this is mostly connected with pension indexation, three times during the reviewed year. Thus, from January 1, 2010, social supplementary pays to the pension were established to raise the pension up to the cost of living. Therefore, in 66 subjects of the Russian Federation payouts in the form of federal extra pays to the pension (for 2,403. 7 thousand people) and in 17 subjects of the RF in the form of regional extra pays to the pension (2,441.1 thousand people) were made.

From April 1, 2010, work pensions were additionally indexed by 6.3% and social pensions by 8.8%. Besides, from July 1, 2010, social pensions have been increased by 3.41%. With account of all 2010 actions (valorization, indexation) the work pension (old age pension) has grown by 23% amounting to RUR8,177.

At the same time one should mind that such increase of the social obligations requires a well-thought approach since in the context of a sustained shortage of the RF Pension Fund it becomes an extra load on the national budget. Expenditures for funding the additional pension increase in January 2010 were estimated at RUR502 billion (about 1.2% of GDP) while for the April indexation the Federal government had to find another RUR 150 billion. The aggregate pension expenditures grew by RUR1.3 trillion (2.4% of GDP) vs 2009, and a result, the pension system shortage increased to 5.2% of GDP in 2010.

In such context, to revise the current national pension policy is absolutely required. Otherwise, to maintain the replacement ratio at the current level (36%) a choice between the two options will have to be made:

- Step up additional financing (0.5% of GDP for 2011 1% of GDP in 2016, 2% of GDP in 2022, etc) to compensate the pension system shortage; or
- Increase the rates of the insurance contributions by 0.5% on the average every year.

Thus we believe it reasonable to come back to the social tax scale that had been in effect before 2010, to carry our moderate indexation that would not increase the tax burden on the labor market in 2011 – 2012. In a mid-term, to secure the pension system, extra funds should be engaged in addition to standard insurance contributions for compulsory pension insurance. Alongside with the reserve funds, privatization of state property may help, also by way of passing the property over to the RF Pension Fund and non-state (private) pension funds in consideration of current contributions under the cumulative component of the pension insurance.

2.2.3. Main events in the budget area in 2010.

In the last year, in spite of the crisis and the need to cut down budget expenditures, the RF Government continued making transformations that started in the second half of the 2000's to improve the quality of the budget governance and to implement the social obligations that had been assumed before. In 2010, the following events in the budget area can be considered as significant:

1. Development and approval of the RF Government Program to improve efficiency of the budget expenditures¹. The need to ensure a long-term balance and stability of the budget system in the form of an absolute fair limitation of the “irresponsible” annual increase of the budget expenditures is a fundamental condition for the Program implementation success.

An innovation in the Program is introduction of another program targeted tool - “a government program” designed to set aims, objectives and instruments of the government policy aimed at the implementation of the priorities of the Concept of a long-term social and economic development or large-scale actions of national or international significance. Last August the RF Government approved the procedure for development, implementation and assessment of efficiency of such government programs², while in November the RF Government passed a resolution where a list of the government programs was approved³. All the programs are structured by the following areas:

- New quality of life (13 programs);
- Innovative development and upgrade of the economy (17 programs);
- National security assurance (2 programs);
- Well-balanced regional development (4 programs);
- Effective government (5 programs).

The funds for the programs will be determined during national budgeting for 2012-2014.

Other significant areas of budget governance quality improvement in the Program are:

- Considerable increase of the target programs share (currently the budget expenditures under a targeted program method are covered by about 15%) in the budget;
- Reforming the mechanism of state order implementation;
- Improvement of the budget network;
- Reforming institutions of the federal (municipal) government control;
- Delineation of authorities between various levels of power, etc.

In spite of the fact that the Program is oriented at the improvement of the budget process at the federal level, the success of its implementation depends on the alignment and effective-

¹ Order of the RF Government of June 30, 2010 No 1101-r

² Resolution of the RF Government No 588 of August 2, 2010

³ Order of the RF Government of November 11, 2010 No 1950-r

ness of the efforts at all the levels. Therefore the RF Government recommended the executive authorities of the RF subjects and the local government bodies to develop and implement similar regional and municipal programs for improving efficiency of expenditures of the respective budgets according to the key provisions of the Federal Program. Also a decision was taken to grant federal subsidies to the regional budgets for the implementation of the regional programs¹.

2. In 2010, amendments² in the RF Budget Code were adopted to be effective since 2011. These amendments primarily changed the structure of functional classification of the budget expenditures and increased the number of budget items from 11 to 14. The following expenditures now have become separate items:

- servicing of the federal government and municipal debts. Before this expenditure item was included in the section “General Government issues”. This innovation aims at the improvement of control effectiveness over government debts specifically in view of its future increase in the mid-term;
- physical culture and sports expenditures. Earlier this budget item was included in the section “Healthcare”;
- expenditures on mass media including TV and radio broadcasting; periodical press and publishing houses, applied research in the area of mass media and other mass media issues. Earlier the mass media expenditures were included in section “Culture and cinematography”.

“Inter-budget transfers” section was also modified. Now it is called “Inter-budget transfers of general nature to the budgets of the RF subjects and municipal establishments”. In this section the targeted transfers such as subventions and subsidies are united in item “subsidies for alignment of the budget provision of the subjects of the Russian Federation and municipal establishments”. All other transfers are grouped into– “other subsidies” and “other inter-budget transfers of general nature”. Transfers to off-budget funds are included in other sections. Thus, since 2011 transfers to the national Pension Fund will be included in section “Social policy”; as a result, the expenditures under “Inter-budget transfers” will be considerably reduced in 2011 – 2013 while the expenditures under “Social policy” will grow (see *Table 13*).

“National security and law enforcement” section was supplemented with an item called “modernization of the inferior troops, rescue military crews of a federal executive body authorized to resolve problems of the civil defense and of the law-enforcement and other bodies”. The desire to localize expenditures in the expenditure structure is explained by the coming (since 2012) transition to the program-based budget where each expenditure area will be shaped as a government program.

In July 2010, according to the amendments³ in the Budget Code, the date of submission of the draft federal budget to the State Duma was moved from August 26 to October 1st. Such decision was made with a view to improve accuracy of the main forecast parameters of the federal budget when it is formed later in the year since by the first of October updated macro-

¹ Resolution of the RF Government of December 31, 2010 No 1203.

² Federal Law of 30.09.2010 No 245-FZ.

³ FZ of 27.07.2010 No 216-FZ “ On amendments in the Budget Code of the Russian Federation with regards to specification of the dates of compiling, reviewing and approving draft budgets and reports on their implementation”.

parameters are usually available, main directions of the tax policy approved, and the Federal Target program scope is corrected.

3. Legal framework for road funds activity. In December 2010, the State Duma reviewed the first version (reading) of a bill aimed at development of the legal framework for establishment (since January 1, 2011) of road funds both at the federal and regional levels¹.

The RF Government initiated creation of a target budget fund for road construction and repair back in May 2010. In particular, the road fund notion was suggested as a portion of the budget funds to be used for financing road activities², and to set up Federal Road Fund as part of the federal budget.

To create this asset, the following revenues will be accumulated:

- excises on gasoline, diesel fuel and motor fuels;
- use of property that is part of the motor roads of general use of federal importance;
- tolls on motor vehicles registered in foreign states when they drive by motor ways in the Russian Federation;
- subsidies from the RF budget system to finance roads of general use of federal importance;
- uncompensated receipts from legal entities and individuals to finance road activity;
- other receipts from fines and damage compensations.

With account of increased rates on the said excisable goods, since 2011 this mechanism will help accumulating about RUR500 billion annually, according to the estimates of the RF Ministry of Finance.

The rationale of the creation and functioning of the road funds raises serious concerns by a number of reasons. Firstly, the Audit Chamber of Russia has systematically focused on non-efficient use of the budget funds of the federal and regional road funds that were functioning earlier. Secondly, a road fund having its own fixed sources of revenue does not meet the principle of general consolidated coverage of the budget expenditures stated in Article 35 of the Budget Code. Thirdly, with the creation of road funds, the issue of a single-channel model of financing the needs of the sector remains unresolved: there are still several channels of bringing budget funds to the road sector organizations. In particular, a sub-program “Development of the Russia’s transportation system (2010 – 2015)” of the Federal Target program is still being implemented as well as co-financing of auto-concession from the Investment Fund.

2.2.4. Analysis of the main parameters of the federal budget of the Russian Federation in 2011–2013.

The world economic crisis brought about significant changes in the environment of the formation of the government budget in Russia. First, a sharp reduction in budget revenues took place – from 22.5% of GDP in 2008 to 18.7% of GDP in 2010 (see *Table 11*). Besides, in a long-term perspective a further reduction of the share of oil and gas revenues in the budget is expected which will not be compensated by high oil prices. This will occur due to several factors: non-raw material sectors will have an outrunning growth, greenfields subject

¹ Some subjects of the Russian Federation e.g. Tatarstan, Lipetsk and Samara regions announced their intention to set up regional road funds in 2011.

² The road activity is activity for designing, construction, modernization, capital repair and maintenance of the motor roads (according to FZ of November 8, 2007 No 257-FZ “On the motor roads and the road activity in the Russian Federation, and amendments in separate legislative acts of the Russian Federation”).

to tax holidays will increase in number as well as brownfields (exhausted) that also enjoy tax benefits, the ruble currency is expected to strengthen. A development scenario is likely to happen where budget revenues will decrease while GDP will continue growing. According to our estimates, in the near decade oil and gas revenues may fall down by 2% of GDP as a result of the said factors.

Secondly, during the crisis the federal government has assumed many additional expenditure obligations causing expenditure growth from 18.3% in 2008 up to 22.7% in 2010. Though the implementation of the Anti-Crisis Program was quite justified and successful, currently optimization of the budget expenditure structure and reduction of redundant and inefficient areas of the budget finance has become a priority.

Thus, the Law on the Federal Budget for 2011 and for the planning period up to 2013 was developed in a revised context of the budget system, and this context predetermined the tasks: to ensure financial stability of the budget system, to cut down the shortage of the federal budget and to improve efficiency of the budget expenditures. The main parameters of the said Law are given in *Table 11*.

Table 11

Main parameters of the federal budget in 2008–2013 in % of GDP

	Actuals			Budget Law		
	2008	2009	2010	2011	2012	2013
Revenues	22,5	18,9	18,7	17,6	17,0	16,8
<i>including from oil and gas</i>	10,6	7,7	8,6	8,1	7,9	7,5
Expenditures	18,3	24,9	22,7	21,2	20,1	19,7
<i>incl. tentatively approved</i>	–	–	–	–	0,8	1,3
Deficit (–)/Surplus (+)	4,2	–6,0	–4,1	–3,6	–3,1	–2,9
Other than oil and gas deficit	–6,4	–13,7	–12,6	–11,7	–10,9	–10,4

Source: Ministry of Finance of Russia, IEP calculations

As the Table suggests, the federal budget deficit will reduce to 2.9% of GDP in 2013, however this reduction can be less due to a number of assumptions. Primarily, there are more optimistic estimates of the oil prices in the mid-term (when the budget was shaped, a conservative forecast was used with the prices at 75-78 \$/bbl). A high dependency of the budget revenues on oil and gas revenues remains. Besides, a growth of the budget revenues is possible if the macro-economic situation improves in the mid-term and the world economy revives after the crisis, and the demand for goods on the Russian and international markets will increase together with the growth of foreign investments. Finally, a positive trend of reduction of the budget expenditures as a result of the implemented reforms of 2009 – 2010 may be expected.

It is also obvious that with a less favorable development of the economy and a change of the ratio between the basic parameters of the social and economic development (oil prices, GDP volume, inflation rates, the ruble exchange rate) the budget deficit can become so high that new issues may appear challenging the growth of the economy and the stability of the budget system as a whole.

For the near three years, receipts from the indirect taxes, MET and customs duties will remain the main sources of revenue for the federal budget (see *Table 12*). Note, that according to the forecast of the RF Ministry of Finance, in 2013, with comparable volume of the real GDP, the revenues of the federal budget will be by 5.7 pp. of GDP lower than in 2008. According to our estimates, approximately 2.5 pp. of GDP cuts are caused by changes in the tax

legislation (UST is replaced with insurance contributions, and the Profits Tax rate is reduced), 1.0 pp. – caused by reduction of revenues from the oil producing sector (MET and export duty reliefs) and 2.1 pp. – by reduction of revenues from taxes related to a lower (in 2013 vs 2007) level of profitability and changes in the economic activity structure.

During 2012 – 2013, a “pin-point” policy to increase fiscal burden on certain sectors of economy, especially, on the oil and gas sector, will be carried out. Since 2011 the MET rate on gas is expected to increase by 61% - from RUR147 to RUR237 for 1,000 cu. m, in 2012 the rate will be indexed for the expected growth of prices (5.9%) up to RUR251; while in 2013 – by 5.5% up to RUR265/1,000 cu. m. The increase of the fiscal burden on the producing sector the national budget system is going to receive additional RUR50-70 billion every year in 2011 – 2013. (see *Table 12*). As for MET on oil, the MET rate will not change in 2011; however in 2012 it is expected to increase from RUR419 to RUR446 for one ton, and in 2013 - up to RTUR470. This measure will annually bring to the budget about RUR75 and RUR150 billion respectively. However, this measure may negatively affect the sector efficiency.

Abolishment of the reduced rate of the export customs duty on oil produced at the specific fields of East Siberia will ensure a surplus revenue to the federal budget of RUR97 billion in 2011 and about RUR30 billion in the following two years. Besides, last December the increase of the export duty on oil products continued to be discussed. Russia as a member of the Customs Union has reserved this right and can use it as early as in the mid-term period. Two options of the duty increase are considered:

- gradual equation of the duties on light and dark oil products by bringing them to 60% of the duties on crude by 2013;
- increase of the average weighted rate at the external border of the Customs Union.
- If the export duties increase, the government will search for other methods of support of the national “oil refining”, meaning not primary treatment but deep crude conversion.

Regardless of the total increase of the tax burden on producing companies, a gradual reduction of oil and gas revenues (as shares of GDP) is expected caused by objective (lower rates of growth of the Urals prices and taxable exports vs GDP dynamics and ruble strengthening) and sector problems (reduced production volumes and lower profitability rates).

As for revenues other than those from oil and gas, an insignificant growth of the VAT receipts is expected related to the growth of sale volumes at the internal market and receipts from excises caused by the annual increase of the rates on excisable goods (mainly on tobacco and alcohol products) in the coming three years (see *Table 12*).

As for revenues other than from the taxes, their growth is forecasted as a result of setting tasks on dividends generated from the stocks of joint-stock companies being in federal ownership, and a portion of profits of federal unitary enterprises.

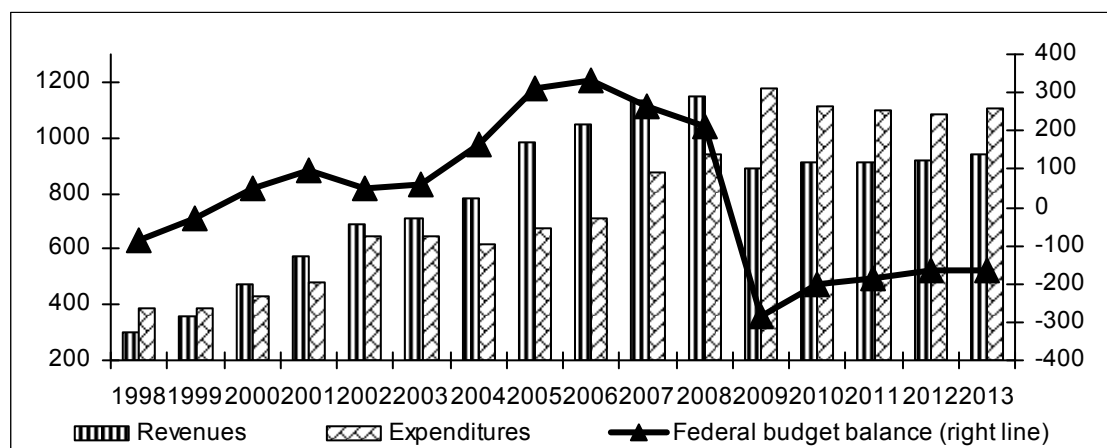
The federal budget expenditures show a tendency for reduction (in % of GDP), but their volumes in constant prices of 1998 and expressed as % of GDP remain at a sufficiently high level that obviously surpass the level reached in the successful 2008 (see *Fig 13*). Besides, in real terms the trend of their reduction will change for the opposite one as early as in 2013.

Table 12

**Actual and expected revenues to the federal budget of the Russian Federation
from the main taxes in 2008–2013 (% of GDP)**

	Actuals				Law on budget	
	2008	2009	2010	2011	2012	2013
Profits Tax	1,8	0,5	0,6	0,5	0,5	0,5
UST/Insurance contributions	1,2	1,3	0,0	0,0	0,0	0,0
VAT– total:	5,2	5,3	5,6	5,6	5,6	5,7
internal production	2,4	3,0	3,0	3,0	3,1	3,1
imports	2,7	2,3	2,6	2,6	2,5	2,6
Excises – total:	0,4	0,3	0,3	0,5	0,6	0,7
internal production	0,3	0,2	0,3	0,5	0,5	0,6
imports	0,1	0,1	0,1	0,1	0,1	0,1
MET	3,9	2,5	3,1	2,8	2,7	2,6
Customs duties – total:	8,4	6,5	6,4	6,7	6,5	6,3
import duties	1,5	1,2	0,8	1,2	1,2	1,2
Export duties	6,9	5,3	5,6	5,5	5,3	5,0
The share of the said taxes and duties in the federal budget revenues in %	93,3	86,5	85,6	92,0	93,4	93,7

Source: Ministry of Finance of Russia, IEP calculations.



Source: Ministry of Finance of Russia, IEP calculations.

Fig. 13. Dynamic trend of the revenues, expenditures and deficit of the federal budget, in RUR billion, and in 1998 constant prices

The growth of expenditures as GDP shares is planned in such sections as “National defense” and “Servicing of the government debt”¹ (see *Table. 13*), while in other sectors the expenditures are going to fall down vs GDP; this can be explained by GDP higher growth rates as compared to the growth rates of expenditures in absolute terms, measures taken to optimize the network of budget institutions, and reduction of the number of implemented federal target programs (43 in 2011 down to 37 in 2012) and the volumes of allocated funds (from RUR 1364.8 billion in 2011 down to RUR1 080.6 – in 2013). The review of the expenditure structure for open federal target programs shows that with a general reduction of the allocations, in 2010 – 2013 an increase in expenditures is observed in “Innovative development and upgrading of economy” only (from RUR436.5 billion in 2010 to RUR 579.3 bln in 2013); this is in full line with the Budget Code provisions.

¹ For the reasons of such growth of expenditures under “Social policy” see above.

Table 13

**Dynamics of the expenditure obligations of the federal budget
in 2010–2013 in % of GDP**

	2008	2009	2010	2011	2012	2013	Variance of 2013 vs2010, in %GDP
Expenditures (without tentatively approved) total	18,3	24,9	22,7	21,2	20,1	19,7	-3,1
<i>including</i>	1,7	1,7	1,6	1,7	1,4	1,2	-0,3
General government issues							
Servicing municipal and federal debts	0,4	0,5	0,4	0,8	0,9	1,0	0,5
National defense	2,5	3,1	2,9	3,0	3,0	3,4	0,5
National security and law enforcement	2,0	2,6	2,4	2,4	2,1	1,9	-0,5
National economy	2,5	4,3	2,7	3,4	3,0	2,5	-0,2
Housing and utilities	0,3	0,4	0,5	0,4	0,2	0,1	-0,4
Protection of natural environment	0,0	0,0	0,0	0,0	0,0	0,0	0,0
Education	0,9	1,1	1,0	1,0	0,9	0,8	-0,2
Culture, cinematography, mass media	0,2	0,3	0,3	0,3	0,3	0,2	-0,1
Health care and sports	0,7	0,9	0,8	1,0	0,9	0,7	0,0
Social policy*	0,7	0,8	0,8	6,0	5,8	5,6	4,9
Inter-budget transfers of general nature *	6,5	9,3	9,3	1,1	0,8	0,7	-8,6
Tentatively approved	-	-	-	-	0,7	1,3	-

* Specifics of re-distribution of funds between these two items relate to the changes of the functional classification of the budget expenditures effected in 2011 (see above).

Source: RF Treasury, IEP calculations.

The growth of expenditures is also prompted by some governance decisions which may be considered as doubtful in terms of the budget policy priorities. Thus, e.g. from 2011, five new federal target programs and three state programs will be financed, and part of these are not included in the priorities of the budget policy as set by President of Russia. Many experts believe, e.g. that the “Clear water” FTP developed under the influence of the Parliament lobby, likewise “Development of the domestic and international tourism” can hardly be described as priorities that require additional financing given the budget deficit; moreover the expenditure share for the new FTP makes almost 20% of the FTP general expenditures for 2011 – 2013.

In 2011–2013 the federal budget expenditures will be cut down in the following sections and areas:

- “Healthcare” - from RUR 375.6 billion in 2011 to RUR 356.1 billion in 2013: at the expense of increasing funds for the implementation of the sector modernization project from the Fund of Compulsory Medical Insurance. The major portion of the allocations from the said Fund will be distributed among regions in the form of grants;
- “Housing and utilities” - in 2012 and 2013 there will be a reduction of the budget allocations for the implementation of the federal target programs and a FAIP part not covered with the programs, including the provision of service and permanent housing to the servicemen (RUR125.9 billion in 2010 to RUR25.3 billion in 2013) in connection with completion of the respective efforts. Besides in 2011 there will be budget allocations to finance subsidies to a state corporation Fund of Assistance to the Housing and Utilities Reform in the form of a property contribution to rehabilitate the Fund property that had been transferred to the ownership of the Russian Federation in 2009 in the amount of RUR15.0 billion; no such actions are planned for 2012 and 2013.

More than double expenditures to service the government debt – from 0.4% of GDP in 2010 to 1.0% in 2013 – require special attention. The growth of the government debt (8.3% of

GDP as of 01.01.2010 up to 18.2% of GDP as of 01.01.2014 – see *Table 14*) may negatively affect the stability of the national fiscal system. At the same time stepping up the government debt will take place primarily through a growing share of internal borrowings (in 2010 – 2013 the internal debt will grow from 5.4% of GDP to 14.3% of GDP, while the external debt will remain within 4% of GDP) which is quite justified in terms of national security and manageability of the debt.

Table 14

Federal debt of the Russian Federation in % of GDP

	Law on budget*								
	2005	2006	2007	2008	2009	2010	2011	2012	2013
Federal government debt (as of the year end)	14,3	9,1	7,2	6,5	8,3	9,4	13,7	16,1	18,2
including:									
internal debt	4,1	4,0	3,9	3,6	5,4	6,6	10,2	12,5	14,3
external debt	10,2	5,1	3,3	2,9	2,9	2,8	3,5	3,6	3,9

*top limit of the federal government debt is shown

Source: RF Treasury, IEP calculations.

The period when the Reserve Fund was a key source of financing deficit of the federal budget ended in 2010, when the Fund allocated RUR1,119.5 billion (2.5% of GDP) for the said purpose. The Reserve Fund allocations have not been spent fully as the expected federal budget deficit was reduced; the non-spent funds as of January 1, 2011 amounted to RUR775.2 billion. (*Table 15*).

Table 15

Dynamic trend of the formation and use of oil and gas funds in 2010, in RUR MM

Indicator	Balances as of the end of 2009 *	Receipts in 2010		Spent in 2010 for:		Balances as of the end of 2010 *
		oil and gas revenues	Assets management receipts	Financing of the federal budget deficit	Financing of the budget deficit of off-budget funds	
Reserve Fund	1830.5 (4.7% of GDP)	–	–	1119.5	24.5	775.2 (1.7% of GDP)
National Welfare Fund	2769.0 (7.1% of GDP)	–	–	–	2.5	2695.5 (6.1% of GDP)
Total	4599.5 (11.8% of GDP)	–	–	1119.5	27.0	3470.7 (7.8% of GDP)

* the balances are recalculated at the exchange rate as of January 1, 2010 and 2011 respectively.

Source: RF Treasury.

In 2010, the RF Government elected not to use the National Welfare Fund, and the Fund balance in absolute terms remained at the 2009 year-end level. The Fund's assets in the amount equal to the population's pension accruals (RUR5.0 – 10.0 billion per year) will continue to be further used in 2011 – 2013 thus ensuring safety of the accumulated assets of the Fund. It is worth noting that given the considerable reduction of spending or full spending of the oil and gas funds' assets, by 2012 the national financial system could be exposed to external shocks having no financial coverage.

To cover the budget deficit, receipts from privatization (RUR298 billion in 2011 up to RUR309.0 billion in 2013) will be actively used.

2.2.5. Prospects of the fiscal policy development

In 2010, the structure of the Russian economy (fuel and energy sectors generate up to 9% of GDP) and the exports oriented at raw materials (2/3 of the exports are produced in the fuel and energy sectors) ensured, through the system of oil and gas revenues, up to 46.5% of the federal budget revenues and 24.6% of the budget revenues of the enlarged government. However, world market prices on fuel and raw materials are highly volatile. The issue of such dependency was partially resolved by establishing in the 2000's a tax system with graduated MET rates and export duties depending on oil prices and Stabilization Fund. When in 2009 the federal budget revenues in real terms decreased by 22%, the Government managed to increase expenditures up by 25% by tapping assets accrued in the Reserve Fund. Nevertheless, according to IEP, tax revenues fluctuate in the range of $\pm 3-4\%$ depending on the external market situation; besides, at various stages of the business cycle an additional fluctuation of the tax revenues can happen within $\pm 2-2,5\%$. In other words, with an average long-term price on oil of 70 \$/bbl, the enlarged government budget can receive about 34% of GDP, but this figure may vary from 28% to 40% of GDP.

With account unpredictable generation of budget revenues from oil and gas, a conservative approach is required to define the level of their spend that would ensure budget stability. The current application of the oil and gas transfer which size is linked to GDP does not limit expenditures to a safe level in terms of the budget balance. To reduce the dependency of the budget revenues on the external economic situation, we should abolish the current procedure of the oil and gas transfer and return to the procedure effective in 2004 – 2007: the procedure was based on the cut-off price, and MET contributions to the Reserve Fund and the export duties were in direct proportion to the excess of the actual tax rate over the rate calculated with account of the average long-term price. In other words, the size of the oil and gas revenues open for use should be limited by a certain threshold oil price kept unchanged during the entire period of budget planning (i.e. three years).

All oil revenues above the established limit should be channeled to oil and gas funds. A budget deficit should be funded from the Reserve Fund only if budget revenues are under-received as a result of the oil price being lower than the oil price estimated in the respective macro-forecast which was used as a basis for estimation of the main parameters of the federal budget.

Such approach can assure budget stability since the threshold level of the budget allocations for spending is fixed as early as the budget planning stage. To use the cut-off price would be reasonable (similar to the price used as a basis for establishment of the Stabilization Fund in 2004 – 2007) for estimation of tax revenues from production and export of oil and gas.

In the context of limitation of government expenditures, efficiency of their spending should be improved. The quality of budget governance can be improved by using a comprehensive approach only that will help to cover the broadest range of the applied regulating tools and to align their application in time. With this in view, in the near future a focus should be placed on resolution of the issues of budget system restructuring, higher transparency of the state procurement system and optimization of certain budget procedures. As a favorable institutional environment evolves in the country, any further development of such governance tools as the result-oriented budget, target program activities, state and private partnership can become an important factor of budget expenditures streamlining and improvement of efficiency of the entire budget process.

2.3. Intergovernmental Fiscal Relations and Subnational Finances

2.3.1. Subnational Budgets in 2010

Basic trends concerning relations between different levels of power are reflected in the structure of revenues and expenditures of the consolidated budget of the Russian Federation. Data on a share of tax revenues and expenditures of the constituent territories of the Russian Federation in the relevant items of the consolidated budget of the Russian Federation is shown in *Table 16*.

Table 16

A share of specific values of the budget of the constituent territories of the Russian Federation in the consolidated budget of the Russian Federation in 1992 – 2010 (%)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Tax revenues	44.2	53.1	53.4	47.6	49.5	53.1	56.6	49.2	43.5	37.4	35.1	39.6	36.1	30.9	31.8	33.9	33.2	36.6	37.2
Tax revenues, net of natural resource charges and customs duties	47.7	61.7	61.4	56.0	55.8	59.5	59.9	53.0	49.0	42.6	40.1	41.9	47.5	49.1	52.0	50.5	53.7	54.8	57.1
Expenditures	34.0	40.3	37.7	43.4	45.4	48.1	54.1	51.9	54.4	54.2	49.3	50.0	50.8	49.5	43.4	48.3	49.2	43.4	43.2

Data Source: The Federal Treasury, the estimates were made by the Gaidar Institute.

The following is worth highlighting in analyzing the data presented in *Table 16*. A share of tax revenues of the constituent territories of the Russian Federation in the consolidated budget decreased considerably from 56.6 to 30.9% over the period between 1998 and 2005. This trend was conditioned by economic situation (growth in prices of energy resources resulted in increase of revenues from customs duties and natural resource charges due to the federal budget), rather than redistribution of sources of revenues between different levels of the budget system. The fact that a share of subnational budgets in tax revenues of the consolidated budget, net of natural resource charges and customs duties, decreased less during the same period, from 59.9% in 1998 to 49.1% in 2005, can be used as evidence. A share of subnational budgets in tax revenues of the consolidated budget of the Russian Federation was reported to increase in the period between 2006 and 2007, because revenues from taxes payable to regional budgets increased faster than tax revenues of the federal budget. In 2008 this share slightly decreased but remained at a much higher level than in 2005. A share of regional budgets in tax revenues of consolidated budget, net of natural resource charges and customs duties, increased visibly in 2008 over the level of 2007.

The economic downturn of 2009 had an effect on the relations under review. A share of tax revenues of the constituent territories of the Russian Federation increased considerably from 33.2 to 36.6% in the relevant revenues of the consolidated budget of the Russian Federation, which was conditioned to a large extent by a slump of federal budget revenues from mineral extraction tax and customs duties. A share of regional budgets, net of natural resource charges and customs duties, increased as well: by 1.1 p.p., from 53.7 to 54.8%, which was conditioned

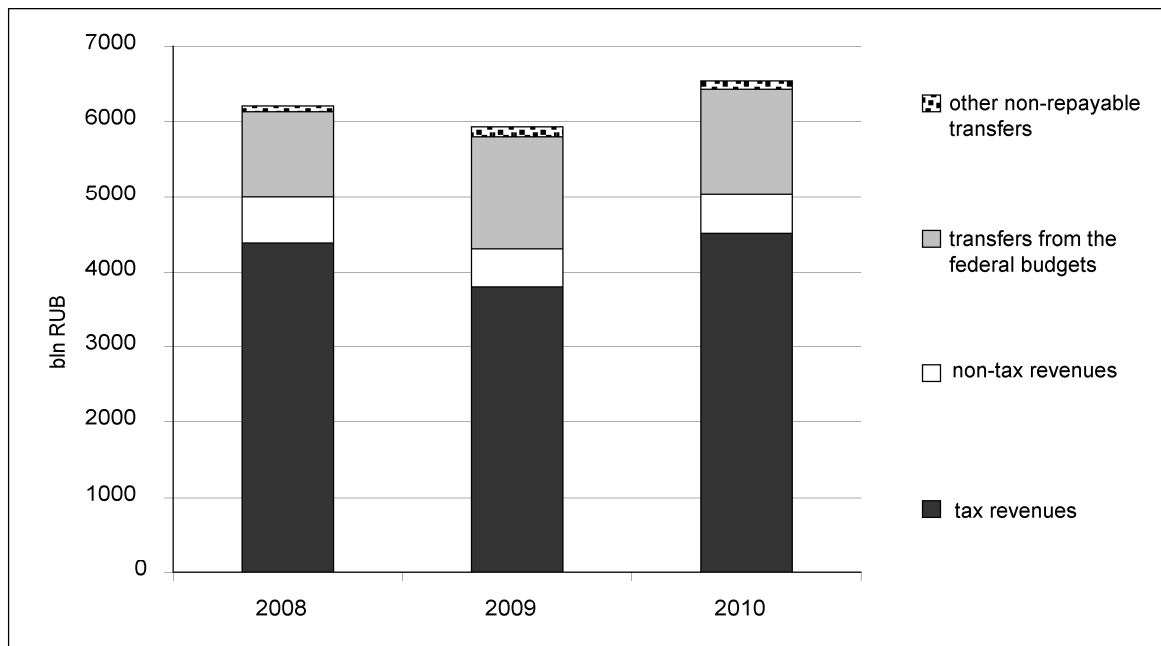
to a large extent by steady revenues from personal income tax paid to regional budgets during the recession (RUB 1666,2 bln in 2008 and RUB 1665,8 bln in 2009). A certain economic recovery was reported in the Russian industries in 2010. According to the data published by Rosstat, GDP increased by 4% in real terms. A share of regional tax revenues in the consolidated budget of the Russian Federation increased from 36.6 to 37.2% due to a faster growth in volumes of taxes payable to subnational budgets. A share of tax revenues, net of natural resource charges and customs duties, increased more by 2.3 p.p., from 54.8 to 57.1%. On the other hand, a share of subnational budgets in revenues of consolidated budget of the Russian Federation decreased considerably from 49.2% in 2008 to 43.4% in 2009, and remained almost the same, 43.2%, in 2010. The foregoing trends was indicative of a marked reduction in the vertical gap in the Russian budget system by aligning shares of tax revenues and revenues of subnational budgets in the consolidated budget of the Russian Federation. It is well to bear in mind that this trend was reported due to a drastic decrease in federal budget revenues in 2009 accompanied by a substantial growth in the federal government expenditures (by 27.4% in nominal terms against the level of 2008) which were covered with accumulated financial reserves.

In light of the recent trends, the Russian expert community's traditional point of view on that the budget system is vertically unbalanced through excessive concentration of tax revenues in the federal budget. The following arguments may cast some doubt on this point of view :

- federal budget revenues include a big share of “natural resource rent” which is extremely unstable and likely to keep reducing as percentage of GDP ;
- the federal budget includes the largest cost-related obligation – financing of the pension system deficit. Ageing of the population will result in growth in expenditures on pension provision and demand for “grants” from the federal budget;
- regional and local budgets include almost all of the taxes, save for “natural resource rent”, namely personal income tax, a “lion’s share” of profit tax (18% of 20%), corporate property tax. Should the country follow the post-industrial (non-primary) scenario, a share of these taxes would be increasing in total revenues of the consolidated budget of the Russian Federation. On the other hand, the federal budget has only one large source of tax revenues, VAT, which would remain relevant under the non-primary sector development model.

Therefore, any substantial tax revenues are unlikely to be allocated to the subnational level.

Let's take a closer look at the situation with revenues of subnational budgets. Dynamics of basic elements of revenues of the consolidated budgets of the constituent territories of the Russian Federation in the period between 2008 and 2010 is presented in *Fig. 14*.



Data Source : The Federal Treasury, the estimates were made by the Gaidar Institute.

Fig. 14. Revenues of the consolidated budget of the constituent territories of the Russian Federation in 2008 – 2010, by component (in nominal terms)

Tax revenues of consolidated budget of the constituent territories of the Russian Federation increased by 19.2% in nominal terms in 2010 against the previous year, their share in overall revenues of regional budgets increased from 64.0 to 69.1%. Tax revenues increased in volume by 9.5% in real terms against the level of 2009 whereas kept decreasing by 12.9% against the level of 2008. One may say that in general tax revenues of regional budgets therefore failed to catch up with the pre-recession values both in volume terms and as percentage of overall revenues of the consolidated budget of the constituent territories of the Russian Federation (this share was 70.7% in 2008). Tax revenues tended to decrease in volumes by 1.8% in nominal terms. As a result, while in 2008 these revenues accounted for 9.8% of the overall revenues of the budget of the constituent territories of the Russian Federation, they decreased to 8.7% in 2009 and 7.7% in 2010. Transfers from the federal budget also decreased in volume to 6.0% in nominal terms against the level of 2009. In spite of a slight reduction, however, volume of transfers remained beyond the level of 2008 in comparable prices (a 4.3% growth in real terms). A similar situation developed with regard to other non-repayable transfers to the consolidated budget of the constituent territories of the Russian Federation: a 14.1% reduction in nominal terms against the level of 2009 and a 32.3% growth in real terms against the level of 2008. It should be noted that most of the other non-repayable transfers from the Fund for the Promotion of the Reform in the Housing and Public Utility Sector. As a result, though a share of non-repayable transfers in revenues of subnational budgets reduced from 27.0% in 2009 to 22.8% in 2010, it kept outstripping the value of 2008 (19.1%). In general, revenues of the consolidated budget of the constituent territories of the Russian Federation increased by 1.4% in real terms in 2010 against the level of 2009 whereas reduced by 10.9% against the level of 2008.

Dynamics of basic tax revenues payable to subnational budgets in the period between 2007 and 2010 are shown in *Table 17*.

Table 17

**Tax revenues inflow to the consolidated budget of the constituent territories
of the Russian Federation in 2007 – 2010, (as % of GDP)**

	2007	2008	2009	2010
Tax revenues, total	10.88	10.63	9.78	10.16
including:				
Corporate profit tax	4.60	4.25	2.76	3.42
Personal income tax	3.81	4.04	4.29	4.02
Excise taxes on goods sold on the territory of the Russian Federation	0.54	0.46	0.63	0.74
Lump-sum taxes	0.37	0.39	0.39	0.40
Property taxes	1.24	1.20	1.47	1.41
Natural resource taxes, dues and regular charges	0.23	0.25	0.19	0.07
<i>For reference: GDP, t RUB</i>	33.25	41.26	38.80	44.49

Data Source : The Federal Treasury, the estimates were made by the Gaidar Institute.

In general, tax revenues of consolidated budgets increased from 9.78% of GDP in 2009 up to 10.16% of GDP in 2010, however, failed to catch up with the level of 2008 (as 10.63% of GDP). Specific types of taxes were multidirectional. Traditionally, there are two taxes which provide basic tax revenues to consolidated regional budgets, namely corporate profit tax and personal income tax, which accounted for about 73% of the total tax revenues in 2010, slightly outstripping the level of 2009 (72%) but being far behind the level of 2008 (78%). The main reason is that though profit tax revenues increased by 0.66 p.p. of GDP to reach 3.42% of GDP, it was markedly below the revenues of 2008 (4.25% of GDP). It should be taken into account, however, that regional rate of this tax raised from 19.5 to 20% from January 1, 2009. Therefore, though a certain recovery in the Russian economy in 2010 resulted in growth in profit tax revenues, the revenues remained far from the pre-recession values as percentage of GDP. Another key tax – personal income tax – showed different dynamics. As reported in the previous review¹, personal income tax was found to be one of the most stable types of tax revenues in consolidated regional revenues amidst the economic downturn. In 2010, personal income tax almost caught up with the level of 2008 as percentage of GDP (as 4.02 and 4.04% of GDP, respectively). The decrease of personal income tax against the level of 2009 can be explained by the fact that it slumped as percentage of GDP in 2009 amidst the economic downturn and increased in the period of recovery of the Russian economy in 2010. The following may be highlighted by examining the dynamics of other tax revenues of the consolidated budget of the constituent territories of the Russian Federation. Excise tax revenues grew steadily as percentage of GDP in the period between 2009 and 2010, mostly because a part of excise tax revenues was transferred from the federal budget to regional budgets in 2009 and excise tax rates increased in 2010. A share of taxes payable by SMEs (lump-sum tax) remained unchanged over the period under review, accounting for 0.4% of GDP in 2010. Property tax revenues, which increased visibly from 1.20 to 1.47% of GDP in 2009, slightly decreased down to 1.41% of GDP in 2010. Nevertheless, the revenues were visibly beyond the value of 2008. The role of mineral extraction tax and other natural resource charges in regional budget revenues decreased in the period between 2009 and 2010. Mineral extraction tax revenues decreased considerably in 2010, which was

¹ The Russian Economy in 2009. Trends and Outlooks., M. IET, 2010

connected mostly with centralization of mineral extraction tax revenues as hydrocarbon material in the federal budget¹.

Dynamics of tax revenues in the consolidated budget of the constituent territories of the Russian Federation have been considered in general above. However, analysis by region is also of interest, because the constituent territories of the Russian Federation differed in recession severity and degree of economic recovery. It should be noted that differentiation of tax revenues in regional budget revenues decreased in 2009 and then increased again in 2010. The relevant coefficient of variation of per capita tax revenues given the budget expenditures index was 87.2% in 2008 and 75.0% in 2009, but increased up to 91.3% in 2010, thus outstripping the level of 2008. Such a dynamics were to a large extent linked with the following aspects. As already noted in the previous review, it was the economically developed regions that were hit most by the economic recession, which resulted in some decrease in interregional differentiation. Late in 2009 the Russian economy began to recover but the constituent territories of the Russian Federation differed largely in degree of recovery and, consequently, growth rates of tax revenues, which resulted in increase of differentiation of per capita tax revenues. To better understand the situation with tax revenues by constituent territory, let's take a look at a breakdown of Russian regions in terms of changes in per capita tax revenues in the period between 2009 and 2010 (see *Table 18*).

Table 18

**A breakdown of the Russian regions in terms of changes in tax revenues
of the consolidated budget of a constituent territory of the Russian Federation**

Number regions in which tax revenues	In nominal terms		In real terms	
	in 2009 against the level of 2008	in 2010 against the level of 2009	in 2010 against the level of 2008	in 2010 against the level of 2008
Increased by more than 25%	3	23	25	3
Increased by 10 to 25%	9	52	30	13
Increased by less than 10%	18	4	13	29
Decreased by less than 10%	28	1	10	14
Decreased by 10 to 25%	18	2	3	21
Decreased by more than 25%	6	0	1	2

Data Source : The Federal Treasury, the estimates were made by the Gaidar Institute.

As may be seen from the presented data, a share of tax revenues in consolidated regional revenues decreased in nominal terms in 52 of 82² constituent territories of the Russian Federation amidst the economic downturn in 2009. Exactly the converse situation was observed in 2010, when the Russian economy began to recover: tax revenues in 79 regions increased in nominal terms against the level of 2009. However, since tax revenues decreased at more than a half of the constituent territories in 2009, it was the base effect that had a serious impact on growth figures in 2010. Of special interest, therefore, is comparing volumes of tax revenues

¹ The regulation for crediting the mineral extraction tax revenues as hydrocarbon material (save for the flammable natural gas) to the federal budget was increased from 95 to 100% from January 1, 2010 (The Federal Law dd. September 22, 2009, No. 218-FZ "On the Amendments to Certain Legislative Acts of the Russian Federation and Annulment of Certain Provisions of the Legal Entities of the Russian Federation").

² The Archangelsk Region and the Nenets Autonomous District are regarded as a single constituent territory of the Russian Federation.

with the level of 2008 in both nominal and real terms in order to assess how the situation with regional budget revenues is improved in 2010. Tax revenues increased in nominal terms against the level of 2008 at 68 regions and by more than 10% at 55 constituent territories of the Russian Federation. However, after allowing for inflation in the period between 2009 and 2010, the picture would change substantially. Tax revenues increased in real terms in 2010 against the level of 2008 at 45 regions, accounting for a bit more than a half of the total. Therefore, almost 50% of the constituent territories of the Russian Federation were facing problems with tax revenues inflow in their budgets, of which 16 constituent territories experienced a 10% decrease in tax revenues, at 2008 values, against 2008. The following constituent territories of the Russian Federation experienced most a negative decrease in real terms in 2010 against the level of 2008: the Tyumen Region (– 42.7%), the Vologda Region (– 33.3%), Moscow (– 24.8%), the Perm Territory (– 24.3%), the Kemerovo Region (– 23.3%), the Lipetsk Region (– 22.5%) and the Khanty-Mansi Autonomous Area (– 18.9%). Hence, in 2010, tax revenues decreased in real terms against the level of 2008 mostly at the high-fiscal-capacity economically developed constituent territories of the Russian Federation, which reinforces the foregoing opinion on that these regions were hit most by the economic downturn.

Let's consider the changes which took place in consolidated budget revenues of the constituent territories of the Russian Federation. In 2009, overall expenditures of the consolidated budget of the constituent territories of the Russian Federation remained at the level of 2008 (RUB 6,256.3 bln and RUB 6,253.5 bln, respectively). In 2010 regional expenditures increased by 6.1% in nominal terms against the level of 2008–2009 whereas decreased by 2.5% in real terms against the level of 2009 and by 10.3% against the level of 2008. The structure of expenditures of the consolidated budget of the constituent territories of the Russian Federation was changed as well (see *Table 19*).

Table 19

Structure of expenditures of the consolidated budget of the constituent territories of the Russian Federation in 2008 – 2010, (%)

	2008	2009	2010
Nationwide issues	7.1	7.3	7.3
<i>Including state and municipal debt servicing</i>	0.6	1.0	1.1
National defense	0.0	0.0	0.0
National security and law enforcement	4.1	3.9	3.8
National economy	19.6	18.1	16.6
Housing and public utility sector	16.3	13.7	12.6
Environmental protection	0.3	0.3	0.2
Education	20.8	21.5	21.9
Culture, cinematography and mass media	3.5	3.4	3.4
Healthcare and sports	12.7	12.1	12.0
Social policy	12.2	15.3	17.6
Intergovernmental fiscal transfers	3.3	4.4	4.5

Data Source : The Federal Treasury, the estimates were made by the Gaidar Institute.

The following can be highlighted by examining changes in major subsections of regional budgets. In general, the trends which emerged as early as the pre-recession year of 2009, continued in 2010. Expenditures under “national economy” and “housing and public utility sector” kept decreasing to reach 16.6% and 12.6% (against 18.1% and 13.7% in 2009), respectively, whereas expenditures on social policy increased even more to account for 17.6% of the overall expenditures in 2010 (against 15.3% in 2009). Expenditures under “education” as well as “healthcare and sports” changed insignificantly in 2010: the former kept increasing

gradually to reach 21.9% in 2010, whereas the latter kept decreasing gradually down to 12.0%. A slight decrease in expenditures under “healthcare” was also related to increase in transfers from regional budgets to territorial funds of compulsory medical insurance. As a result, in 2010 a cumulative percentage of sections “healthcare and sports” and “intergovernmental fiscal transfers” remained at the level of 2009 (16.5%). Expenditures under “nation-wide issues” also remained at the level of 2009 (7.3%), and expenditures on servicing public and municipal debt increased insignificantly from 1.0 to 1.1% of the total regional expenditures.

With the regard to expenditures under “national economy”, it is important to consider dynamics of both the entire section and subsections, because this type of expenditures is heterogeneous as opposed to most of the other expenditure sections. Examining the dynamics for certain major subsections under “national economy” in 2010, we see once again that the trends of 2009 continued developing. Expenditures allocated to support the agricultural industry continued to grow to account for 3.4% of the overall expenditures (3.1% in 2009), whereas expenditures under “road facilities” and “other national economy issues” decreased even more to 5.5% and 2.8% (against 6.0% and 3.9% in 2009), respectively.

Overall deficit of the consolidated budget of the constituent territories of the Russian Federation remained unchanged in 2010, but its scope decreased to 1.5% of the total expenditures, which was much less than in 2009 (5.3%). Examining the value of budget deficit by constituent territory, it should be noted that only 20 of 82 regions had a surplus of the consolidated regional budget at 2010 year-end. As a result, the need for borrowings remained at the subnational level. In addition, it should be noted that the need for borrowings could arise from the need for refinancing of the existing debt. Data on volumes of the public debt owed by the constituent territories of the Russian Federation in the period between 2007 and 2010 and municipal debt in 2010 is shown in *Table 20*.

Table 20

**Volumes of public debt owed by the constituent territories of the Russian Federation
in 2007 – 2010 and municipal debt in 2010 (bln RUB)**

	Debt size, bln RUB				
	as of January 1, 2008	as of January 1, 2009	as of January 1, 2010	as of July 1, 2010	as of January 1, 2011
All constituent territories of the Russian Federation	456,9	599,6	889,6	934,5	1096,0
<i>incl.:</i>					
<i>Moscow</i>	89,3	121,5	243,1	264	299,3
<i>Moscow Region</i>	92,1	156,1	163,7	151,2	146,8
Constituent territories of the Russian Federation (net of Moscow and the Moscow Region)	275,4	322	482,8	519,3	649,9
Municipalities	n/a	n/a	134,9	143,6	169,8

Data Source : Ministry of Finance of Russia, the estimates were made by the Gaidar Institute.

The data on changes in volumes of the public debt owed by the constituent territories of the Russian Federation in 2009 (an increase by RUB 290,0 bln) and in 2010 (an increase by RUB 206,4 bln) shows a slight decrease in borrowings in 2010. It is, however, the substantial decrease in growth rates of borrowings and loans in Moscow as well as of public debt in the Moscow Region in 2010, that was most responsible for the said decrease. The two above mentioned regions accounted for more than 45% of the total amount of public debt owed by

the constituent territories of the Russian Federation as of January 1, 2010. The picture would be different if we examine dynamics of volumes of the regional debt, net of Moscow and the Moscow Region. Volumes of public debt of the other constituent territories of the Russian Federation increased by RUB 167,1 bln by the end of 2010 against the level of the beginning of the year, and were a bit less (RUB 160,8 bln) in 2009. More than 78% of growth in volumes of the public debt were reported in H2 2010. It is noteworthy that balances of repaid federal loans totaled RUB 127,2 bln in 2010 for the regions (net of Moscow and the Moscow Region). By comparing the data, we can see that most of the borrowings were obtained as federal budget loans (see the next paragraph for details on federal financial assistance). In 2010, debts grew both at the regional and municipal levels. Municipal debts increased from RUB 134,9 bln as of January 1, 2010 to RUB 169,8 bln as of January 1, 2011.

To summarize, the following can be highlighted. The situation with execution of subnational budgets improved visibly in 2010. Tax revenues in the consolidated budget of the constituent territories of the Russian Federation increased in volume. However, many parameters, which describe the situation with subnational finances, were found to be much lower than the pre-recession values. Most of the Russian regions still had a deficit-ridden budget, which gave rise to the need for extra borrowings. Federal financial aid, including budget loans, kept playing an important role, like in 2009, in the provision of financial stability at the subnational level.

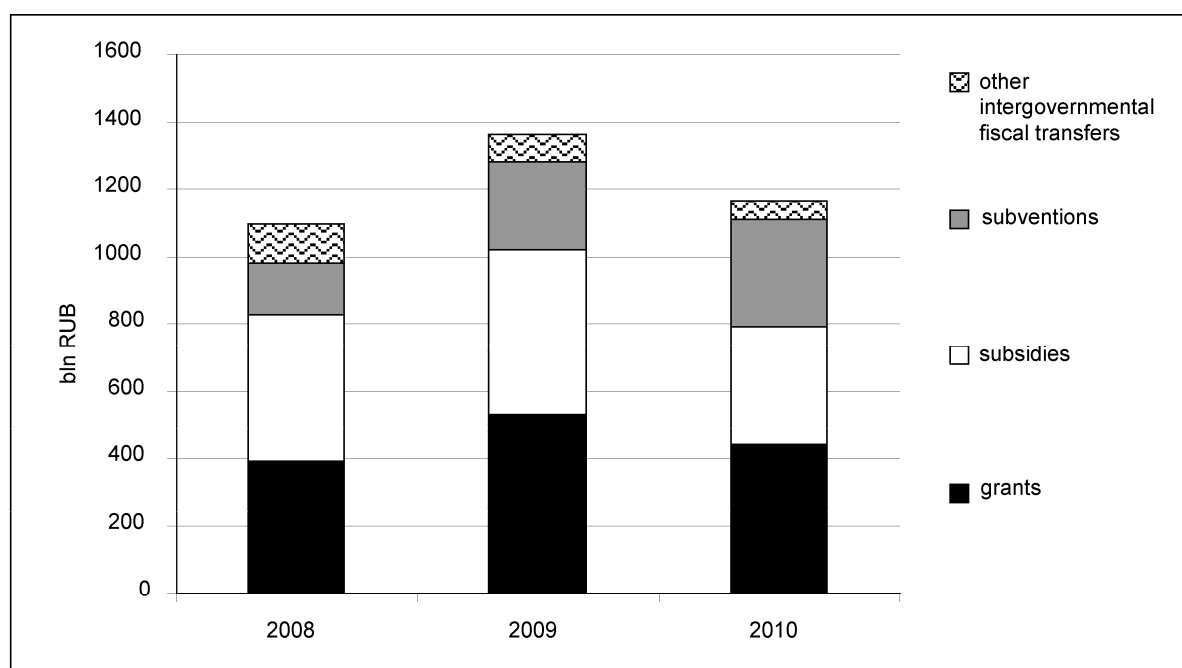
2.3.2. Financial Support from the Federal Budget

In general, the volume of funds (budget loan balances) allocated from the federal budget to the budget of the constituent territories of the Russian Federation decreased by 4.1% in nominal terms in 2010. A total volume of federal transfers decreased by 6.9% from RUB 1,480.4 bln to RUB 1,378.3 bln, whereas balances of obtained and repaid budget loans increased by 28.9% from RUB 127,5 bln to RUB 164,4 bln. It should be noted that the volume of federal budget loans allocated in 2010 to the regions remained at the level of 2009 (RUB 169,8 bln and RUB 170,0 bln, respectively). The balances increased considerably as a result of considerable decrease from RUB 43,2 bln in 2009 to RUB 5,4 bln in volumes of repaid budget loans by the regions in 2010, which may be connected with increase in the number of federal budget loans issued for a period of more than one year.

Let's examine dynamics of certain types of federal transfers (see *Fig. 15*).

All types of transfers, save for subventions, which increased in nominal terms by 33.1%, decreased in 2010 against 2009. Other intergovernmental fiscal transfers decreased by 25.2% and subsidies by 22.4% decreased most against the level of 2009. Grants also decreased in volumes by 9.6%. However, if we compare the amounts of transfers to the regions with the amounts transferred in 2008, the picture would be slightly different. In general, total volume of transfers (at 2008 values) increased by 6.4% in 2010 against 2008. On the other hand, other intergovernmental fiscal transfers substantially decreased in real terms by 51.9% and subsidies by 20.3% against the level of 2008. At the same time, subventions in 2010 (at 2008 values) more than doubled subventions in 2008 (a 108.8% growth in real terms). In addition, in 2010 grants increased in real terms by 13.1% against the level of 2008.

The foregoing dynamics resulted in specific changes in the structure of transfers in the period between 2009 and 2010 (see *Table 21*).



Data Source : The Federal Treasury, the estimates were made by the Gaidar Institute.

Fig. 15. Transfers to the regions from the federal budget in 2008 – 2010 (at 2008 values).

Table 21

**Transfers to the Russian regions from the federal budget
in 2008 – 2010, in nominal terms**

	2008		2009		2010	
	mln RUB	as % of total	mln RUB	as % of total	mln RUB	as % of total
Transfer by region, total	1,094,680	100.0	1,480,385	100.0	1,378,337	100.0
Grants	390,398	35.7	578,277	39.1	522,685	37.9
including:						
fiscal capacity equalization transfers	328,648	30.0	375,485	25.4	396,996	28.8
grants on the provision of support to fiscal equalization	46,035	4.2	191,886	13.0	105,955	7.7
Subsidies	435,867	39.8	530,073	35.8	411,439	29.9
including:						
subsidies on road facilities	101,799	9.3	104,304	7.0	61,437	4.5
subsidies on agriculture	73,593	6.7	90,641	6.1	87,930	6.4
Subventions	153,170	14.0	284,440	19.2	378,650	27.5
including:						
subventions on exercise of powers for promotion of employment	37,413	3.4	77,414	5.2	87,090	6.3
subventions on the provision of housing to veterans of WWII	0	0.0	45,825	3.1	116,851	8.5
Other intergovernmental fiscal transfers	115,245	10.5	87,595	5.9	65,562	4.8

Data Source: The Federal Treasury, the estimates were made by the Gaidar Institute.

As shown in the Table, grants decreased in volumes in 2010 in nominal terms against the level of 2009 mostly due to a reduction from RUB 191,9 bln to RUB 105,9 bln in the amount of grants on the provision of support to fiscal equalization. As a result, a share of grants on fiscal equalization decreased in the total amounts of transfers from 13.0 to 7.7%, whereas a share of fiscal capacity equalization transfers increased from 25.4 to 28.8%. In general, these

changes should be regarded as positive ones, because fiscal capacity equalization transfers are allocated by using the most transparent method based on impartial factors. It is important to emphasize that decrease in volumes of grants on fiscal equalization was accompanied by a substantial growth in balances of budget loans. In general, however, the amount of grants fiscal equalization and balances of budget loans decreased by 15.4% in nominal terms from RUB 319,4 bln in 2009 to RUB 270,3 bln in 2010. The decrease reflects the above mentioned ease of tensions in subnational finances in 2010 against 2009.

A share of subventions increased considerably in the total amount of transfers in the period between 2009 and 2010, from 14.0% in 2008 to 27.5% in 2010. Growth in volumes of subventions was conditioned mostly by a consistent increase in subventions on exercise of powers for promotion of employment due to escalating tensions in the labor market, and a subvention on the provision of housing to veterans of WWII on the occasion of the V-Day 65th Anniversary¹ which was introduced in 2009. It is the latter type of subventions that was responsible for most of the growth in subventions in 2010: the subvention on the provision of housing to veterans of WWII increased from RUB 45,8 bln to RUB 116,9 bln, accounting for more than 30% of the total subventions in 2010. Furthermore, it should be noted that in 2010 housing utility subventions for specific categories of individuals increased by 17.8% from 84.8 to RUB 99,9 bln.

A share of subsidies in the total amount of transfers gradually decreased in the period between 2009 and 2010, from 39.8% in 2008 to 35.8% in 2009, to 29.9% in 2010. A visible reduction in cofinancing from the federal budget as part of federal special-purpose programs and budget investments which were not included into federal special-purpose programs, was most responsible for substantial reduction in the amounts of subsidies in 2010. In general, the reduction accounted for about 35% against the level of 2009. Furthermore, subsidies to the Federal Road Agency were reduced from RUB 104,3 bln in 2009 to RUB 61,4 bln in 2010. As a result, a share of these subsidies decreased from 7.0 to 4.5% in the total amount of transfers. Subsidies on agriculture decreased too, but not that much, by 3% against the level of 2009. Nevertheless, a share of these subsidies increased from 6.1 to 6.4% against a much bigger decline in the total amount of transfers. In addition, it should be noted that a series of federal budget subsidies were discontinued in 2010, of which most relevant were :

- 1) subsidies on the provision of individuals with rent and utility subsidies (RUB 11,7 bln in 2009) ;
- 2) subsidies on compensation for a part of payment which parents pay for maintenance of their kids at public and municipal educational institutions operating under the basic pre-school general education curriculum (RUB 8,2 bln in 2009) ;
- 3) subsidies on public support to introduction of integrated modernization of education (RUB 5,3 bln in 2009) ;
- 4) subsidies on training of labor force and specialists for high-tech enterprises, which includes purchase of modern training-laboratory and training-production equipment (RUB 1,9 bln in 2009).

In addition, it is noteworthy that subsidies on purchase of motor and municipal vehicles decreased by nearly 50%, from RUB 19,7 bln in 2009 to RUB 9,96 bln in 2010. It should be noted, however, that a subsidy of RUB 1,02 bln on purchase of school buses manufactured on

¹ Pursuant to the Order of the President of the Russian Federation dd. May 7, 2008, No. 714 “On the Provision of Housing to Veterans of WWII, 1941–1945”.

the territory of the Russian Federation for general educational institutions was introduced at the same time in 2010.

In spite of decline in the total amount of subsidies in 2010, cofinancing was increased for specific subsidies, including the following major subsidies :

- 1) subsidies on additional measures aimed at easing tensions in the labor market of the constituent territories of the Russian Federation (by RUB 2,9 bln or 8.2%) ;
- 2) a subsidy to the budget of the Krasnodar Territory on measures aimed at developing the infrastructure at the city of Sochi (by RUB 9,3 bln or more than 4 times) ;
- 3) subsidies on medical rehabilitation of children (by RUB 2,8 bln or more than 3 times against the level of 2009).

In general, referring to the basic parameters of transfers from the federal budget in 2010, the following can be highlighted. The trends of 2009 continued in 2010, namely increase in a share of subventions and decrease in a share of subsidies and other intergovernmental fiscal transfers in the total amount of transfers from the federal budget. Though the total volume of grants on fiscal equalization and budget loans increased in 2010, it exceeded considerably the level of 2008, which was to a large extent due to certain sustained tensions regarding the execution of the consolidated budget of the constituent territories of the Russian Federation. Increase in a share of fiscal capacity equalization transfers in the total amount of transfers from the federal budget became a positive trend in 2010.

2.3.3. Federal Law “On the Federal Budget for 2011 and Planning Period of 2012 and 2013” as Related to Allocation of Intergovernmental Fiscal Transfers to Other Budget System Levels

A total of about RUB 1,252.4 bln was scheduled for allocation to regional and local budgets in 2011, which is 9.1% less in nominal terms than in 2010. Overall federal budget expenditures are expected to increase by 5.4%. A share of intergovernmental fiscal transfers to other levels of the budget system will eventually decrease from 13.6 to 11.7% in the federal budget expenditures against 2010.

The **grants** scheduled for allocation from the federal budget in 2011 will total RUB 523,3 bln, which is almost equal to the level of 2010 (RUB 522,7 bln). In 2011, the main channel of financial aid to regional government authorities – fiscal capacity equalization transfers from **the Fund for Financial Support of the Regions (FFSR)** – is expected to be maintained at the level of 2010 (RUB 397 bln). It should be noted that the 2010 upward trend in a share of the FFSR in total amount of transfers from the federal budget is expected to continue in 2011. Under the Federal Law “On the Federal Budget for 2011–2013”, a share of fiscal capacity equalization transfers must increase from 28.8% in 2010 to 31.7% in 2011. It should be emphasized, however, that the scheduled increase in a share of the FFSR is to be reached by reducing the total amount of transfers and maintaining the volume of fiscal capacity equalization transfers at the level of 2010. Given that the Fund accounted for 73% of the intergovernmental fiscal transfers in 1999, and fiscal capacity of the Russian regions became more unbalanced since 1999, the scheduled volumes of grants from the FFSR in 2011 – 2013 seem to be insufficient if maintained at the level of 2010 (i.e. without any indexation whatsoever within three years).

Since 2005 **the Compensation Fund (CF)** has been accumulating funds to finance all of the existing in the legislation federal expenditure mandates established in an explicit form, which are financed through subventions to subnational budgets. The Federal Law “On the Federal Budget for 2011 and for the Period till 2013” provides for a material decrease in the

volume of subventions from RUB 378,7 bln in 2010 to 246,2 in 2011 or by 35% in nominal terms. Such a substantial reduction in the amount of subventions was conditioned primarily by completion of the program on the provision of housing to veterans of WWII which was financed with federal budget subventions of RUB 116,9 bln or about 30% of the total volume of subventions in 2010.

With regard to **subsidies**, the Federal Law “On the Federal Budget” provides for an increase of RUB 24,5 bln in relevant allocations to total RUB 435,9 bln in 2011 (by 5.9% in nominal terms against 2010). As a result, a share of subsidies will be increased in 2011 from 29.9% in 2010 to 34.8% in the total volume of intergovernmental fiscal transfers allocated to lower levels of power. Following are the main targets of cofinancing of regional and municipal expenditures in 2011:

- government-sponsored program on the development of the agricultural industry and regulation of agricultural markets, raw material markets and food markets for 2008–2012 (22.8% of the total subsidies);
- motor road (highway) building and modernization (12.8%)¹;
- additional measures aimed at easing the tensions in the labor market of the constituent territories of the Russian Federation (6.4%);
- financing supplementary medical aid from district primary care doctors and pediatricians, general practice doctors (family doctors) (5.0%).

It should be noted that while cofinancing expenditures on federal support of the agricultural industry remained one of the federal top priorities in the period between 2009 and 2010 (in 2008–2009 a share of relevant allocations accounted for about 17% in the total volume of subsidies, and increased up to 21% in 2010), **subsidies on road facilities** were substantially reduced at the onset of the economic recession (the relevant allocations in 2009 were reduced by 32.6% against the initial version of the Federal Law “On the Federal Budget for 2009”). As a result, a share of subsidies on road facilities reduced in total subsidies from 23.4% in 2008 to 19.6% in 2009 and 14.8% in 2010. These subsidies are scheduled for further reduction to eventually account for 12.8% of the total subsidies in 2011. It should be noted that the volume of federal budget subsidies on road facilities is to be reduced together with creation of a federal road fund and regional road funds. Relevant amendments have not yet been made to the federal legislation to date.

In addition, it should be noted that efficiency of **subsidies as part of the government-sponsored program on promotion of the development of the agricultural industry** and regulation of agricultural markets, raw material markets and food markets for 2008–2012 gives rise to a serious doubt. Delegation of powers to support agricultural production at the regional level may result in better support to the regions which can afford such a policy rather than those which have favorable climatic and natural conditions. This trend may be strengthened through allocation of federal budget funds in support of the agricultural industry based on the principle of cofinancing. To be more exact, more financially stable regions may benefit from such a support in their “trade wars” for agricultural markets with less financially stable regions.

In 2011, substantial volumes of funds will be allocated to implement measures aimed at easing the tensions in the labor market of the constituent territories of the Russian Federation (RUB 27,8 bln), as well as promoting the development of SMEs (RUB 16 bln). It must be

¹ These subsidies include relevant expenditures as part of federal special-purpose programs.

borne in mind, however, that it is the authorities of a constituent territory of the Russian Federation that are responsible for efficient utilization of the funds.

2.4. Possible scenarios of social and economic development of the Russian Federation in 2011–2013

The following factors will determine main macro-economic parameters of the development of the Russian economy in 2011 – 2013: the situation in the world economy, the status of the internal institutional environment and business climate, the budget policy of the RF Government and the monetary policy of the Bank of Russia. In this section we focus on the analysis of the external development factors (the world economy) and the budget (general parameters of the budget and the national debt) and monetary policy.

In the world economy perspective, the main factors and sources of economic growth of Russia are: the level of prices and physical scope of demand for basic raw materials of the Russian export on the world market (oil and other raw materials), the access to capital on the world financial market for Russian borrowers, growth rates of the world economy and demand for non-raw materials exported from Russia.

Risks and restrictions of the economic growth in Russia are determined by the lengthy recovery of the leading world economies from the crisis, suspended expansion of the physical demand for raw and non-raw materials of the Russian export, a faster growth rate of new emerging markets and enhancement of competition between the BRICS countries on the world capital market; all these can reduce the access to capital for Russian companies and minimize opportunities for expansion of the Russia's internal market; this, in turn, makes impossible for Russia to develop with a focus on the internal market only (as China and India), without being involved in the global economy, and may cause emergence of new centers of recession on the developing and developed markets.

Should the world economy demonstrate successful development, the leading economies might overcome the crisis of 2007–2009 by 2012, and in 2013 the growth rates of the world economy can reach 4.0-4.5%.

The main conditions for implementation of this scenario are:

A responsible and tough policy of the leading world countries to cut their budget deficits and to carry out a coordinated monetary policy. However, in the mid-term, the leading countries will come out of the crisis and develop in the environment of an extremely high debt burden on their national budgets; this means they will have to reduce expenditures for their social programs and maintain internal demand; also they may face new challenges in their economies. The higher debt load and the growth of pension costs may become a long-term problem for the world economies to sustain their economic growth.

Reaching agreements within G8 and G20 regarding new requirements to the global financial market, improvement of quality of regulation of financial institutions, formation of a new system of setting and supporting exchange rates of the key world currencies and, possibly, transformation of the “reserve” notion towards more flexible and broader currency portfolio and other financial assets.

Resolution of the issue of global macroeconomic imbalances on the principles of mutual benefits, consideration of interests of all parties concerned and objective economic conditions and competitive advantages; removal of non-market restrictions on capital reallocation, and adherence to non-discriminative terms in the international trade.

We believe, in such context the world oil prices will remain almost unchanged in terms of constant prices or will have a slight positive trend. The developments of the Arabic countries early 2011 may have a short-term uplifting effect, and by the mid of the next year the “Arabic factor” will cease to play an important role in the setting prices on the world oil market.

There is an alternative scenario associated with pessimistic developments in the world and in the Russian economy, as a consequence. The main assumption underpinning this scenario is possible implementation of the mentioned risks and emergence of a new crisis in the world economy. The assumptions include:

1. Mistakes made by the developed economies at the stage of recovery, the absence of co-ordination of actions, inability of the governments to lever a further step up of the budget deficit, etc.

2. Low efficiency of the fiscal incentives in China: with account of stagnating external demand, this can lead to a sharper slowdown of the development of the Chinese economy with possible negative social and political implications, and to a decline of the aggregated demand for raw materials on the world market.

3. Development of significant, for the financial world, local or regional crisis on the developing markets, and/or a “traditional” crisis (as in the 1990’s) in the developing countries.

Regardless of specific reasons and the time of a new recession, if this scenario is realized, it would reduce average annual growth rates of the world economy in 2011 – 2013 (down to 3% - 4%). .

For Russia, the development of this scenario would mean high volatility of prices on raw materials, lower volumes of exported raw materials and an extremely limited access to the world market. Note that in terms of the ratio of the leading world currencies, this scenario may demonstrate the highest degree of uncertainty since one of the possible conditions for its implementation is a crisis of a reserve currency in one of the issuing countries.

The budget policy of the RF Government affects the prospects of the economic growth by the following channels:

shaping expectations of economic agents (a degree of a long-term budget balance under various levels of oil prices, the size and ways to finance the Pension Fund deficit, etc.); formation of the macro-economic environment (affecting the interest rate, inflation rate, etc.);

meeting budget social obligations;

implementation of most important strategic infrastructure projects. .

Let us review three possible cases of the social and political development of the Russian Federation in 2011 – 2013:

1. Base case

2. Optimistic case

3. Budget expansion case.

The base case in a number of its parameters corresponds to an innovation case (Inn2 option) of the project “Main scenario terms and main parameters of the long-term forecast of the social and economic development of the Russian Federation for the period up to 2030” developed by the Ministry for Economic Development of Russia. In particular, the nominal price on Urals is gradually increasing from 81 \$/bbl in 2011 to 84 \$/bbl in 2013, the USD/Euro exchange rate is fixed at 1.3 USD/Euro. However, unlike in the “Main scenario terms....” we suppose that the capital inflow into Russia under this scenario will not exceed 3% of GDP (equal to \$45 billion in 2010) and the world economy growth rates will make up to 4.5% per year, as said before.

We believe that under this scenario, the federal expenditures in 2011 – 2013 will not exceed 19-20% of GDP; this is in line with Federal Law “On the federal budget for 2011 and the planning period of 2012 and 2013”.

Under this scenario, the federal budget deficit is financed by the state market borrowings (the funds of the RF Reserve Fund will be exhausted in 2011 while the funds of the National Wealth Fund (NWF) will not be used for this purpose). We do not review an option to finance the federal budget deficit by the state property privatization proceeds since the terms and possible scope of proceeds from privatization cannot be assessed with a sufficient accuracy.

In the optimistic case, the Urals price is expected to be at 100 \$/bbl in 2011 prices for the entire period and corresponds to 104 \$/bbl in 2013 (the dollar devaluation rate is 2% per year). We assume here that the world economy growth rate can be as high as 5% per year while the capital inflow into Russia can reach 3.5% of GDP (corresponds to \$50 billion in 2010). In 2011-2013, the federal budget expenditures are in line with the base case in nominal terms.

The budget expansion case is an option with additional federal budget expenditures related to possible adoption, in the pre-election period of 2011 – 2012, of new budget obligations, the beginning of full scale implementation of the announced State Program of weaponry procurement, the increase of monetary allowance of the servicemen, additional expenditures for the reform of the Ministry of Interior Forces, the increase of finances for the current federal target programs, etc. According to our estimates, the additional budget expenditures may reach 4-5% of GDP. In this case we also assume that the RF Central Bank will ensure, in spite of monetization of the federal budget deficit, a gradual decline of the growth rates of monetary supply at the expense of raising rates for deposits of commercial banks in the Bank of Russia and rates for reverse repo transactions and reserve requirements, etc.

A forecast of dynamic trend of the macroeconomic and financial variables and the indicators of the Russia’s federal budget has been developed based on the structural econometric model of the Institute of Economic Policy named after E. T. Gaidar. The model presents a system of regression equations and identical equations describing dynamics of the main indicators of the social and economic development of Russia.

The calculation results of the main macroeconomic and financial indicators for the reviewed cases are shown in *Tables 22–24*.

Table 22

Base case					
	2010	2011	2012	2013	
1	2	3	4	5	
Oil prices (Urals, in \$/bbl)	78,2	81,0	83,0	84,0	
Real GDP growth rate, %	4,00	2,80	2,90	2,90	
GDP in nominal terms (RUR Billion)	44491	50183	55702	60928	
GDP (\$MM)	1465	1707	1934	2101	
Investment surplus into fixed capital, %	6,00	3,90	3,50	2,90	
Surplus of real income of the population, %	4,30	3,00	2,90	2,70	
Federal budget revenues (% of GDP)	18,65	18,80	18,70	18,80	
Federal budget expenditures (% of GDP)	22,67	21,24	20,18	19,98	
Surplus (+) /deficit (-) of federal budget (% of GDP)	-4,02	-2,44	-1,48	-1,18	
Exports (\$billion)	398,0	411	422	430	
Imports (\$ billion)	248,8	313	359	388	
Trade balance (\$ billion)	149,2	97	63	42	
Balance of current accounts (\$ billion)	72,6	42	13	-18	
Balance of capital transactions (\$ billion)	-30,5	0,0	15,0	30,0	
Balance of payments (\$ billion)	36,8	37,3	22,6	7,2	
External debt of the private sector (\$ billion)	436,1	440,0	450,0	490,0	

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(continued) table 22

	1	2	3	4	5
Debt/GDP ratio, %		29,8	25,8	23,3	23,3
International reserves (\$ billion)		479,4	522	549	561
Nominal exchange rate RUR/USD		30,36	29,40	28,8	29
Nominal exchange rate RUR/EURO		40,27	38,22	37,44	37,70
Index of the real effective ruble exchange rate (July 1998 = 100)		122,6	134,0	141,8	145,5
CPI growth rate, %		8,8	8,1	6,8	6,3
Reserve funds growth rate, %		26,64	17,33	16,04	14,43
M2 growth rate, %		28,51	19,09	20,68	18,83
Monetization (M2/GDP), %		45,3	47,9	52,0	56,5
National debt (% of GDP)		8,8	11,5	12,8	13,9

Table 23

Optimistic case

	2010	2011	2012	2013
Oil prices (Urals, in \$/bbl)	78,2	100,0	102,0	104,0
Real GDP growth rate, %	4,00	3,20	3,80	4,30
GDP in nominal terms (RUR Billion)	44491	51218	58186	64693
GDP (\$MM)	1465	1742	2020	2270
Investment surplus into fixed capital, %	6,00	4,50	5,00	5,90
Surplus of real income of the population, %	4,30	3,50	3,50	4,00
Federal budget revenues (% of GDP)	18,65	19,40	19,60	19,90
Federal budget expenditures (% of GDP)	22,67	20,81	19,31	18,82
Surplus (+) /deficit (-) of federal budget (% of GDP)	-4,02	-1,41	0,29	1,08
Exports (\$billion)	398,0	460	473	488
Imports (\$ billion)	248,8	316	368	418
Trade balance (\$ billion)	149,2	144	106	70
Balance of current accounts (\$ billion)	72,6	89	56	10
Balance of capital transactions (\$ billion)	-30,5	0,0	15,0	30,0
Balance of payments (\$ billion)	36,8	84,2	65,5	35,5
External debt of the private sector (\$ billion)	436,1	440,0	450,0	490,0
Debt/GDP ratio, %	29,8	25,3	22,3	21,6
International reserves (\$ billion)	479,4	569	639	680
Nominal exchange rate RUR/USD	30,36	29,40	28,8	28,5
Nominal exchange rate RUR/EURO	40,27	38,22	37,44	37,05
Index of the real effective ruble exchange rate (July 1998 = 100)	122,6	134,2	142,7	149,3
CPI growth rate, %	8,8	8,3	7,3	6,6
Reserve funds growth rate, %	26,64	22,67	16,71	15,52
M2 growth rate, %	28,51	24,51	23,71	19,88
Monetization (M2/GDP), %	45,3	49,0	53,4	57,6
National debt (% of GDP)	8,8	9,3	8,5	8,0

Table 24

Budget expansion case

	2010	2011	2012	2013
Oil prices (Urals, in \$/bbl)	78,2	100,0	102,0	104,0
Real GDP growth rate, %	4,00	3,10	3,60	4,10
GDP in nominal terms (RUR Billion)	44491	51452	58883	66139
GDP (\$MM)	1465	1750	2045	2281
Investment surplus into fixed capital, %	6,00	4,20	4,50	4,90
Surplus of real income of the population, %	4,30	3,90	3,90	4,40
Federal budget revenues (% of GDP)	18,65	19,40	19,40	19,30
Federal budget expenditures (% of GDP)	22,67	24,80	23,55	24,65
Surplus (+) /deficit (-) of federal budget (% of GDP)	-4,02	-5,40	-4,15	-5,35
Exports (\$billion)	398,0	460	473	487
Imports (\$ billion)	248,8	319	377	425
Trade balance (\$ billion)	149,2	141	95	62
Balance of current accounts (\$ billion)	72,6	86	45	2
Balance of capital transactions (\$ billion)	-30,5	0,0	0,0	0,0
Balance of payments (\$ billion)	36,8	80,5	40,1	-2,8
External debt of the private sector (\$ billion)	436,1	440,0	450,0	460,0

(continued) table 24

	1	2	3	4	5
Debt/GDP ratio, %		29,8	25,1	22,0	20,2
International reserves (\$ billion)		479,4	565	610	612
Nominal exchange rate RUR/USD		30,36	29,40	28,8	29
Nominal exchange rate RUR/EURO		40,27	38,22	37,44	37,70
Index of the real effective ruble exchange rate (July 1998 = 100)		122,6	134,9	144,8	150,9
CPI growth rate, %		8,8	8,9	8,3	7,9
Reserve funds growth rate, %		26,64	22,05	20,08	20,53
M2 growth rate, %		28,51	21,40	17,63	18,01
Monetization (M2/GDP), %		45,3	47,6	48,9	51,4
National debt (% of GDP)		8,8	13,0	16,9	21,4

Under **the base case**, the quantitative values of the main indicators of the social and economic development of Russia and the monetary sector show that the positive growth rates of real GDP will not exceed 3% by the end of 2013. By the end of 2013, the real GDP of Russia will exceed the level of 2008 by 4.3% only. In 2013, the per capita GDP (at the current exchange rate) with account of the growth of the ruble exchange rate and the forecasted reduction of the population is going to exceed the 2008 level by approximately 20%.

The economy will revive due to stable oil prices (in the comfortable range for Russia) and the renewed inflow of foreign capital thus ensuring financing of the investment demands of the Russian companies. As for investments into fixed capital, the recession will not be overcome by the 2013 end. In 2013, the investments into fixed capital will reach 98.3% vs the 2008 figure. At the same time, in 2011 – 2013, the real incomes of the population are going to increase by approximately 15.9% vs the pre-crisis level.

We assume that the oil prices will be within a sufficiently “comfortable” range (that would not trigger a currency or a financial recession) but not in the best range possible, and therefore the national financial situation will remain tense, under this case. Assuming that the nominal federal expenditures are kept at the level set by Federal Law “On the federal budget for 2011 and for the planning period of 2012 and 2013”, the budget deficit is likely to remain in the entire period of consideration. The Reserve Fund can support financing of the budget deficit in 2011 only.

We do not suggest using NWF funds to finance the budget deficit, and believe NWF will accumulate funds worth about 5% of GDP.

One of the most important assumptions for restoring the positive growth rate of real investments into fixed assets and the GDP real growth is that Russian companies and banks will return to the world capital market, and the inflow of direct foreign investments into Russia will be sustained. According to the estimates made, to support the set rates of investment growth, a stable net flow of private foreign investments into Russia should start not later than 2012 and reach \$15 – 30 billion per year.

We forecast, for the reviewed period, that the services negative balance will go up as well as payments balance for production factors and interest payments. Accordingly, in 2013 we expect a negative current accounts balance of \$15 – 20 billion in Russia.

As we assume that the RF Central Bank while moving to inflation targeting policy reduces its presence on the currency market, the Bank of Russia will accumulate its international reserves but very slow. By the end of 2013, according to our estimates, the reserves will reach \$550 – 600 billion – this is below the maximum levels of 2007 – 2008.

Before 2013, the positive payment balance (in 2011 – 2012 due to the positive balance of the current accounts while in 2013 – due to the capital inflow) will support a stable exchange

rate of the ruble currency in the currency basket (we believe that in the bi-currency basket, USD and EURO ratio remains at 0.55:0.45). In such case, a change of the USD/EURO ratio may be triggered by a change in mutual quotations of the reserve currencies on the world market. As a result of a softer influence of the Bank of Russia on the exchange rate, the growth of ruble volatility vs USD and EURO currencies would not be reflected in the summary annual exchange rate values as the differently directed fluctuations absorb each other.

Simultaneously, the reduction of the annual CPI growth rates to 6.0 – 6.5% will obviously slow down the rates of the real strengthening of the ruble currency. In particular, by the end of 2013, the real effective rate of the ruble will strengthen by 20% vs the mid of 2008 or by 25% vs the end of 2008. We expect that the positive dynamics of the Russian exports against stagnation of world prices on raw materials will be maintained. Imports will grow faster than exports during the considered period and will exceed the record breaking values of 2007 as early as in 2011.

The model predicts serious changes in the monetary sector of the Russian economy. As mentioned before, the model demonstrates a visible slow down of inflation.

Secondly, the change of the monetary policy by the Bank of Russia means that the Bank will expand transactions on the market of state securities (prompted by necessity to finance the federal budget deficit not only by the Reserve Fund or external borrowings) and will actively re-finance commercial banks against securities (e.g. corporate bonds) bought for the Bank portfolio and issue credits secured by pledge to commercial banks for long terms (at least for one year).

As a consequence of such change of the main fiscal tools, real interest rates in the economy must grow. Thus, real interest rates for credits issued to a non-financial private sector for up to one year will fall within the range 1.5–2.0% in 2011–2013. We expect the growth of a monetary multiplier up to 2.6 – 2.7% (M2/reserve money). In other words, the bank sector is going to resume its credit expansion most actively as it was before the 2008 crisis.

Summarizing **the base case**, the following characteristics should be outlined:

1. The real GDP volume will be restored up to the pre-crisis level by the end of 2012 only; the volume of real investments will not return to the 2008 indicators;
2. Russian companies will come back to the world capital markets;
3. An obligatory transition to new mechanisms of security of the monetary supply of the RF Central Bank, and the growth of real money value in the economy will occur;
4. The conditions for keeping the federal budget deficit, the full use of the Reserve Fund and an extremely slow accumulation of funds in the NWF will be maintained;
5. Inflation rates will obviously fall down against strengthening of the real effective rate of the ruble currency and high growth rates of the monetary stock and monetization of the Russian economy.

The **optimistic case** provides for increase of average oil prices (Urals) up to 100 \$/bbl in 2011 and 102-104 \$/bbl in 2012 – 2013. This will allow increasing the growth rates of the Russian economy up to 3.5–4.5% per year. Thus, by the end of 2013, the real GDP will be approximately by 7% higher than in 2008. In 2012, the per capita GDP (in USD at the current rate) will increase by about 40% up to \$16 – \$16.5 thousand vs 2007.

Under this case, the real volume of investments into fixed assets will be restored to the pre-crisis level in 2012-2013.

High prices on the world raw markets will generate federal budget revenues sufficient to fund the federal expenditures at the target level. Moreover, in 2012 – 2013, a surplus of the

federal budget (up to 1% of GDP) may occur, and funds will continue to be accumulated in the Reserve Fund.

A favorable foreign economic situation under this case creates conditions that will sustain the stable situation with the national payment balance. The payment balance and its two main components will remain positive during the entire period of review. In particular, the payment balance will be from \$35 to \$85 billion per year, and the annual inflow of private capital into Russia will reach \$ 30 billion.

With this scenario, the Bank of Russia will not be able to avoid a sizable growth of international reserves returning to the policy of curbing the nominal strengthening of the ruble. Thus, by the end of 2013, the international reserves of the Central Bank of Russia will exceed the 2008 level growing up to \$670 – 680 billion.

The nominal exchange ruble rate will increase up to 28.0 – 28.5 RUR/USD or approximately by 10% vs the 2010 average annual rate in 2011 – 2013. At the same time, the inflation (CPI) continues to decrease but still remains at a higher level than in the base case (6.5 – 7.0%). As a result, the ruble will continue to be stabilized successfully, and by the end of 2013, the real effective ruble rate will exceed the 2008 summer level by 26% - 27%.

In this case, we assume that the RF Central Bank will move to inflation targeting policy and use interest rates as a main working tool (though with a greater focus on the currency market), the real money value is expected to grow as well. According to our estimates, the real interest rate for one-year credits issued to the non-financial sector may be 1.0 – 1.5%. Monetization of the economy is going to build up to approximately 60% of GDP as in the base case.

Thus the main differences between **the optimistic and the base case** are:

1. A faster recovery of the GDP real volume that will exceed the pre-crisis level in terms of investments into fixed assets.
2. A favorable situation with the payment balance and its constituent components, fast accumulation of international reserves.
3. Return to the policy of the federal budget surplus and concentration of funds in the Reserve Fund.
4. Slow decline of the inflation rates, fast real and nominal strengthening of the ruble currency against high growth rates of the money stock and monetization of the Russian economy.
5. Restricted opportunities of the Bank of Russia in moving to inflation targeting policy, the need to place a greater focus on the currency market situation.

The budget expansion case, in spite of the favorable external situation, will preserve the budget deficit at 5 – 5.5% of GDP which may negatively impact the economic growth rates and real investments. Thus, the real GDP growth rates and investments into fixed assets are by appr. 0.5 – 1.0% lower than in the optimistic case.

Financing of the federal budget deficit at the expense of the market borrowings leads to a higher real interest rate for the borrowers (up to 2.5 – 3 pp. at the internal market), higher rates of inflation (due to final monetization of the debt by the authorities) and a slow credit activity of the banks. The CPI growth rates in this case will not drop below 7.9%. Even if the Central Bank curbs the nominal strengthening of the ruble currency, the real exchange rate of the ruble will exceed by 28% the level of 2008 summer by the end of 2013. The national debt will reach 21 -21.5% of GDP late 2013, this is close to critical values (in terms of the ability to serve the debt if the market situation changes) for such country as Russia whose national finances and the assessment of the country risks greatly depends on the oil price fluctuations.

The strengthening of the ruble also negatively influences the national payment balance. Due to the fast growth of imports, the current accounts balance expects to become zero in 2013; given the absence of inflow of capital (as a result of low investment activity inside the country and enhancement of risks associated with the debt growth) this may lead to a negative payment balance and stabilization of the international reserves volume close to the pre-crisis maximum - \$610 billion.

Summarizing the **budget expansion case**, we can note that this scenario suggests dependency of the RF economy on the oil prices and creation of conditions for a budget crisis in future. The imbalance of the RF budget system within the period under review (up to 3 years) is going to negatively affect the rates of economic growth, the payment balance, the speed of inflation reduction and the situation in the money circulation sector.

Section 3. Financial Markets and Financial Institutes

3.1. The Year of 2010: Recovery of Russian Financial Market

The year of 2010 saw the continuation of the recovery of the national financial market which kicked off between March and April 2009. The two crises in Russia's recent history (1997-98 and 2008-09) display substantial differences the major of which is that the 1997-98 crisis was a local one, while the latter crisis had a global nature. The crisis in the late 1990s was aggravated by the RF Government's obvious economic policy flunks. Having learned a bitter lesson, the Government managed to eschew a déjà-vu in the late 2000s and secured a financial cushion; however, stagnation in the economic policy resulted in a high degree of the nation's dependence on the external environment.

The 2008-09 crisis did not overrun the 1997-98 one in terms of intensity of the fall of stock indices (see *Table 1*). During the first crisis, the RTS index tumbled by 91.3%, while the MICEX one – by 73.0%; meanwhile, the intensity of the fall of both indices in 2008-09 accounted for 78.2% and 68.2%, respectively. The length of the fall of stock prices during the recent crisis was shorter than during the previous one: while in 1997-98 the RTS index was falling for 14 months and the MICEX one – for 13 months, the respective lengths in 2008-2009 were 8 and 7 months, respectively. That should be attributed primarily to the fact that during the recent crisis, it took oil prices just 5 months to hit the bottom vis-à-vis the 24 month-long period during the 1997-98 crisis (see *Fig. 6 below*).

Table 1

Quantitative Parameters of the Financial Crises of 1997/98 and 2008/09 in Russia

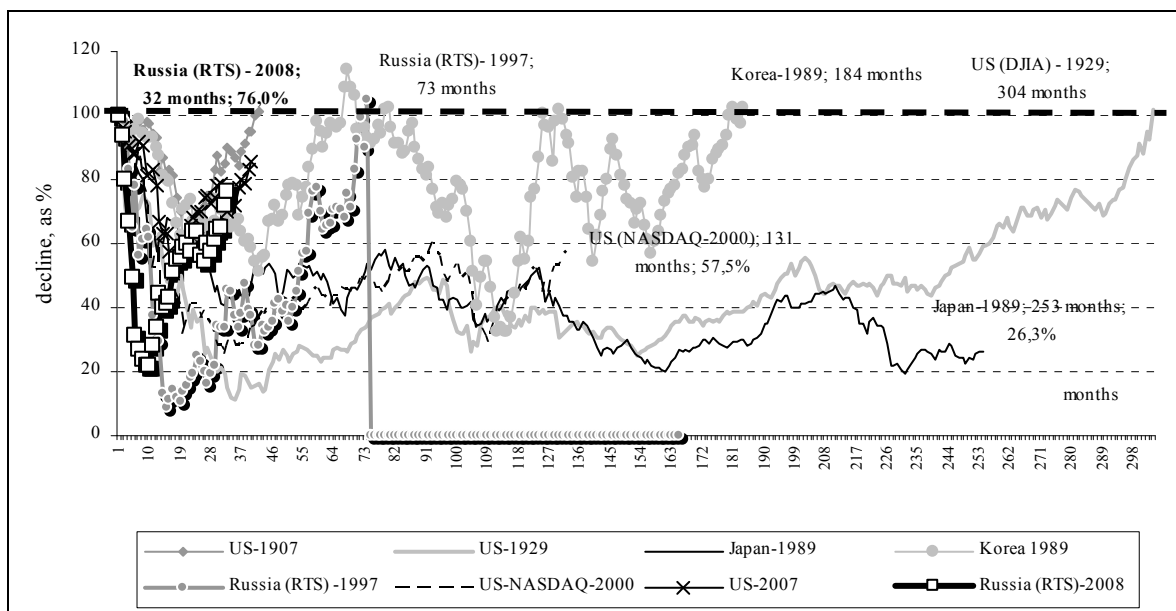
	Crisis 1997/98	Crisis 2008/09
1. fall from the peak		
1.1. Intensity, %		
RTS index	-91,3	-78,2
MICEX index	-73,0	-68,2
1.2. Length, months		
RTS index	14	8
MICEX index	13	7
2. Recovery, months		
RTS index	59	24
MICEX index	8	25

Source: the RTS and MICEX data as of 31.01.2011

The recovery of the MICEX index during the two crises in question took a pace different from the RTS' one. During the 1997-98 crisis, because of the 5-fold depreciation of Rb., the MICEX index recovered just in 8 months, while the RTS forex index – in 59 months. In 2008-09, Rb. depreciated roughly by 50%, and it won back roughly 50% of the depreciation during the subsequent appreciation. That is why both indices have been bouncing back roughly at the same pace – the RTS index – for 24 months in a row, while the MICEX one – for 25 months. As of early 2011, the recovery has not been complete as yet: as of 31 January 2011, the RTS and MICEX indices hit, accordingly, 76.0% and 85.9% of their pre-crisis peak

values. With such market recovery rates in place in 2011, both indices are most likely to hit their pre-crisis values, which is why this time the ultimate recovery of the market would most likely to happen far sooner than in 1997-98.

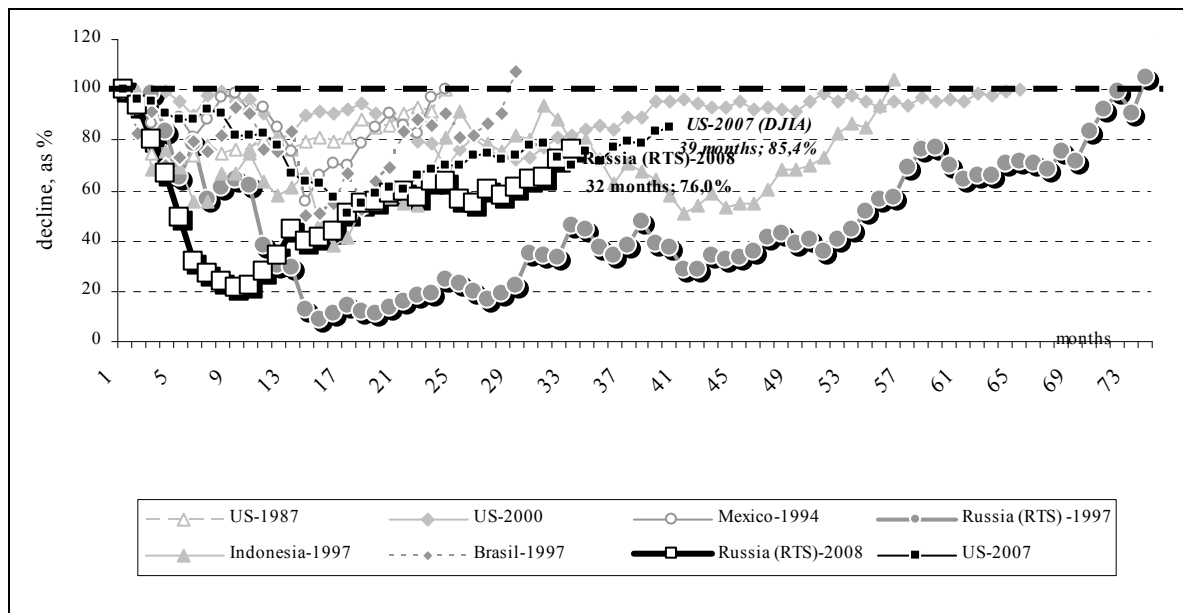
Against the backdrop of the long-term financial crises of the past century (see *Fig. 1*) Russia's financial crisis of 2008-09 appears clearly V-shaped. Gauged by the intensity of decline, it falls far behind the Russian crisis of 1997-98, which posted the record-breaking rates in this respect vis-à-vis most notorious crises of modern times, as well as the collapse of the DJIA in the times of the Great Depression of 1929-1933 and the fall of NIKKEI 225 – in the late 1980s. The length of the cycle – between the fall of the RTS index and its complete rebound was “just” 32 months. That was far shorter a period when compared with such past crises as “Russia 1997/98” (73 months), “South Korea- 1989” (184 months) and “the Great Depression” (304 months), as well as the crises that are far from being over: NASAQ-2000 (131 months) and NIKKEI-1989 (253 months).



Source: by data of RTS, MICES, and www.finance.yahoo.com

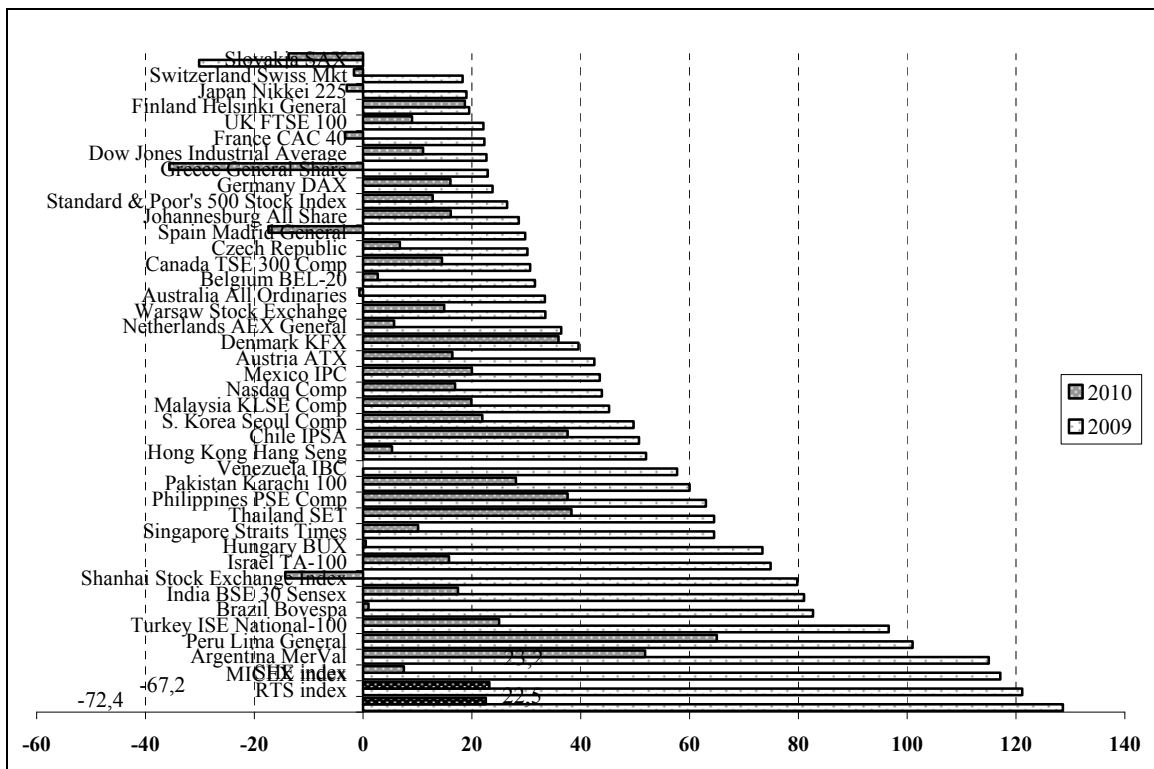
Fig. 1. Depth and Length of Long-Lasting Financial Crises in the World as of January 2011 (peak=110%)

Against the backdrop of the most dramatic short-term turmoils over the past decades, such as the blue chips crisis in the US in 1987 and 2007, the 2000 collapse of the DJIA, the 1994 Mexican crisis, the 1997 crises in Indonesia and Brasil, the current Russian crisis proves more intense, albeit average in terms of its length (*Fig. 2*).



Source: by data of RTS, MICES, and www.finance.yahoo.com

Fig. 2. Depth and Length of Short-Term Financial Crises in the World, as of January 2011 (peak=100%)

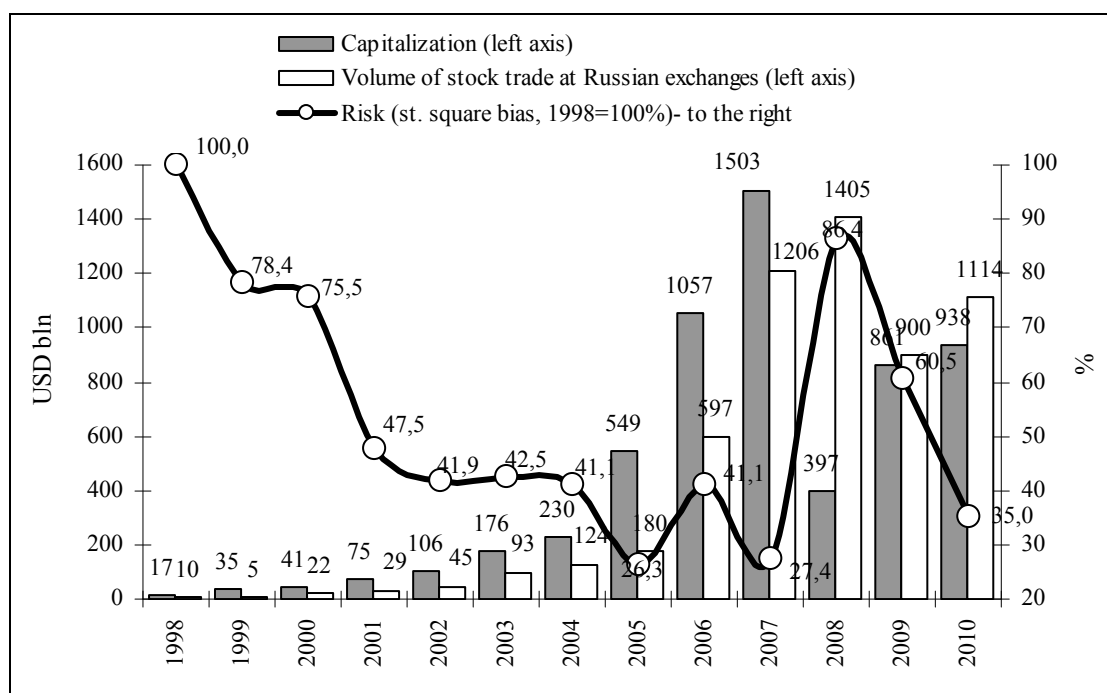


Source: by data of RBK and WFE.

Fig. 3. Yield Rates of Stock Indices Worldwide in 2009–2010, as %

The 2008-09 crisis proved the Russian stock market's reputation of one of the riskiest markets in the world. It falls deeper than other markets, but bounces back at a faster rate. In 2008, the RTS and MICEX indices sank by -72.4% and 67.2%, respectively, thus outpacing all known stock markets worldwide in this regard. In 2009, on the contrary, they reaped the highest yields (see Fig. 3), with the RTS index posting a 128.6% growth and the MICEX index adding 121.1%. In 2010, the RTS index increased by 22.5% and the MICEX index - by 23.2%, which helped the Russian stock market to enter the Top-10 most lucrative markets worldwide.

In 2010, the aggregate capitalization of Russian corporations accounted for USD 938 bln., up by 8.9% vs. the previous year (Fig. 4). Meanwhile, the aggregate volume of trading at Russian exchanges hit the level of USD 1,114 bln. in 2010, up by 23.8% vs. the prior year's figure. However, the market so far has failed to catch up with the 2007 figure of USD 1,206 bln. and the 2008 one (1,405 bln.). The failure to do so can be ascribed to two factors: first, prices of most issuers' papers have so far failed to recuperate to match their pre-crisis figures. As demonstrated below (Fig. 8), according to the Emerging Market Portfolio Research's data, the 2010 volume of attraction of capital to international equity funds, whose activity strongly impacts the dynamics of Russia's stock indices, reached the pre-crisis level only in the end of the year. The slowdown of growth in the number of active domestic investors in the stock market¹ and measures on regulation of the rise in trading by means of automated processes FSFM and MICEX began to undertake since mid-2010 hindered growth in the volume of trading with securities at stock exchanges.



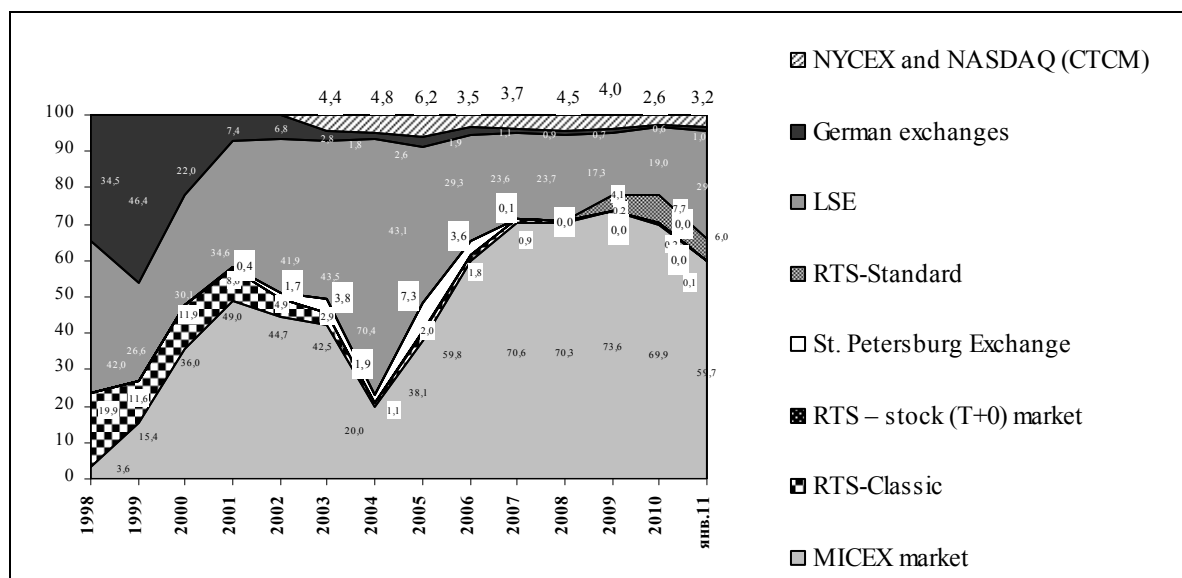
Source: by data of JSC RTS, S&P, IMF.

Fig. 4. Capitalization, Liquidity and Volatility of the Russian Stock Market

¹ Mazunin A., Smorodskaya P. Fondovyi rynek fizlitsom ne vyshel. Chislo brokerskykh schetov svidetelstvuyet o snizhenii sprosa na birzhevuyu trgovlyu. Kommersant, 23 December 2010.

As in the times of the 1997-98 crisis, the beginning of the 2008-09 crisis was marked with a dramatic increase in the stock market's volatility. In 2008, the indicator of the standard bias of the daily yield rate of the RTS index made up 86.4% of the 1998 figure, while in 2007 it accounted for just 27.4%. In 2010, the indicator slid to 35.0% of its 1998 level, which roughly matches its average annual levels over 2004-2007, when the Russian stock market had been advancing steadily.

In 2010, the Russian stock exchange market managed to retain its global competitive positions in terms of trading with domestic JSCs' shares. That was proved by data on the correlation between volumes of trading with stock and depositary receipts on Russian corporations' shares on national and overseas stock exchanges presented in *Fig. 5*.



Source: calculations by exchanges' data.

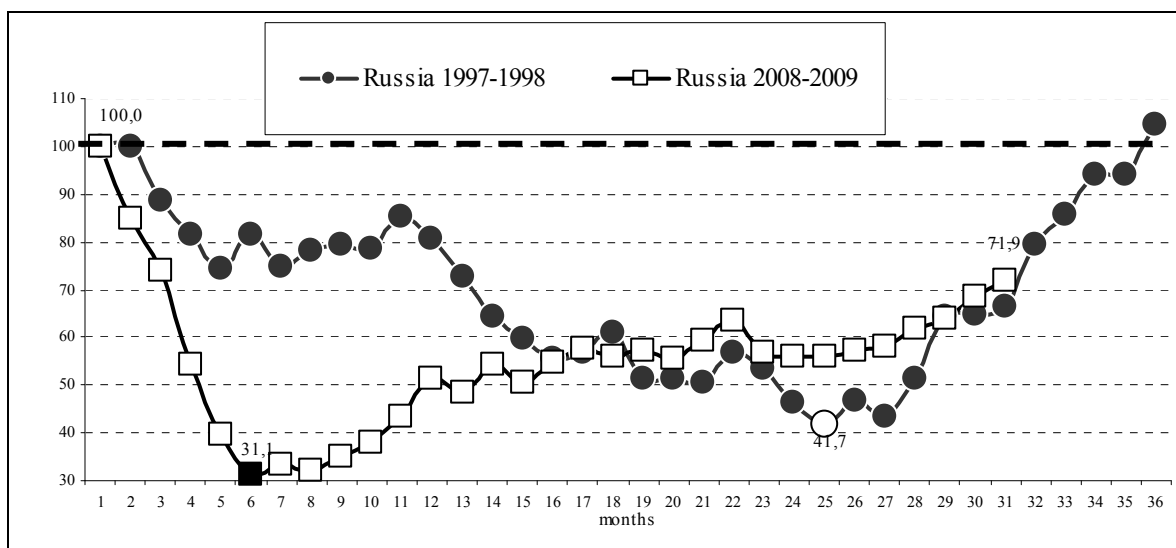
Fig. 5. Specific Weight of Exchanges in Volumes of Trading with Russian JSCs' Shares

In 2010, the proportion of Russian exchanges in organization of trading with Russian corporations' shares and DRs was at the same level as in 2009 and accounted for 77.9%. The key development became a notable increase in the proportion held by RTS in the respective volume – it rose from 4.3% in 2009 to 8.0% in 2010. The increase was powered by a growing popularity of the RTS-Standard (RTSS) section, which dramatically changed the system of trades and settlements on the Russian stock market by enabling actors to dump the antiquated system of preliminary depositing of assets by participants in trading prior to the opening of the trading session. The MICEX's attempt to launch in 2010 an alternative system, that is, MICEX+ , so far has failed to change the balance of forces. Meanwhile, the transition from the settlement-backing system and preliminary provisioning of assets to the system of guarantees of trade settlement by a clearing center as of the moment T+N put the market participants before the dilemma of modernization of their own system of guaranteeing clients' transactions. The only viable option seems to be unification of the transactions guaranteeing systems at both exchanges, which became one of the factors expediting implementation of the decision on their merger.

3.2. Factors Determining the Dynamic of the Russian Stock Market

An examination of the 2008-09 crisis and the financial market's subsequent recovery allows a greater understanding of key factors that affect prices of Russian shares. One of them is oil price. During both crises, a dramatic downfall in oil prices ultimately resulted in the collapse of the national stock market. Furthermore, the fall in stock quotations, as a rule, anticipates the downfall in oil prices, as international investors keep a close eye on superheated local markets and withdraw investments under a tiniest sign of a volte-face of trends.

As noted above in comments to *Table 1*, a longer fall of the RTS index in 1997-98 vis-à-vis its fall in 2008 should be ascribed to the fact that the downfall in oil prices over the former crisis was lasting for 24 months, while during the latter one – just 5 months (see *Fig. 6*). At the same time, it took oil prices 11 months to bounce back after 1998, while after the collapse in 2008, as of January 2011, it has been already for 25 months that they failed to hit their past peaks, with their highest values accounting for 72.2% of the peak value registered in June 2008. As the future developments showed, in the aftermath of the crisis of the 1990s, oil prices had a practically 20-fold upside potential. By contrast, regardless of a far faster pace of the stock market's recovery, presently the growth potential of oil prices has been practically exhausted. Furthermore, given scenario-based conditions and main parameters of the long-term forecast of Russia's socio-economic development for the period through 2030 (hereinafter referred to as *scenario-based conditions-2030*) designed by the RF Ministry of Economic development, oil prices may repeat their absolute peak of June 2008 only as early as by 2030¹. Meanwhile, it should be understood that projecting oil prices poses a special, extremely challenging problem, which no one has so far managed to satisfactorily crack.



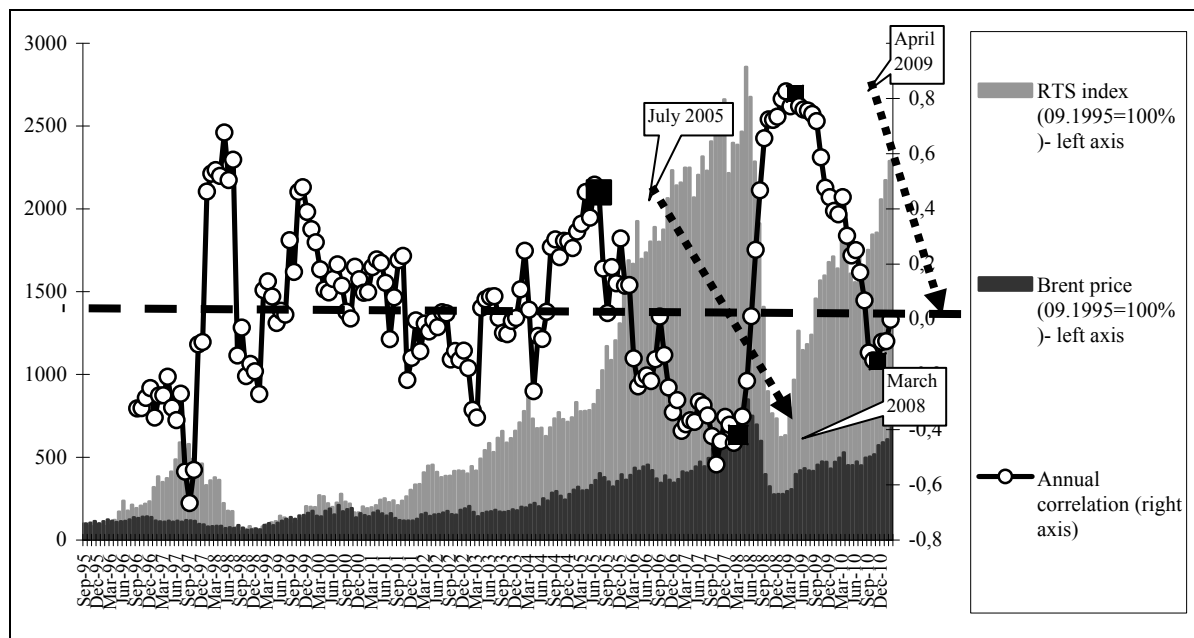
Source: by data of IFS IMF.

Fig. 6. Downfall and Recovery of Brent Prices during Financial Crises in Russia (Peak of the Price = 100%)

¹ Kuvshinova O., Tovkaylo M. Rasti ili kopit. Vedomosti 10 February 2010. On Vedomosti's homepage, the article was complemented with the text of the Executive Summary to the Scenario-based conditions by the RF Ministry of Economic Development.

That the dynamics of oil prices and stock indices are intertwined is evidenced by data of Fig. 7, which presents results of changes of the correlation ratio between monthly relative changes in the RTS index and Brent prices over a 12 month-long period. The distinguishing feature of the moving correlation curve is that it mirrors a strengthening or weakening of the correlation between the indices in question with the 12-month lag.

The correlation between relative changes in oil prices and the RTS index appears clearly cyclic. While the index is climbing up to its pre-crisis peak or right in between its passing that peak and prior to the rise of the acute phase of the crisis the correlation ratio plunges momentarily and become negative. In other words, the oil price and the value of the index suddenly begin to change in different directions. During the collapse of the stock market, the positive correlation between changes of the index and oil prices begins to revive. Once the economy hits the bottom, the correlation is on the rebound to minus 1.



Source: calculated by data of IFS IMF and the RTS Exchange

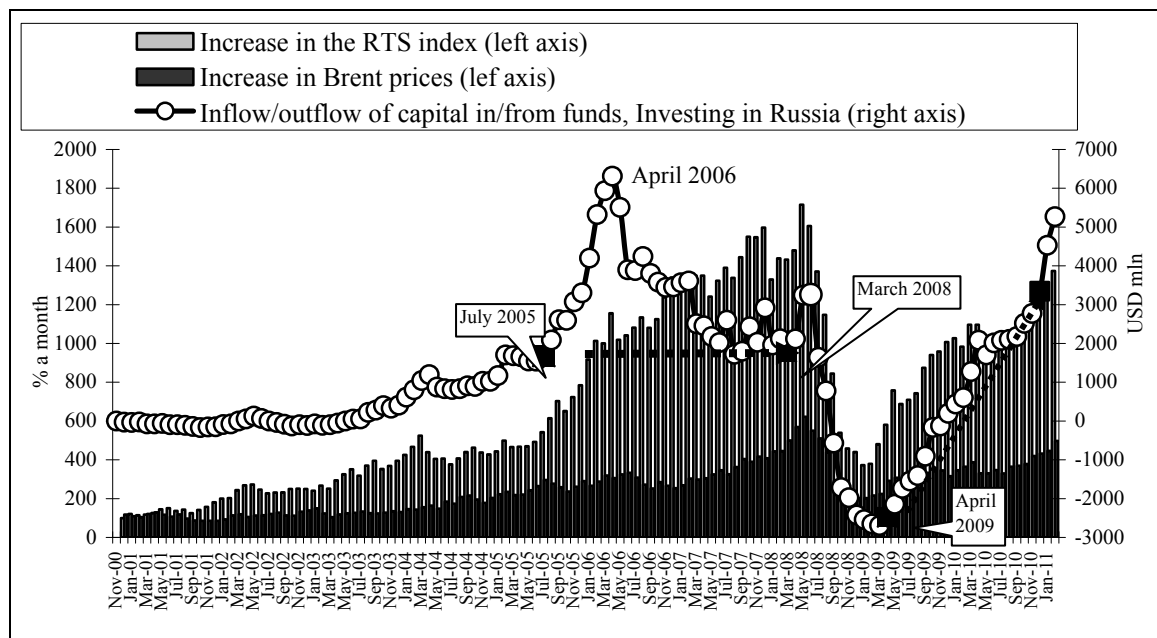
Fig. 7. Correlation between Changes in the RTS Index and Prices of Brent between September 1995 and February 2011

During the 1997-98 crisis, the RTS index hit its peak value in July 1997. Prior to that, the correlation ratio had been in the negative zone between -0.21 and 0.36. Between August and September 1997, the ratio plunged further to -0.55 to -0.67. Subsequently, it was being in the region of zero for another several months. Between January and July 1998, during the acute phase of the crisis, the correlation ratio hit the level between 0.46 and 0.68, ie. oil prices and stock prices were synchronized divers. In September 1998, the RTS index hit its bottom at the level of 438 points. Between August 1998 and late 1999 the correlation was close to zero, which exposes the absence of simultaneity in the indices' dynamics.

After the crisis of the late 1990s, the Russian stock market had been rising practically uninterruptedly between late 2001 and May 2008. The most notable milestone in the dynamic of the correlation, however, was **July 2005**, when the trend of the index underwent a drastic change. Between August 2004 and July 2005 the correlation ratio had been within the range

of 0.22 to 0.49. Between August 2005 and **March 2008** the correlation ratio was steadily in decline and reached -0.53 in October 2007. That is to say, since August 2005 and through the moment the stock market went downhill since the second half 2008 the stock prices and oil prices had taken different courses. Since April 2008, the correlation ratio had been positively high for nearly 2 years and hit its peak of 0.82 in **April 2009**. Since May 2009, the correlation began languishing and plunged to the levels between 0.08 and 0.15.

We believe the cyclicity of the correlation between relative changes in oil prices and quotations of Russian corporations' shares should be ascribed to a substantial influence of in- and outflows of foreign portfolio investors' capital. The most accurate indicator of the flows are data of EPMR which reveal weekly and monthly in- and outflows of foreign investment funds' investments in Russian issuers' stock¹. Fig. 8 presents data on rises in oil prices and stock prices in conjunction with totals of foreign funds' capital invested in/withdrawn from Russia.



Source: calculated on IFS IMF, RTS data and EMPR resource.

Fig. 8. Increase in the RTS Index, Oil Prices, Inflow (Outflow) of Resources in Funds Investing in Russia

The data on capital flow allows understanding of why there is no correlation between oil prices and stock prices in the periods between July 2005 and March 2008, and April 2009 and late 2010.

¹ In this particular case, indicators of capital in-and outflow regularly published by CBR bear less informational value as far as the stock market is concerned, for it is capital invested on the market for Rb.-denominated fixed income instruments. Perhaps, the financial market regulator and monetary authorities should be in need for establishment of a national system of monitoring in-and outflow of portfolio investors' capital on the stock and bonds market, for the EMPR resource is commercial and its data are not available for most Russian investors and government representatives.

Between July 2005 and April 2006 investment funds investing in Russia dramatically boosted volumes of attraction of capital: in span of just 10 months, the funds attracted new capital worth a total of USD 4.8 bln. Meanwhile, oil prices changed from USD 66.68/b to just 69.0/b. The spike in short-term investment capital in Russia at the time is explained by granting the country with investment ratings. Specifically, FITCH did so on 17 November 2004, followed by S&P's move on 31 January 2005. Plus, on 31 May 2005 the court rendered the first verdict on the Khodorkovsky case, and numerous portfolio investors were in the mood for buying Russian authorities' assurances of the uniqueness of the case in question.

The euphoria had been lasting until April 2006, with the RTC index adding 15.5% just in one month. Since May 2006 the capital inflow in investment funds investing in Russia was replaced by its outflow. Capital flight from Russia between May 2006 and March 2008 accounted for USD 4.6 bln. Meanwhile, oil prices rose from USD 73.28/b to USD 112.71/b. In all likelihood, the capital flight was fueled by analysts' increasing concerns about risks associated with the overheating of emerging markets due to the looming signs of a crisis on the market for sub-prime mortgage securities. In August 2006, the US reported the first substantial decline in real estate prices; meanwhile, at the IMF conference in September 2006, N. Rubini publicly announced a looming financial crisis in the US.

The outflow of portfolio investments from Russia kicked off in May 2006, followed by a brief intermezzo in mid-2008, with the investment funds seeing a capital inflow in April, May and June - most likely, under the impact of the pre-crisis oil price boom. Between July 2008 and March 2009 investors withdrew as much as USD 6 bln. from the investment funds investing in Russia. The average oil price tumbled from USD 123.45/b to USD 65.8/b over that period. As a result, the correlation between the index and oil prices soared to 0.83 in March 2009. Since that time the oil prices were on the upswing, and the next month saw the renewed capital inflow in the funds investing in Russia. Because of those reasons, the RTS index was reviving pretty fast and the level of the correlation between changes in oil prices and changes in stock prices remained high.

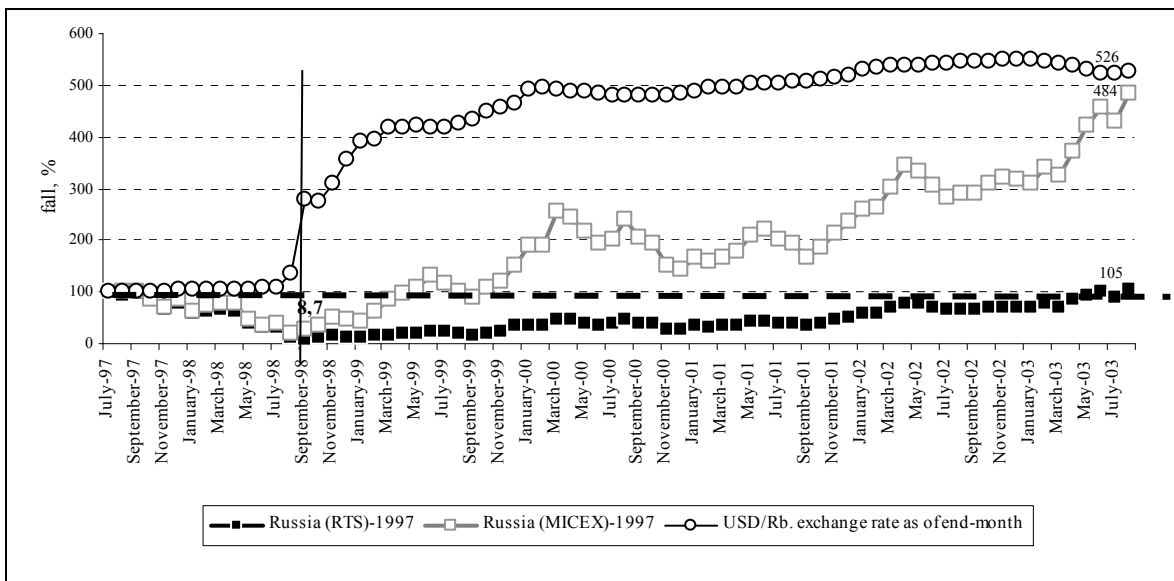
In span of 24 months between April 2009 and February 2011, it was just one month when foreign equity funds reported capital withdrawals. Overall, in the period in question, the funds collected USD 9.1 bln. from investors. While the average oil prices surged from USD 65.8/b in April 2009 up to USD 112.1 in February 2011, the growth in question was unstable on a month-on-month basis. By contrast, the rise in investments in the funds investing in Russia was steady. As a result, in the second half 2010, the correlation between oil prices and stock prices plummeted once again.

Differences in the intensity of depreciation of Rb. during the two crises concerned determined different dynamics of the RTS and MICEX indices' revival. The assessment of shares in the portfolio of the MICEX index is made in Rb. equivalent, while that of the RTS index – in USD equivalent. That is why after the 5-fold more depreciation¹ of the Russian currency in 1998 the pace of the subsequent recovery of the MICEX index was greater than the one of the RTS index (*Fig. 9*). The MICEX index had bounced back to its pre-crisis peak already by May 1999, ie. just in 8 months after the economy passed the bottom of the crisis. By contrast, it took the RTS index 59 months to fully recover after passing its bottom value during the crisis.

¹ Over the period between 1998 and 2003.

RUSSIAN ECONOMY IN 2010

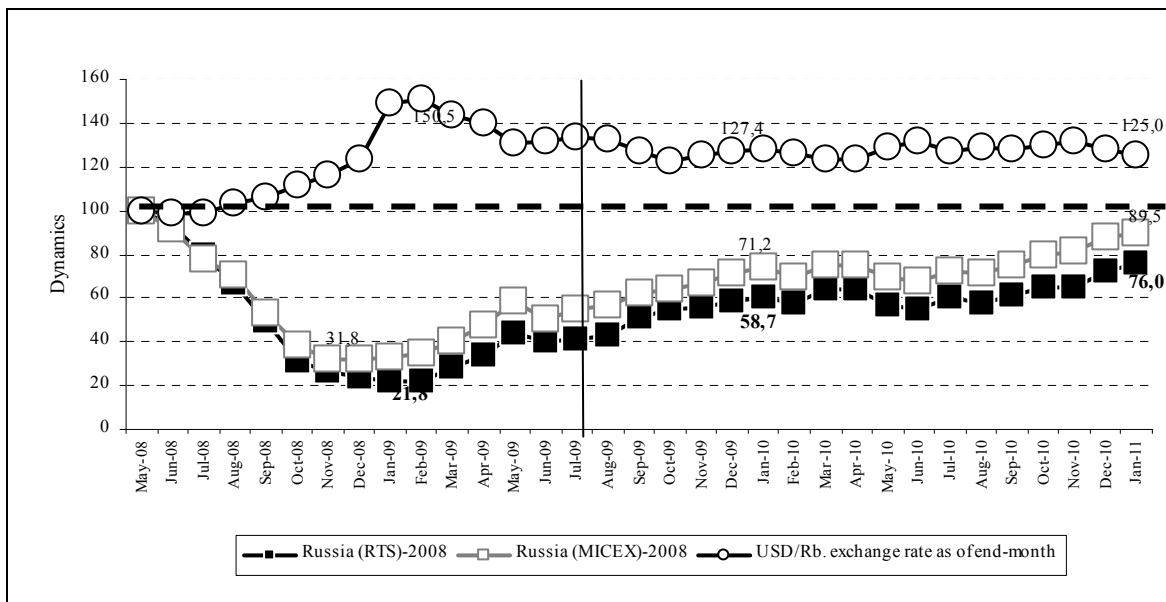
trends and outlooks



Source: by data of JSC RTS, MICEX and Bank of Russia.

Fig. 9. Changes in the USD Exchange Rate, the RTS Index and the MICEX Index during the 1997-98 Crisis (July 1997 = 100%)

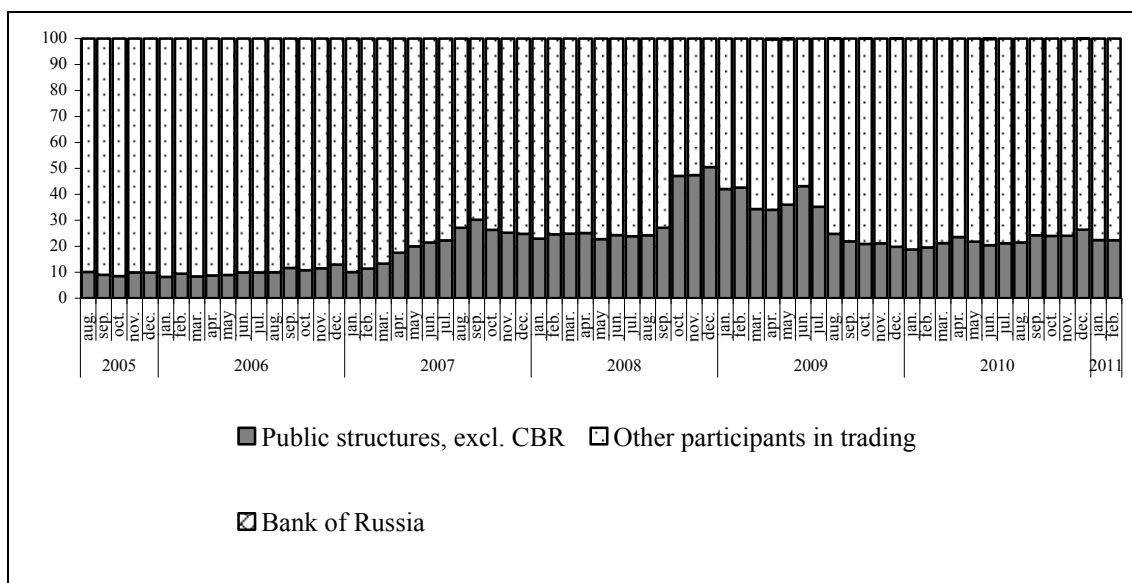
During the 2008-09 crisis, the maximal level of Rb. depreciation accounted for 50% (Fig. 10), followed by the appreciation of the Russian currency. That is why the RTS and MICEX indices were recuperating practically at the same speed, with the latter index slightly outpacing the former one. In January 2011, the RTS index hit 76.0% of its peak value of May 2008, while the MICEX one - 89.5%.



Source: by data of JSC RTS, MICEX and Bank of Russia.

Fig. 10. Changes in the USD Exchange Rate, the RTS Index and the MICEX Index during the Crisis between May 2008 and January 2011 (May 2008 = 100%)

Domestic developments in Russia, as a rule, have recently had a loose effect on price changes for Russian corporations' stock. The simplest explanation behind the phenomenon lies in a drastic increase in volumes of short-term foreign investment in the domestic equity market, as demonstrated by *Fig. 8*. In this sense, it is interesting to examine the VEB's record of implementation of anti-crisis measures on support of the domestic stock market in 2008-09, which are often subject to a biting criticism. For example, Mr. Vladislav Reznik, Chairman of the State Duma Committee for financial markets believes, "...this measure clearly was irrelevant and excessive", "it distorted the real market picture"¹. Such assessments are partly determined by the fact that both VEB and the RF Ministry of Finance have failed so far to provide any publicly available account of how the funds were used and what was their effect on the market.



Source: by data of MICEX.

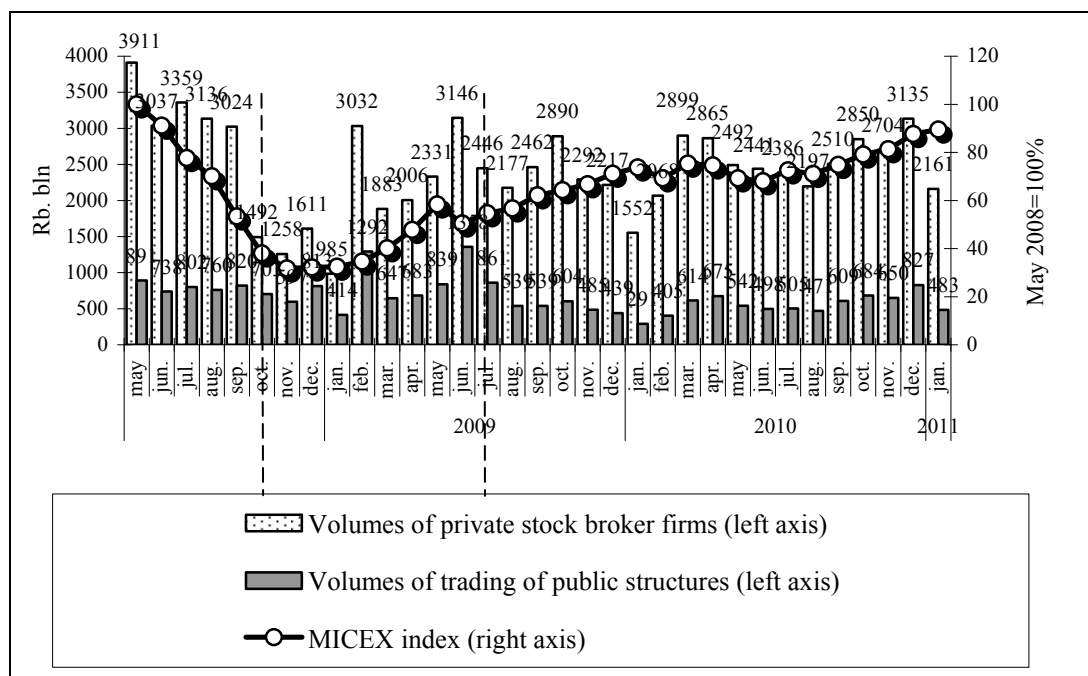
Fig. 11. Proportion of Private and Public Brokers in the Volume of Stock Trading at MICEX, as %

It is on record that in October 2008 VEB was given Rb. 175 bln. in a subordinated loan under 7% annualized. The loan was extended for the sake of supporting the equity market. The bank repaid the loan, along with the interest, on 15 December 2009. The amount in question is roughly equivalent of USD 6 bln. According to the EMPR, it was the same amount foreign investment funds withdrew from Russian issuers' stock between July 2008 and March 2009, with some 3.8 bln. out of the said amount being withdrawn between July and September 2008, ie. prior to the start of VEB's interventions on the financial market. Before the start of the VEB's interventions, the capital outflow from foreign funds investing in Russia had been fading notably. In April 2010, foreign funds already began attracting new capital onto the market.

¹ Rushailo P. Razgovor nedeli. Vladislav Reznik: v kakoy-to moment pridetsya uvelichit pensionny vozrast. Kommersant Dengi, № 7, 21.02-27.02. 2011, p. 30.

The data on the start and the end of the VEB’s intervention on the market allows evaluation of the state-owned banks and their affiliated structures’¹ trading activity at MICEX. The data are presented in Fig. 11. The peak of the public structures’ activity fell on the period between October and December 2008. At the time, VEB was likely to acquire Russian issuers’ shares, thus supporting the market. As stated in the VEB annual report, as of 1 January 2009, the Bank owned a securities portfolio acquired at the expense of the national Welfare Fund’s resources that totaled Rb. 159.7 bln. That is to say, over 90% of the capital allocated on support was spent during the period concerned. Meanwhile, over the same three months foreign investment funds cashed in USD 1.9 bln., or Rb. 60 bln. from sales of stock.

Fig. 12 demonstrates that the MICEX index hit the bottom in December 2008; in October, November and December 2008, its values accounted for 731.96, 611.32 and 619.53 points, respectively, while in January 2009 it made up 624.9 points. The RTS index hit the bottom in January 2009; between October and December 2008 its values stood at 773.37, 658.14 and 589.79 points, while in January and February 2009 – at 535.04 and 544.58 points, respectively. This might evidence that the VEB’s massive buys of nosediving shares in the late 2008, perhaps, did help have the jitters investors, primarily domestic ones, to get rid of their stock at the bottom of the crisis. That, perhaps, kept the market afloat and saved it from yet a deeper fall by another percentage points. But, had there been no VEB investments at the time, nothing yet more daunting would have occurred with the Russian stock market. Those who ran scared and wanted to get rid of their shares at any price would have faced a low liquidity of the market, which might have cooled them down. The economy began to gradually recover in March-April 2009, and the market saw a new inflow of foreign portfolio capital.

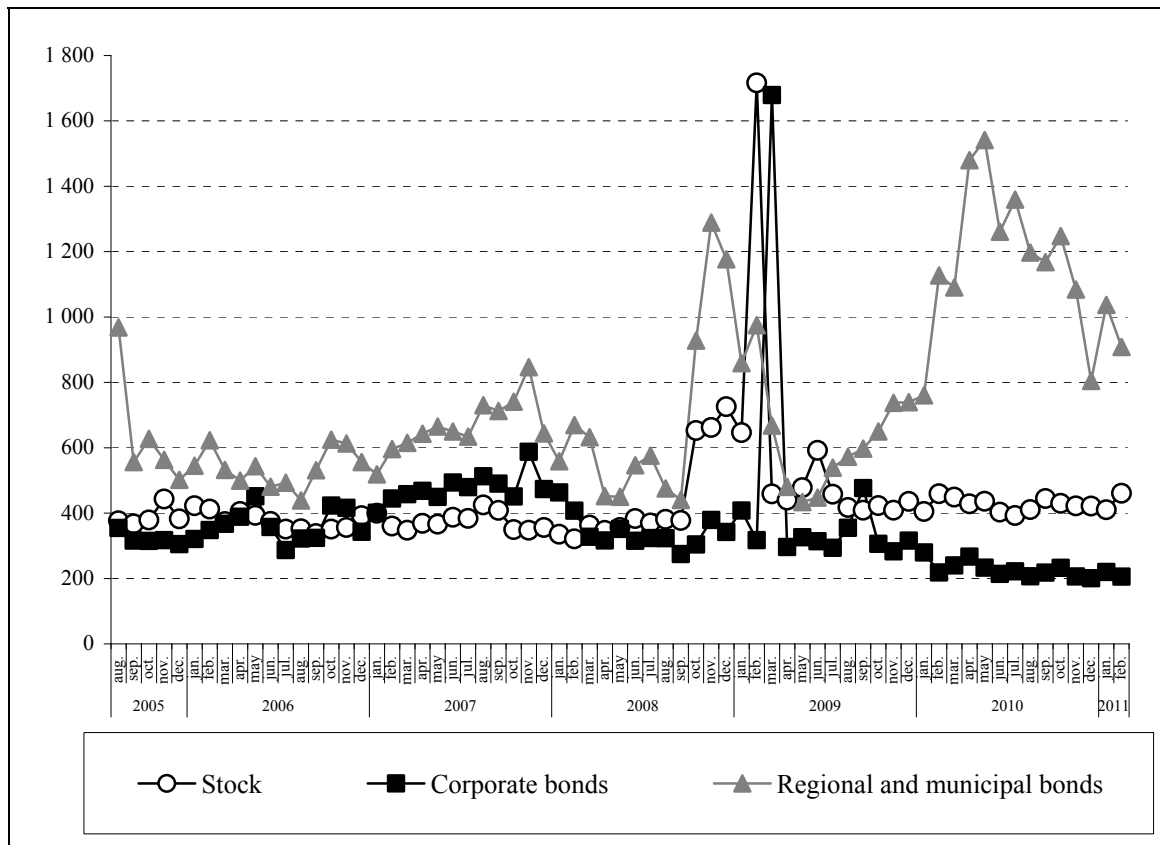


Source: calculated by the MICEX data.

Fig. 12. Dynamic of the Index and Volumes of Trading of Different Groups of participants in the Exchange Market of MICEX between May 2008 and January 2011

¹ VEB, VTB, VTB Kapital, VTB 24, Gazprombank, Sberbank, KIT Finans, Svyaz-bank, and Bank of Moscow

The situation with the VEB’s reversing sale of the shares is not clear. In its 2009 annual report, the bank reckoned that it had sold a fraction of the stock package acquired at the expense the aforementioned loan from the National Welfare Fund yet in the second half 2009. As demonstrated by *Fig. 11*, at the time, the state-owned structures showed no increased activity on the exchanging market for shares, except for July, which was in sharp contrast with the period when VEB was buying those shares. Plus, taking away USD 6 bln. from the market between July and December 2009 should have become a knife in the back of its gradual upwards dynamic. There was nothing like that at the time, either. All that allows assumption that VEB did not sell the full package of shares in question, while the Rb. 175 bln. it returned to the RF Ministry of Finance in late December 2009 was taken from some other source. In general, it can be asserted that the government’s financial interventions to support the market were unjustifiable. Such interventions might have smoothed the gradient of the market’s fall, but they failed to affect the trend itself. In this case, it looks like the public bank swung a lucrative “marginal” deal by using a very generous by its term and conditions loan, rather than the state gave an upper hand to the stock market and investors.



Source: calculated basing on the MICEX data.

Fig. 13. Herfindahl-Hirschman Index

In addition to the process of revival of the stock market’s capitalization and liquidity (*Fig. 4*), the secondary exchanging stock market saw the level of its concentration decline, which proves stability of performance of the market-based pricing on the domestic market. This is

proved by data of *Fig. 13*, which contains data on the Herfindahl-Hirschman Index¹ (HHI) of turnover on the market for shares, corporate and regional bonds at MICEX between January 2005 and February 2011. According to FAS's approach, the market is a low concentrated one under HHI value being under 800, moderately concentrated with $800 < \text{HHI} < 1,800$, and highly concentrated with HHI making up 1,800 plus².

The Russian securities market has recently been low concentrated, with the HHI value drifting below 800. It was only during the crisis, between August 2008 and March 2009, that the HHI values sometimes were over 800, as far as stock and Rb.-denominated bonds are concerned. But even that HHI on shares sky-rocketed in February 2009 was a result of 16 REPO deals worth a total of Rb. 1,620 bln., which some brokers erroneously stroke with Gasprom ordinary shares on 2 February 2009. The Arbitration Commission under JSC MICEX consequently annulled the deals with its decision of 18 February 2009.

Interestingly, during the 2008 crisis and in its aftermath the HHI values on corporate bonds remained steadily lower than those on the stock market. That is likely to mirror the existence of a more diversified circle of participants in the market for corporate bonds vs. the stock market. In February 2011, the HHI on shares hit 460.8 vis-à-vis 205.6 posted by the HHI on corporate bonds. Back in 2001, the HHI on regional bonds was steadily over 800, which allows attributing the market to moderately concentrated ones, whose array of participants is fairly limited. In February 2011, the HHI on regional bonds accounted for 908.5.

Fig. 14 exhibits data on changes in the structure of transactions with shares on MICEX. They reveal a trend to a post-crisis recovery in the structure of exchanging equity deals associated with the REPO segment. By using REPO transactions on the stock market brokerages, as a rule, draw short-term borrowed capital for a subsequent marginal lending. In December 2008, the proportion of REPO transactions accounted for 68% of the aggregate cost of exchanging deals with shares at MICEX; the subsequently figure slid to 50% at the end of the year and bounced up to 59% in February 2011. The upsurge in the proportion of REPO deals evidences the marginal lending to transactions involving securities has got a fresh start. This, on the one hand, means investors are keener to ride the market for risky assets, while it serves an indicator of the rising speculative activity on the national stock market, on the other.

The growing popularity of systems of short-term, primarily algorithmic, trading and engagement of trading robots has emerged as an important avenue of the exchanging stock market's development. This is proved by results of "Best Private Investor" contests RTS and MICEX were running in the late 2010. The victor was a trader who used robots. According to the Russian exchanges' data cited by Kommersant, up to 90% of trading claims and 50% of the turnover at the RTS FORTS fall on robots; at the MICEX's spot stock market, hyperactive trading robots hold 45% of claims and 11-13% of volumes of trading, with 95% of the said

¹ Herfindahl-Hirschman Index is calculated by squaring the percentage share of each given participant in the volume of exchanging trading and summing up the results:

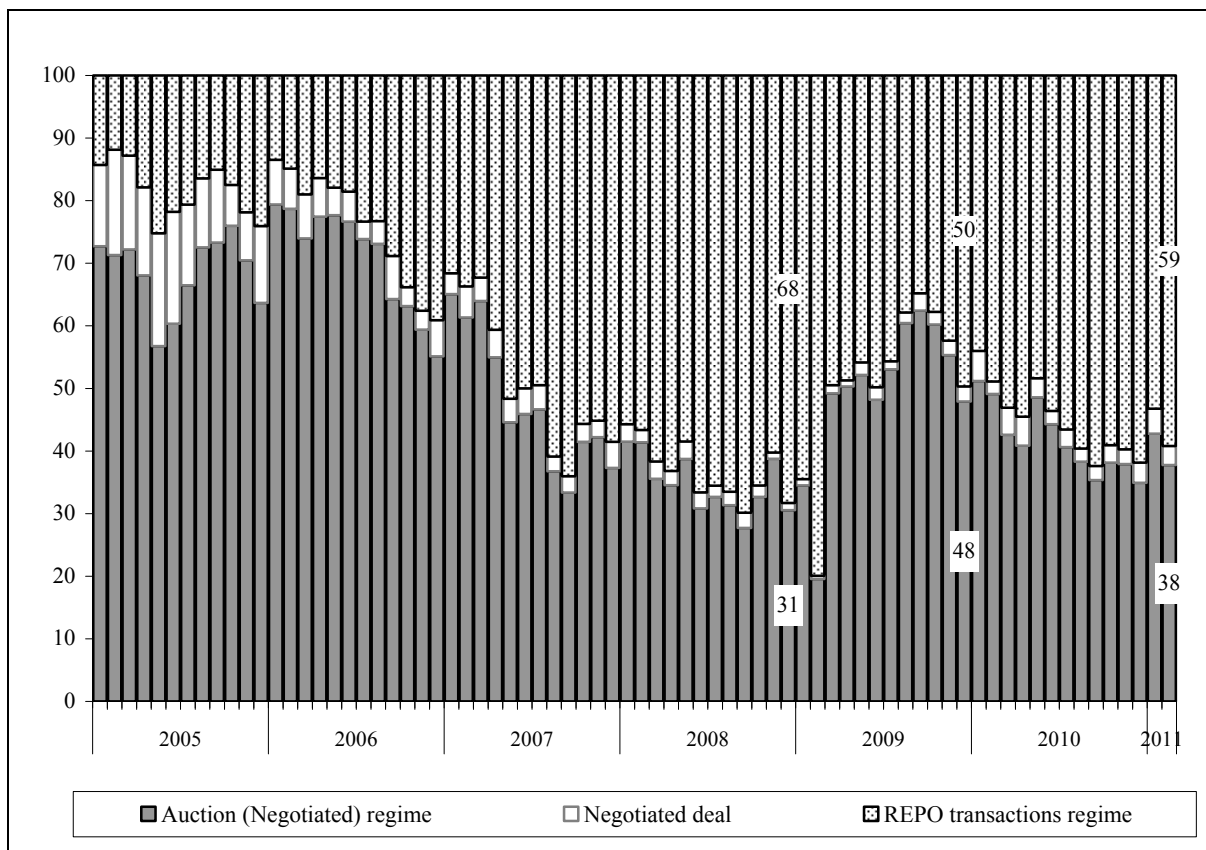
$$\text{HHI} = (D1)^2 + (D2)^2 + \dots + (Dm)^2,$$

where D_i – share on the market of i -th participant in percentage equivalent;

$i = 1, 2, \dots, m$.

² See p.2.6.4. of the Methodological recommendations on the procedure for conduct of evaluation and assessment of the state of competitive environment at the financial services market approved by the RF Ministry of Anti-Monopoly Policy with Executive order of 31.03.2003 № 86.

applications subsequently being withdrawn without concluding a deal¹: "... The problem of algorithmic trading does exist, and a great number of robots seems spooky; the rise in their number overloads the exchanges' gateways, which, theoretically, can entail technological problems"², Mr. V.D. Milovidov is quoted as saying in the same article. Responding to the challenge, in the late July 2010, MICEX sent out to its participants a proposal to approve amendments to the exchanging trading procedures that provided for identification of robots that put forward trading claims outnumbering 1% of the aggregate number of claims put by all the participants, ie. over 40,000 claims a year. The exchange will block such hyperactive robots' operations in the event they pose a threat to the normal functioning of the exchanging trading system. In March 2011, MICEX kept taking on trading robots: since 1 March 2011, the exchange set a minimal commission fee of Rb. 0,18 per deal. Plus, it established requirements to the minimal size of the round lot at an amount of no less than Rb. 1,000, which should result in enlargement of most stock and shares round lots. The measures focus on encouragement of conclusion of large deals and minimization of the number of deals exempt from commission fee³.



Source: by MICEX data.

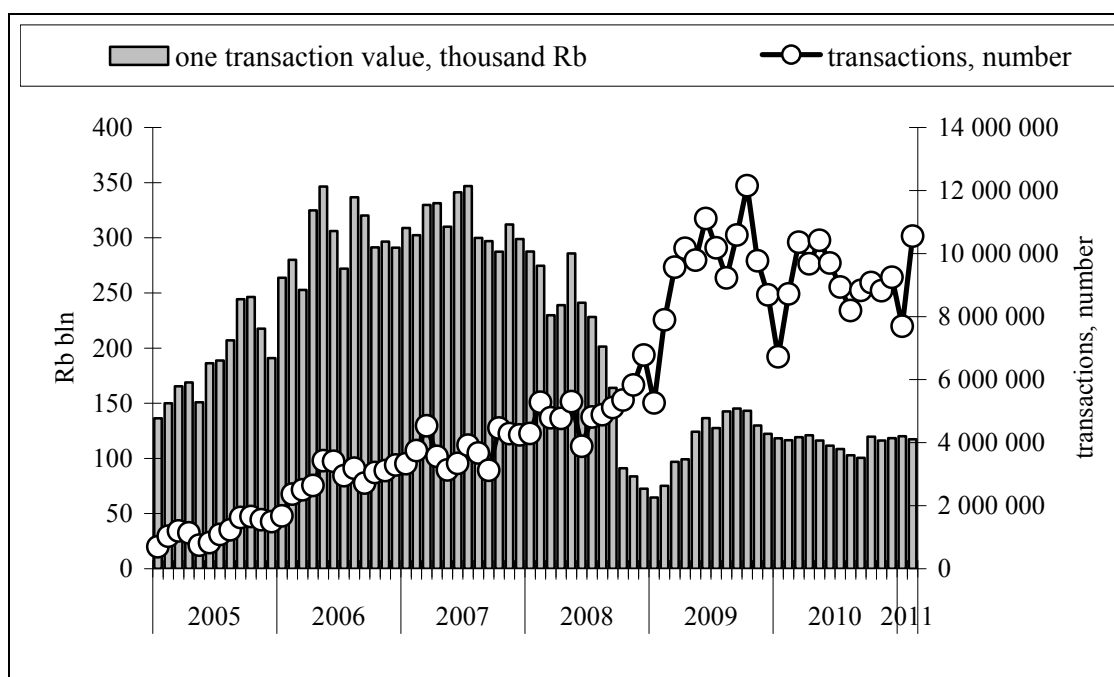
Fig. 14. Structure of Deals with Stock on MICEX, as %

¹ Smorodskaya P. MMVB vzyalas za robotov: birzhevuyu trgovlyu distantsiruyut ot avtomatov. Kommersant, 20 July 2010.

² *Ibid.*

³ Trifonov A. MMVB ne khochet melochyitsya. Vedomosti, 8 February 2011.

Fig. 15 presents data on the number of deals and the average volume of one deal in the regime of market (anonymous) stock trading at MICEX. The data show that during past two years, the average monthly number of deals soared from 6.8 mln. in December 2008 to 10.6 mln. in February 2011, or by 55.9%. Meanwhile, the average volume of market deals involving shares at the exchange was notably down, despite the ongoing process of stock prices' recovery. In September 2009, the average size of the deal involving stock under this particular regime of trading at MICEX accounted for Rb. 145,200, while in February 2011 -117,300, or down by 19.2%. The advancement of the algorithmic trading manifests itself primarily in the rising tide of claims in the trading system. However, a notable increase in the number of exchanging deals in tandem with the fall in their average volume also witnesses investors growing increasingly keen to engage in speculative trading strategies.



Source: by MICEX data.

Fig. 15. Market Deals with Stock at MICEX

During the crisis, FSFM took a pro-active stand and in an attempt to fence the market participants from overly risky operations, interfered with the trading. Due to the market's increasing volatility, on 18 September 2008, the regulator banned short interests for brokers. The ban was lifted on 26 September 2008, re-imposed on 30 September 2008 and remained effective through 15 June 2009. Since 25 September FSFM also limited the use of leverage for margin deals¹ stricken by brokers' clients. Once introduced, the regulator's restriction resulted in leverages on marginal transactions for all investors capped with the 1:1 ratio. The right to use of the previous ratio of 1:3 was restored solely for "qualified investors" since 15 June 2009, albeit with some additional restrictions. Introduction of such limitations demanded

¹ A margin transaction is the one the broker's client enters into to buy securities at the expense of a loan granted to him. In contrast to short interest used for a hit-and-run entry, marginal trading strategies are used, as a rule, on a bull market to ensure extra profit from the use of the leverage.

for a FSFM's permanent and efficient supervision, which in reality was non-existent¹. At that juncture, in a 2009 paper, the Institute's experts suggested that while brokers somehow observed with the margin lending limitations, short interests thrived, regardless of the regulator's bans².

The year of 2010 saw adoption of critical decisions in the financial market regulation area. They centered on tightening requirements to the professional market participants, size of their own capital, countering manipulations with prices of financial assets, championing consolidation of the stock infrastructure, introducing prudential supervision provisions. The move can be characterized as a course to strengthening of the state's role on the stock market, its direct interference with its participants' core operations.

On 30 July 2009, FSFM approved the Executive Order "On approving changes introduced in capital adequacy ratio of participants in the securities market, as well as managing companies of investment funds, mutual investment funds and non-state pension funds approved by Executive Order of FSFM of 24.01.07 № 07-50-pz-n". In compliance with the document, the regulator raised the capital adequacy ratio for professional participants in the securities market which exercise:

- Brokerage and securities trust management – from Rb. 10 mln. up to 35 mln. from 1 July 2010 and further up to 50 mln.- from 1 July 2011;
- Dealer operations- from Rb. 5 mln. up to 35 mln. from 1 July 2010 and further up to 50 mln.- from 1 July 2011;
- Depository operations (except for settlement depositories)- from Rb. 40 mln. up to 60 mln. from 1 July 2010 and further up to 80 mln. from 1 July 2011;
- Operations on maintenance the registers of owners of registered securities - from Rb. 10 mln. up to 100 mln. from 1 July 2010 and further up to 150 mln.- from 1 July 2011.

Today, FSFM has not yet abandoned the practice of mounting pressure on the financial intermediaries' operations. In March 2011, on its web-page, the regulator posted a draft executive order on modifying license requirements to registrars. Instead of the effective requirement to a registrar to service at least 50 issuers with the number of shareholders over 500, it is proposed to have each registrar service at least 20 issuers with the number of shareholders over 500 and no less than 250,000 non-zero nominee accounts. Experts suggest that roughly a half of the 45 currently operating registrars will fail to qualify the requirement³. Following its inspections in 2010, FSFM revoked licenses from such large registrars as JSC "Aktionerny capital" and JSC "Tsentralny Moskovsky Depositariy". On 28 August 2010, the regulator also revoked a license for the right to exercise activities in the capacity of a specialized depository from Depositariy Irkol, one of the leaders in the sector of pooled investment.

¹ The authors of the Report on results of the control measure "Examination of efficacy in 2008 of the effective law and normative and legal base on the financial market and the securities market for the purpose of stabilization of the financial system at the Federal Service for Financial Markets, the RF Ministry of Finance (on request)" conducted by the Accounting Chamber of RF believe that, "the government agencies do not carry out the systemic analysis of the situation on the stock market on a permanent basis, do not track down and analyze large financial institutions' operations on the stock market, which results in the RF Government and the country's leadership lacking a comprehensive and actual information of the environment of, and situation at, the Russian financial market». The Bulletin of the Accounting Chamber of RF, 2010, №1, p.100. Posted at: http://www.ach.gov.ru/userfiles/bulletins/05-buletен_doc_files-fl-1855.pdf.

² Rossiyskaya ekonomika v 2009 godu. Tendentsii i perspektivy (vypusk 31)- M., IEPP, 2010 pp. 148-151.

³ Smorodskaya P. Registratoram vystavily nenulevoy schet. Kommersant, 1 March 2011.

The FSFM's efforts, which are aimed at a substantial tightening of requirements to professional security market participants' own capital, are a part of the regulators community' concerted attempt to raise requirements to banks and insurance companies' capital. Since January 2010 banks had to boost their capital to match the mandatory mark of Rb. 90 mln. and further up to 180 mln. by 2012. The government is currently crafting amendments to the Civil Code of RF, which suggest tighter requirements to the minimal amount of economic companies' authorized capital. The regulators' common logic is likely to be driven by the desire to bolster the Russian corporations' level of efficiency by raising administrative barriers to market entry and encouraging, in the up-bottom mode, processes of concentration of businesses. It is not accidental that these measures concurred with the economy and the financial market exiting the crisis and looking for new drivers of businesses' efficiency.

The FSFM's assessments of the impact of the tighter requirements to the capital adequacy ratio appear different from those made by the stock market participants. The regulator forecasted that the new requirements would compel some 8-10% of professional participants to quit the market¹. Naufor in turn estimates the respective figure to make up over 20%². The Federal Antimonopoly Service officially objected the FSFM's stance, but the regulator ultimately turned victorious in the higher echelons of power.

The data on the number of licensed brokers, dealers and participants in exchanging trading at MICEX are given in *Table 2*. The data show that in the aftermath of the implementation of the new requirements, between 1 July 2010 and 1 March 2011 the number of brokers dwindled 8.2%, the one of dealers – 9.4%, while the number of participants in exchanging trading at MICEX even posted a 0.4% growth. That said, the figures do not quite accurately mirror the impact of the FSFM's decisions have had on the market participants. They are to face yet tighter requirements to the capital adequacy ratio since 1 July 2011. Besides, in the course of a looming examination of the market participants' reports on the amount of their own capital the wave of revoked licenses should be rising further on. So, it seems that NAUFOR's projection is more adequate and, perhaps, even too conservative, and the figure is highly likely to be passed by a substantial margin.

Table 2

The Number of Professional Participants in the Stock Market

	2007	2008	2009	01.07.2010	01.03.2011
1. The number of organizations holding a license from FSFM on the right to carry out:					
1.2. Brokerage services	1445	1475	1335	1318	1210
change to the prior period, as %		2.1	-9.5	-1.3	-8.2
1.3. Dealer operations	1422	1470	1337	1318	1194
change to the prior period, as %		3.4	-9.0	-1.4	-9.4
2. The number of participants in the exchanging trading at MICEX	460	463	477	481	483
change to the prior period, as %		0.7	3.0	0.8	0.4

Source: by data of FSFM, NAUFOR and MICEX

Too little time passed to evaluate consequences of the impact of the regulator's move on efficiency of financial intermediaries' operations and protection of investors' interests. At the moment, there is an array of problems which cannot help but raise concerns.

¹ Askar-zade. N. Za malenkogo brokera. Vedomosti, 28 July 2010.

² Smorodskaya P. Brokery budut zhit po sobstvennym sredstvam. Trebovaniya FSFR obretayut silu zakona. Kommersant, 1 October 2010.

Tightening requirements to the capital adequacy ratio does not go in pair with visible moves to enhance the transparency of the financial intermediaries' operations. Their financial reporting and key performance indicators remained unavailable for the public at large. Traditional research into how greater barriers to market entry and exit tell on a greater efficiency of businesses require intermediaries to unveil such indicators as labor compensations costs, profit, the proportion of borrowed capital, among others. As most of these indicators are hard to calculate using the official reporting data and they are not published, it is impossible to run an objective evaluation of efficacy of regulator's measures using traditional international methodologies. This allows an assumption that the regulator acts blindfold and without the much-needed analysis of respective consequences. Such a spontaneous change of rules of the game can grow into a genuine factor of instability of the business environment and hinder market investments into the sector.

Not backed by real moves in the area of the policy aimed at development of the financial market, the aforementioned measures on a sizeable growth in compulsory requirements on the businesses' capitalization can engender consequences other than the regulators hope for. In addition to supplanting licensed small brokers, dealers and trust managers from the market, FSFM dumped efforts on a further championing of the law on investment consultants. Hence, the legal forms of delivery of investment and financial services to the population have become extinct, particularly, in the provinces. New rules limit possibilities for the rise in the national market of "niche brokers" who specialize on servicing certain segments of the market, and that poses another obstacle to innovations in the sector. Local brokers, dealers and trust managers can be replaced by black hats: unlicensed shadow brokers for private investors, Ponzi scheme operators, unlicensed forex market operators, gaming clubs, and Internet-based services¹. As evidenced by the record of the national stock market back in the mid-1990s, financial pyramids flourish where legal forms of financial intermediation do not function².

While dramatically increasing risks of the rise of illegal financial services, the government's measures do not solve another significant problem, either, - that is, boosting the domestic financial institutions' competitiveness and nurturing national leaders in the financial services sector. To make the financial intermediation sector competitive, one should have an extensive network of financial intermediaries, which should be in close proximity to most small investors. Large companies, national champions emerge under a ruthless competition and with the economic environment fostering innovation, thus allowing innovative companies to cash in an extra business rent. There are no such conditions on the Russian market.

Since 1 July 2011 the brokers and dealers should increase their own capital up to Rb. 50 mln., or USD 1.7 mln. That is way tighter the requirements than those in the US and EU. In the US, it is just brokerages that keep clients' assets, which are obligated to maintain the USD 250,000 capital in combination with prudential requirements. Requirements to capital for brokerages that operate using the sub-agent scheme with the clients' assets deposited with a higher-level brokerage's depository imply their own capital should be between USD 50,000 and 100,000, depending on whether such companies fulfill their clients' orders on their own, or transfer them to another broker. In the EU, financial companies that deposit their clients'

¹ According to Mr. R. Goryunov, President of RTS, "the number of unlicensed brokers will be rising, unless we foster growth in the number of decent participants". Maltsev O. Regionlnaya fondovaya chistka. Finans. №10, 22-28.03.2010. p. 59

² Biyanova N., Nikolsky A. Mavrodi prinyal vyzov. Vedomosti, 12 January 2011; Yurischeva D., Nantay V., Mazunin A., Trifonov V. Sergej Mavrody splel finansovuyu set. Kommersant, 11 January 2011.

assets should maintain their capital at the level of Euro 125,000, while companies which are not engaged in depository operations shall have their own capital no less than Euro 50,000.

Such low requirements to financial intermediaries' capital in the US and Europe ensure the investor community's access to versatile investment and financial products. In the US, SEC and FINRA are tasked to oversee operations of some 5.1000 brokerages and dealer companies that run individual and corporate accounts of some 110 mln. investors. Plus, SEC has registered to date 11,000 investment consultancies that run 14 mln. clients' assets worth a total of some USD 38 mln. Lastly, on the state level, as many as 275,000 private individuals and some 15,000 corporations were registered as investment consultants¹.

Meanwhile, it is just five companies – Fidelity Investment, Charley Schwab, Ameritrade, E*Trade and Scottrade which hold some 80% of the market for retail brokerage services for private persons. An analysis of the background of such companies as Fidelity and Schwab evidences that behind their success stories and leadership in the investment retail has been a continuous strive for innovation in the area of products and services. The legislature and regulator's mission in this regard is to focus on creation of innovation-friendly conditions and to make sure corporations can hold an innovation rent from introduction of innovations, without which there are no incentives to advancement and prowess in this field.

In Russia, 60% - plus of brokerages' clients and active clients who strike at least one exchanging deal a month are serviced by seven largest brokerages (*Fig. 16*). However, when compared to the largest investment houses and brokerages in the developed countries or those in China, India or Brazil, none of them has so far qualified for the leadership in the sector. One of the reasons for such a situation is imperfect national law and an absence of the government's commitment and resolve to foster a business climate which would propel a prompt expansion of the most innovative companies.

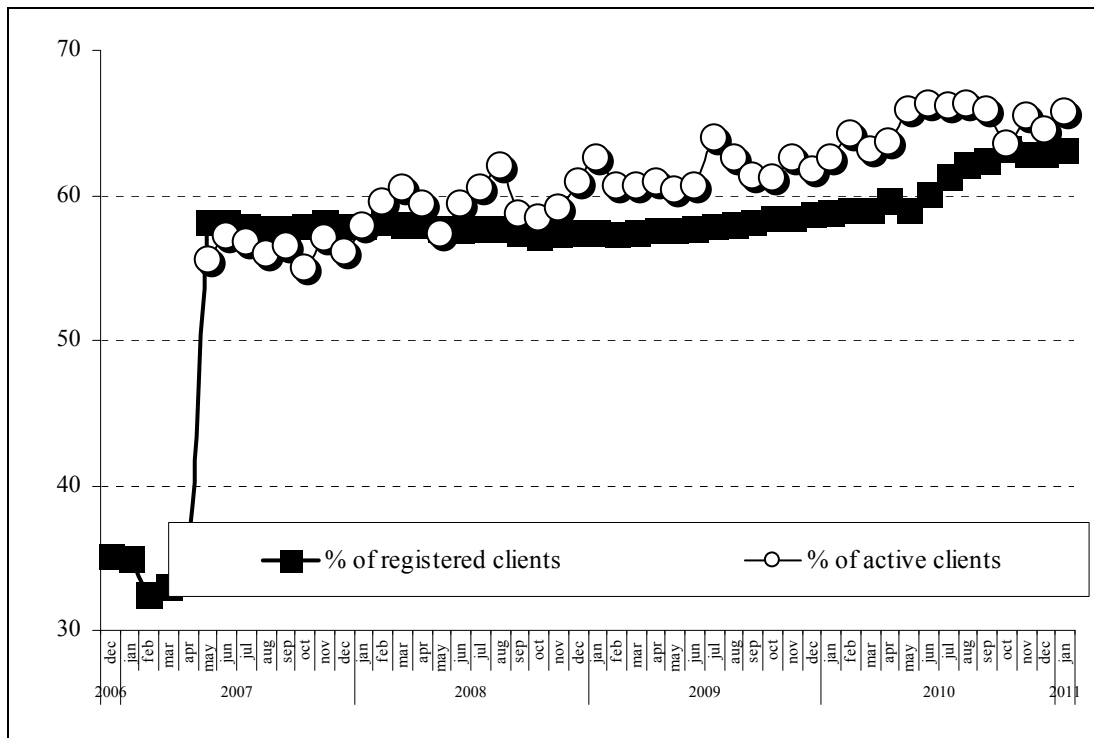
Legislators are keenly aware of the uncompetitive nature of Russia's legal environment in the financial sphere. Mr. D. Ananyev, Chairman of the Federation Council Committee for financial markets and money circulation, admits that, "...Russian financial law does not appear flexible enough, but overly imperative, and investors find it hard to build on its basis convenient forms of doing business, for property rights are not secured efficiently and informational transparency is insufficient"².

Lastly, one should not help but underestimate the impact of the enacted against the market participants and SROs' will decision on raising requirements to capital adequacy ratio on deterioration of the business climate both in the economy on the whole and the financial market in particular. The decision in question appears just a link in the string of state's numerous direct interferences with business. As a consequence, the business climate in the country has lately worsened and the capital flight has been on the upswing. In 2010, the media tattled of a possible sale of Troika Dialogue, one of the largest private investment banks, to a state-owned one. Meanwhile, Mr. R. Vardanyan, Troika's founder, publicly voiced his desire to quit the company as early as in 2013. Given his reputation both in Russia and overseas and caution he, as an investment banker, exercises in his assessments and statements, his explanation of the current processes in the business and financial spheres appears fairly provocative. For example, he cites that, "...there is no understanding of how decisions are made both in business

¹ U.S. Securities and Exchange Commission. Study on Investment Advisers and Broker-Dealers. January 2011, p.6-8. Posted at: www.sec.gov

² Chuvilyaev P. Dmitry Ananyev: bolshinstvo systemnykh problem v finansovom zakonodatelstve ostayutsya nereshennymi. Kommersant Dengi, № 24, 21.06.-27.06. 2010, p. 16.

and in the government”; “the civil servants’ attitude to business worsened”; “the crisis demonstrated there is no capitalism but some kind of pseudocapitalism”; “for any business the planning horizon is limited by one year or three years at best”; you should be prepared for different things, for example, “receiving a request to sell business and be prepared for having your license revoked or for everyone been instructed not to work with you any longer”¹.



Source: calculated by MICEX data

Fig. 16. The Share of Top 7 Brokerages in Clients' Assets, as %

That private financial structures have grown increasingly concerned about the state’s interference in their business was evidenced by acquisition in 2001 by Zoulian Trustees Limited (Cyprus) of 99.5% of voting shares in JSC Investment Holding Finam. The acquisition was approved by the RF Federal Anti-Monopoly Service. A Finam representative commented that, “...so far we have not faced a hostile takeover, but anything can happen in Russia.”² The statistics of the banking sector also illustrate growing doubts over the domestic market’s prospects. In 2009-2011, shareholders of ten foreign banks³, such as International Personal Finance, Santander, Rabobank, Barclays, Swedbank, HSBC, KBC Group, Morgan Stanley, to name a few, announced scaling back on their presence on the Russian market. Meanwhile, numerous investment companies and banks in Russia declared they would hence focus on wealthy individuals as an alternative to financial retail services. Thanks in large measure to a direct involvement of FSFM, the Bank of Russia and the RF Ministry of Finance in negotiations between professional participants in the stock market in February 2011, the two largest

¹ Askar-zade. N, Safronov B. Krizis pokazal, chto kapitalizma u nas net. Vedomosti, 30 September 2010.

² Zhelobanov D., Gubeidullina G. “Finam” ukhodit v ofshor. Vedomosti, 1 July 2010.

³ DemytyevaK., Khvostik E. Inorodnoye telo. Kommersant, 9 March 2011.

domestic exchanges, MICEX and RTS, decided to merge. The decision on the merger and the Bank of Russia's retirement from the MICEX's capital prior the end of 2011 was made on 29 December 2010 at a meeting on establishment of an international financial center. Consequently, on 1 February 2011, the top five RTS's shareholders – that is, Troika Dialogue, Aton, Alfa-Bank, Renaissance Broker and Da Vinci Management Company - signed an agreement on their intention to sell their stakes in the exchange. The deal suggests that MICEX acquires a control bloc in RTS with a subsequent merger of the two exchanges. RTS was appraised to cost USD 1.15 bln. Its 35% stake will be bought for cash, while the rest will be swapped for shares in JSC MICEX at the ratio of 1:35¹. It is symbolical that all that was made public on the premises of the Bank of Russia. At the height of the consolidation of the Russian exchanges, in late 2010, there popped up information of their possible merger with Deutsche Borse. Media sources suggested that the information evidenced that in the frame of the work on establishment of an international financial center the matter was discussed by individuals close to government structures behind the RTS and MICEX top management and shareholders' back².

Creation of a consolidated exchange on the basis of MICEX and RTS, can, other conditions being equal, ensure a positive effect in the form of concentration of liquidity, greater efficiency in transacting in different segments of the financial market, cuts in direct and indirect transaction costs for participants in trading and investors, and solidification of Russia's standing on international capital markets. However, there persist some risks, too. Monopoly can affect an exchange's innovational activity, result in higher tariffs for infrastructural organizations' products and services, push participants in the Russian markets to more vigorous entering overseas markets. Meanwhile, the major risk a consolidated exchange structure would face could lie in a government structures' greater influence on its operations. Formally, the Bank of Russia should withdraw from the exchange within 2011. However, government structures have plethora of informal leverages to influence the exchange and the settlement infrastructure through votes of subordinated to them state-owned banks, control over appointment of heads of infrastructural organizations, and adoption of regulatory documents. That is why a major challenge the consolidated exchange will see in the short run will lie in shaping such a corporate governance system which should establish a legitimate balance of interests between private corporations and public structures in regard to the new exchange's operations. That said, as government structures have lately intensified their interference in business, such a balance will be hard to strike in the years to come.

As to legislation, the year of 2010 saw enactment of several federal acts which may have a positive effect on advancement of the national financial market. Specifically, Federal Act of 27 July 2010 № 224-FZ "On countering the improper use of insider information and market manipulation and on introducing amendments to individual legislative acts of Russian Federation" reads that the national financial, forex and commodity markets have now become subject to control over the use of insider information and market manipulation. The Act established the definition of insider information, identified the circle of individuals who qualify for insiders, formulated signs of insider trading and activities that fall under market manipulation, and determined measures on their restraint. Criminal and administrative responsibility for the

¹ Smorodskaya P. RTS storgovali s MMVB. Gosudarstvo sklonilo birzhi k obyedineniyu. Kommersant, 2 February 2011.

² Maltsev O. Ministerstvo birzhevoy trgovli. Istoriya s Deutsche Borse. Finans, № 47-48, 20.12.2010-16.01.2011, p. 56.

improper use of insider information and market manipulation was introduced in the form of amendments to the Criminal Code of RF and the Code of RF of Administrative Violations. In compliance with by-laws to the Federal Act, FSFM suggests to obligate stock exchanges to daily produce calculations, on the basis of special formulas and with the use of their databases, on exchanging transactions and to report suspicious deals to the regulator.

The other novelty became Federal Act of 27 July 2010 № 208-FZ “On consolidated financial reporting”. The Act reads that credit, insurance and other organizations, whose papers float at stock exchanges and with other organizers of trading on the securities market, are bound to publish their annual consolidated financial report according to IFRS. This means that from 2010 on, all issuers, with their outstandings, rather than the previous 20-25 ones, should publish their reports according to IFRS. Since 2015 the requirement will become binding for all corporate issuers whose bonds were permitted of trading. Let us hope this positive practice will expand shortly to embrace all the professional participants on the security market and companies that manage pooled investments. It is also imperative to urge issuers to compile and disclose the IFRS-based reports quarterly, for that would allow a comprehensive fundamental evaluation as a pillar to investment decision making on the domestic market.

Lastly, last year saw adoption of a number of amendments to the Tax Code of RF, which concerned operations on the stock market and the market for pooled investment. The novelties comprise, in particular, personal income tax benefits for private individuals and corporate profit tax benefits for legal entities that invest in start-ups and venture projects. The said categories of taxpayers are now exempt from the respective taxes on incomes generated by sales (redemption) of participation shares and stock in Russian organizations which are not traded on organized securities markets, provided the shares sold belonged to the taxpayer for more than five years, while over-the-counter stock belonged to their owner for long. According to some other amendments introduced to Art. 378 of the Tax Code, assets transferred to the mutual investment fund are now subject to the property tax collected from the managing company. Also, amendments were introduced to Art. 388, which now reads that land lots assigned to the MIF are subject to the land tax payable by the managing company out of the assets that form the fund.

So, the year of 2010 witnessed the state bolster its reign as the regulator of financial markets and institutions. However, in addition to its traditional market control and oversight functions, government structures started engaging more vigorously in governing infrastructural organizations, dictating conditions of doing business, participating in the largest banks and investment companies’ property structure. It is yet premature to judge to the full extent efficiency of these moves; however, it can be ascertained now that the financial market, as well as other sectors of the economy, has faced increasingly unfavorable conditions of doing business and the private sector has increasingly clearly sensed risks and increased costs of doing business in Russia.

The mounting administrative pressure makes one contemplate mechanisms which might secure a reasonable balance between the government’s interests and the business structures’ ones. Such a mechanism might take the form of obligating public structures to pursue a development policy that would suggest employment of indicative forecasts of quantitative indicators of the sector’s advancement, simplification of the effective law to bolster innovational activities by businesses, the government structures’ contribution to implementation of strategic projects aimed at creation a more favorable business climate. These and other problems are highlighted in a greater detail in the concluding part of the present Section.

3.3. Financial Institutions: Seeking for a New Growth Concept

3.3.1. Residual Forms of Support to the Financial Sector

During the recession period of 2008–2009 the federal government was acting as a good administrator which manually managed to maintain the financial system facing bad loans and low liquidity. One may say that the state learned from the lesson of the previous recession, when it failed to save large banks and was held liable for being a source of the problems faced by private institutions ten years ago. The state had to spend USD 212 bln from the international reserves to support banks to balance their foreign exchange assets and liabilities through long-term loans to state-owned banks. To strengthen the resource base of the banks, the state took a risk, from the economic point of view, by ensuring repayment of bank deposits in the amount of RUB 700 K. When the recession was in full swing, the state granted a total of RUB 2,5 t loans to the banks.

In 2010, most of these measures were discontinued unlike at many developed economics which had to actively pursue a quantitative relaxation monetary policy. Only a few of the measures continued, namely the guarantee to repay RUB 700 K of bank deposits. Some of the state-owned entities began to repay a part of their outstanding working capital loans. In December 2009, VEB reported repayment of RUB 175 bln, a loan which the bank obtained as part of the antirecession stock market support. Sberbank of Russia repaid about RUB 200 bln, or 40% of the total antirecession support, to the Ministry of Finance in H1 2010. The bank is likely to continue repaying in the course of privatization deals scheduled for a period between 2011 and 2013. Rosselkhozbank will repay its public loans through IPO. Rosselkhozbank obtained a public contribution of RUB 30 bln to replenish its charter capital during the recession period. In September 2009, the Government of the Russian Federation purchased from VTB an additional issue of RUB 180 bln as part of the antirecession support, at a par value of 4,8 kopeks per share. During IPO which was held on February 17, 2010, the state sold 27.9% of the issue at par value of RUB 9,1468 per share thus gaining RUB 95,7 bln, including a profit of RUB 45,5 bln¹ on this block of shares. It is obvious that the antirecession debt owed by VTB will be paid in full after the subsequent sale of a 10% interest in VTB during a new SPO.

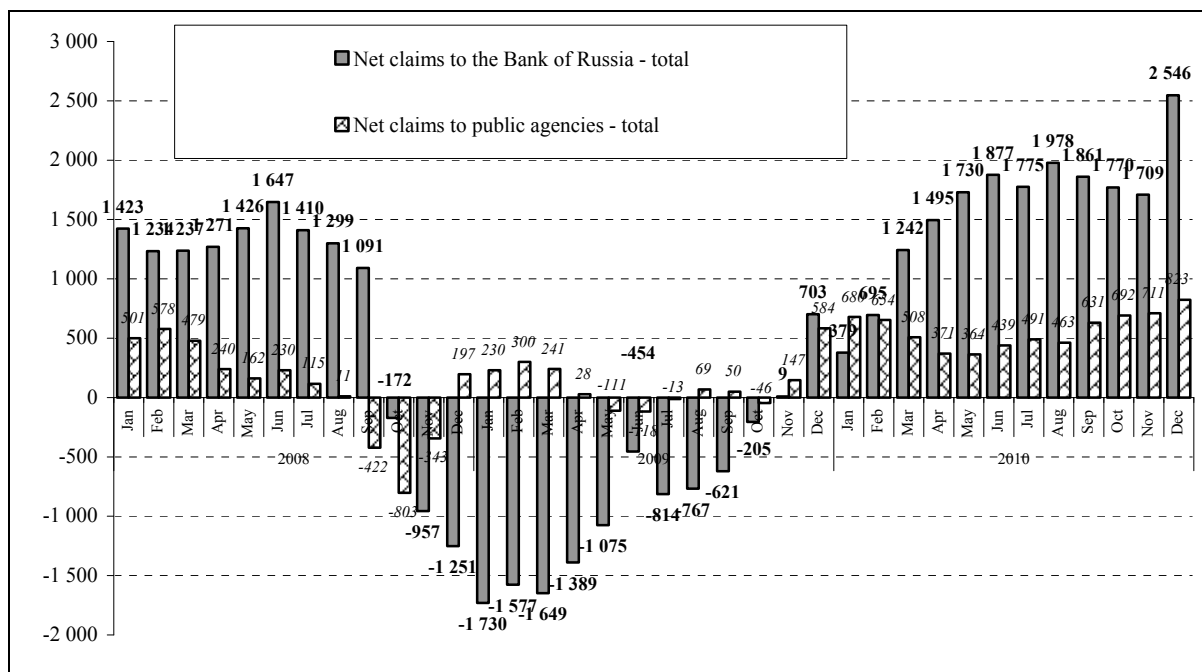
In 2010, with a view of stimulating banking lending, the refinancing rate of the Central Bank of Russia was reduced from 8.75% as of the beginning of the year to 7.75%, a historically lowest rate in modern Russia. The rate increased to 8.00% on February 28, 2011. The crediting rate on direct REPO deals, which represents *actual* refinancing rate of banks in Russia, was even lower, 5 to 6% at the 2010 year-end. The mandatory bank reserve requirements remained at a lower level against the recession period. On December 27, 2010, President Medvedev D. A. signed a federal law which extended till July 1, 2011 the moratorium on exclusion of banks from the deposit insurance system for non-observance of the requirements to a package of estimates related to appreciation of capital, assets, profitability and liquidity, as well a series of mandatory requirements.

In general, one may say that as of the beginning of 2011, the Russian banking system suffered from excess of short-term loans and outrunning growth in bank deposits against lending growth rates rather than from lack of such loans.

¹ Asker-zade N.. A Good Bargain. Vedomosti. February 14, 2011.

3.3.2. Liquidity and Current Stability of the Banking System

From the very onset of the recession period between August and September 2008, Russian banks became a target of large-scale support from the Bank of Russia and the Ministry of Finance. The model of financing through carry trading was replaced by the model of financing through loans from monetary and public authorities. Such a support was given on the basis of repayment financing. As early as late 2009, main bridge financing recourses were withdrawn from the banking system. In 2010, not only did the banking system recovered but also outran the level of its pre-recession short-term liquidity through predominantly domestic borrowings in the form of back deposits, reinforcement of corporate bank accounts, public spending growth (see *Fig. 17*).



Source: based on the data published in the Credit Institutions Review of the Bank of Russia.

Fig. 17. Bank support assessment, bln RUB

In July 2008 net claims to the Bank of Russia and public agencies totaled nearly RUB 1,5 t, i.e. banks were creditors of the Central Bank of Russia and public agencies. The amount of money which banks maintained on deposit and correspondent accounts with the Central Bank of Russia, in bonds of the Bank of Russia and government securities, exceeded by the foregoing amount a small size of the loans obtained from the Bank of Russia and deposits of public agencies. Beginning with September 2008, the situation changed drastically as the Central Bank of Russia and public agencies became net creditors of banks. At the onset of the recession it was decided to reduce mandatory reserves requirements, allocate temporarily budget and state-owned corporations' idle money in banks, support the practice of loans to banks from the Bank of Russia through direct REPO deals and then unsecured and other types of loans. The support to banks was focused on loans from the Bank of Russia. net liabilities owed by banks to the Central Bank of Russia and public agencies totaled RUB 975 bln as early as October 2008 and RUB 1,3 t in November. In January 2009 net liabilities owed by

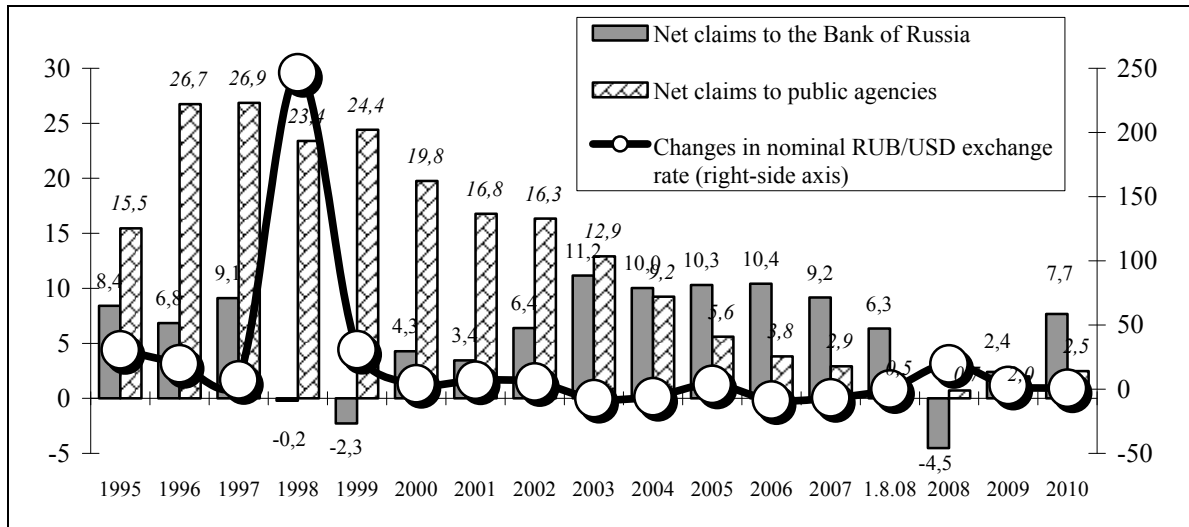
banks reached a maximum of RUB 1,5 t. Hence banks as net creditors of public agencies, RUB 1,5 t, turned into net debtors owing the same amount to the public agencies, which means that maximum support to banks through lending totaled nearly RUB 3 t.

Beginning with February 2009, i.e. from the moment when the Russian Stock Market resumed its growth, the Ministry of Finance and the Bank of Russia launched a policy of gradual “withdrawal” from the banking system. In December 2009 banks resumed to be net creditors of the Bank of Russia and public agencies, RUB 703 bln and RUB 584 bln, respectively. In December 2010 these figures reached RUB 2546 bln and RUB 823 bln, respectively. Excessive liquidity which was accumulated in the banking system, became a new problem thereby increasing substantially risks of inflationary pressure on the economy.

Fig. 18 shows the same data by volume of banks’ net claims to the Bank of Russia and public agencies in relative terms against assets of the banking system. The data also shows that the net creditor status against the Ministry of Finance and the Central Bank Of Russia is a typical situation, save for deviations from the situation amidst financial crises. However, both sources and trends of allocation of excessive banking liquidity changed substantially. Late in the 90s – early in the 00s, most of the banking liquidity was spent to purchase government securities, in many cases in prejudice of lending to the real sector. Therefore, decrease in bank loans to the Ministry of Finance reflected a positive, upward trend in lending to the real economy in general. Obviously, this was a positive event as soon as the trend resumed after the recession period between 2008 and 2009.

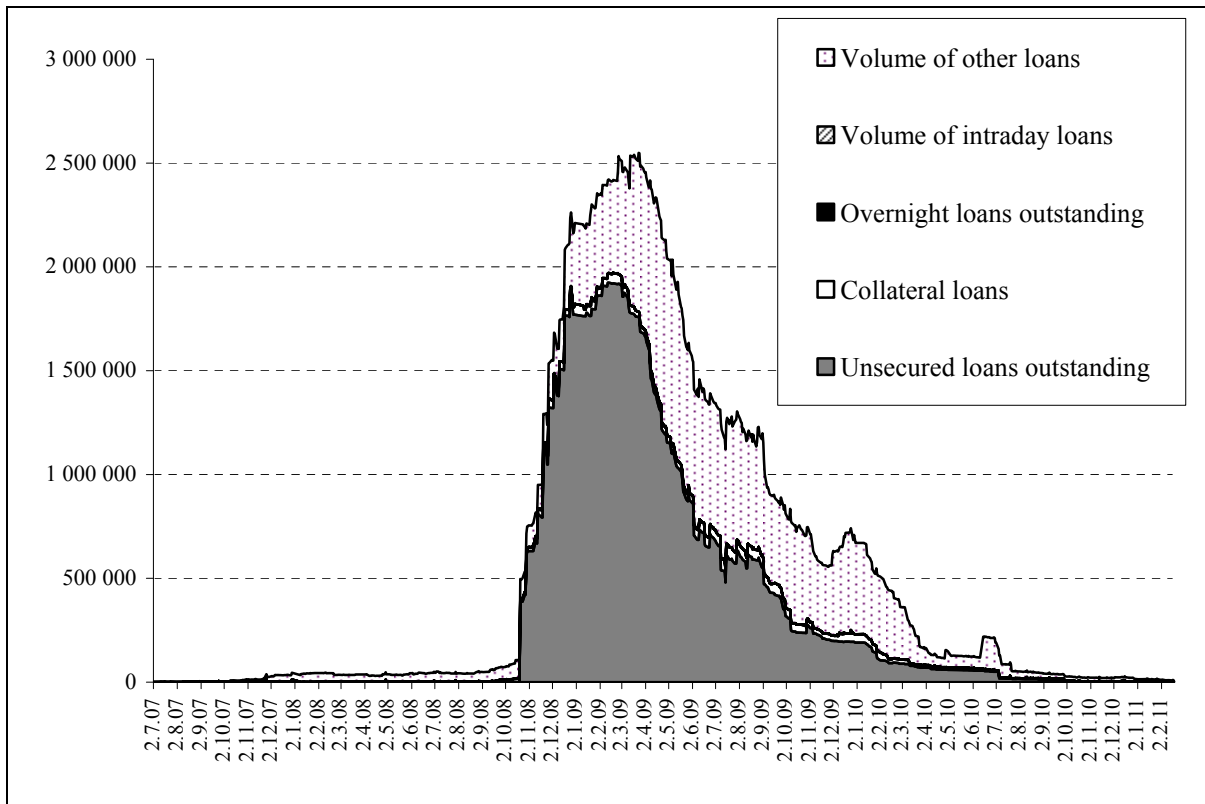
Slower recovery of banks as creditors in relative terms after the current financial crisis against the crisis of 1997–1998 reflects serious changes in the sources of bank credit resources. While it was cheap and short-term foreign exchange loans in external markets that served as such source on the eve of the crisis in 1998 and between mid-2000s and the crisis of 2008, liquidity of the banking system was generated by relaxing the domestic monetary policy by financial authorities in 2009–2010. Keeping this in mind, it seems that beginning with the late 90s, the vector of development of the banking system was heading the right direction in general, i.e from lending to the Ministry of Finance through the risk-bearing carry trading strategy towards lending to the real sector through the same strategy and, finally, towards an attempt to grant retail and corporate loans through internal financial recourses. The problem is whether or not the banking system is able to keep this development vector.

Fig. 19 provides analysis of different form of loans to banks from the Bank of Russia. Unsecured loans which the Bank of Russia began to grant on October 20, 2008, were the main type of credit support to banks during the recession period. This type of lending is not traditional for the central banks in other countries, given a serious credit risk to which the Bank of Russia is exposed. Lack of relationship between these tools and size of credit portfolios of banks, save for loans secured by different assets (*Fig. 13*), was typical of the credit support which the Bank of Russia offered to banks during the recession period. This may be a reason for such strong support to banks by the Bank of Russia which assumed a serious risk exposure, the retail and corporate credit portfolio of banks failed to grow in the recession period. Beginning with September 2010, different programs on bank support from centralized loans were nearly discontinued, which is not surprising amidst a fast growth in liquidity at banks in 2010.



Source: based on the data published in the Credit Institutions Review of the Bank of Russia.

Fig. 18. Banks' net claims to public agencies and the Bank of Russia (as % of assets (liabilities) value)

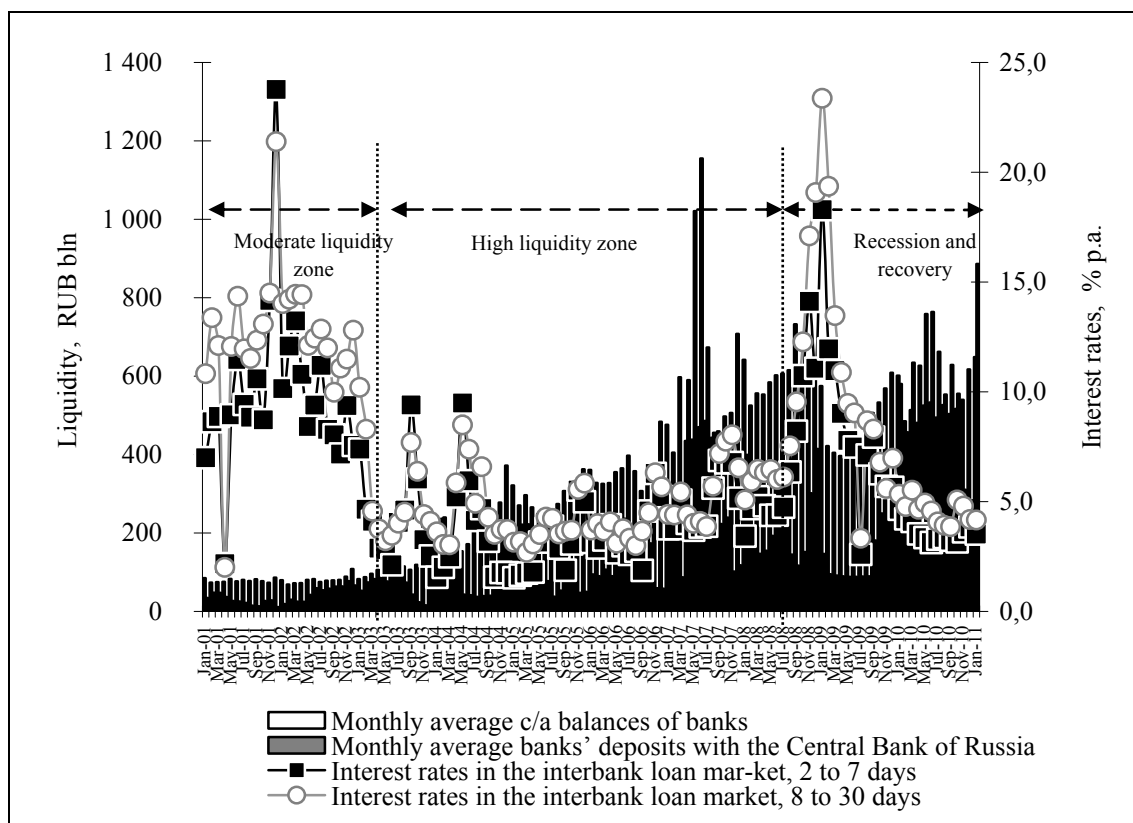


Source: based on the data published by the Bank of Russia.

Fig. 19. Bank of Russia loans to banks, RUB mln

Short-term loans to banks through direct REPO deals was the most traditional method which the Bank of Russia applied intensively to stabilize the banking system during the recent recession period. Fig. 20 shows three periods in the development of the Russian banking sys-

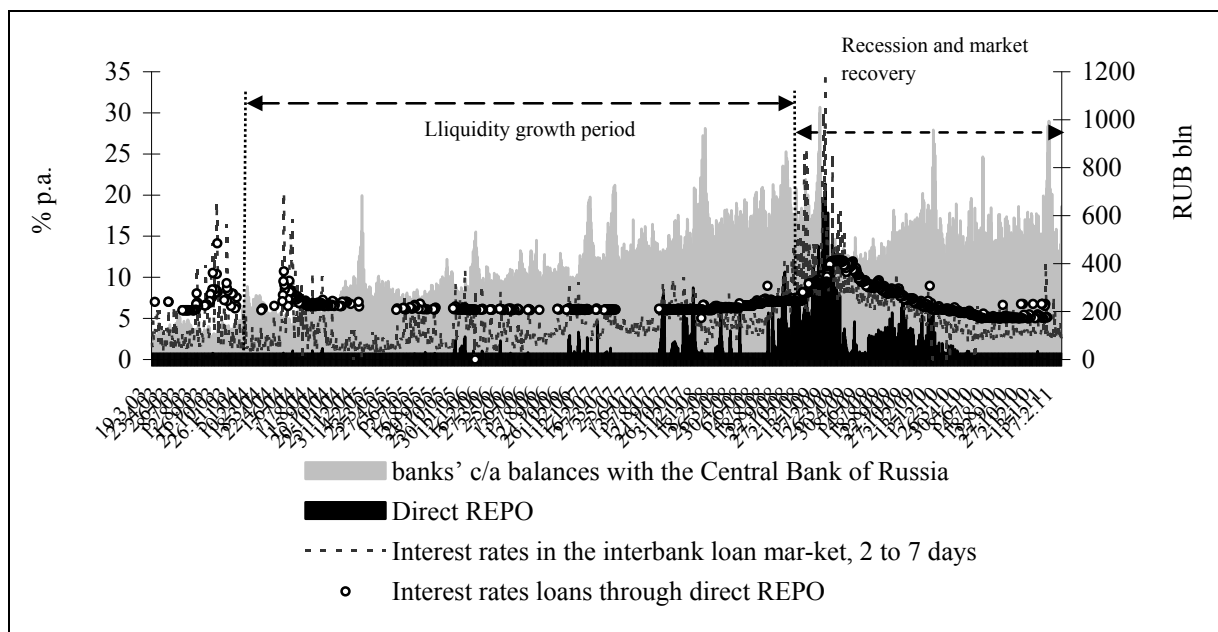
tem, where each period depends a specific source prevailing in support of liquidity. The first period, which lasted from the beginning of the 2000s till 2003, was characterized as moderate liquidity after the recession of 1998, when banks were funded preliminary with internal sources and interest rates were very high in the interbank market. The second period, which lasted from 2004 till July 2008, was marked by a boom of the carry trading strategy, when banks could borrow cheap in foreign markets. Inflow of foreign cheap short-term money resulted in excessive liquidity in the banking system and low loan interest rates in the interbank market. The third period began in August 2008, i.e. from the onset of the current financial crisis. The period is characterized by temporal discontinuance of the carry trading strategy, which resulted in a fast growth in loan interest rates as well as subsequent state intervention which replaced non-resident money with public funds thereby smoothing the situation in the interbank market. Later, when the market began to recover, banks generated sufficient liquidity, interbank loan interest rates resumed the previous, pre-recession level. Beginning with July 2010, volume deals in the direct REPO market slumped and such loans became irregular due to thin market in December of the same year and discontinued in January 2011. “Exhausted” direct REPO loans coincided with revocation of the banking license from International Industrial Bank, which allows one to suppose that the Bank of Russia used intensively this tool to support the financial situation in this problem bank in 2009 and H1 2010.



Source : based on the data published by the Bank of Russia.

Fig. 20. Average monthly bank liquidity and interest rates in the interbank loan market in 2001 – January 2011

Fig. 21 shows relation between interest rates in the interbank loan market with direct REPO. In the period of growing liquidity the Bank of Russia employed direct REPO deals only in specific cases and in moderate scale. From the onset of the financial crisis, direct REPO deals were more frequent for the purpose of stabilizing the situation in the interbank loan market. Such deals began to close on a regular, daily basis and their volumes increased rapidly against the prerecession figures. Stabilization of the situation with short-term liquidity at banks in 2010 resulted in reaching the pre-recession interest rate in the interbank loan market, and eventually the Bank of Russia refused to employ direct REPO on an intensive basis.



Source: based on the data published by the Bank of Russia.

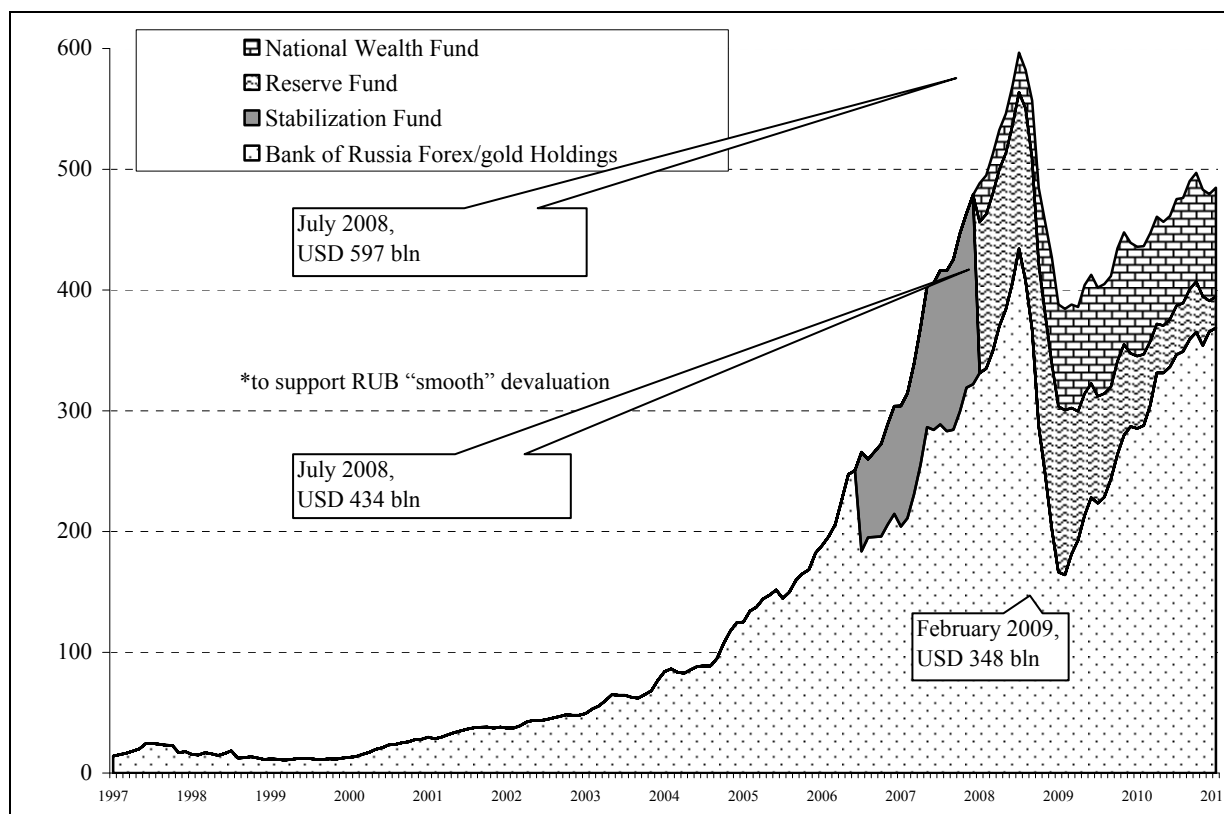
Fig. 21. Using direct REPO for regulating bank liquidity in 2003 – February 2011

3.3.3. Towards Recovery of International Reserves

As shown in *Fig. 22*, in July 2008 the international reserves reached a maximum of USD 597 bln. When the recession was in full swing in February 2009, the international reserves reduced to USD 384 bln., i.e. by USD 212 bln. Most of the reduction resulted from sale of foreign exchange by the Bank of Russia in the course of the so-called “regulated devaluation” of the Ruble, when the RUB weakened against the US dollar from RUB 23,45/USD in July 2008 to RUB 35,45/USD or by 51.2% in February 2009. Unlike August 1998, the devaluation was extended for as long as six months to allow banks and individuals to exchange some of their ruble assets with US dollars or restructure foreign currency debts.

The fact that the Bank of Russia sold foreign exchange, even at undervalued exchange rate, in the period of regulated devaluation didn’t imply complete loss of the international reserves, as a part thereof was simply converted into growth of the Bank of Russia’s ruble assets, which were used for a large-scale lending to the banking system (see *Fig. 17* and *19*). Between February and October 2009, the RUB strengthened against the US dollar from RUB 35,45/USD to RUB 29,05/USD or by 18.7%. The large-scale granting of ruble loans to banks concu-

rently with a visible strengthening of the RUB in 2009 served as additional channel for growth in profitability of banking operations as well as incentive to convert a part of banks' ruble assets into foreign exchange to reach balance between bank's foreign exchange assets and liabilities.



Source: based on the data published by the Bank of Russia and the Ministry of Finance Russia.

Fig. 22. International reserves of the Russian Federation, bln USD.

In 2010, the Bank of Russia managed to recover a part of the international reserves (i.e. total international reserves net of the Reserve Fund and the National Wealth Fund which is controlled by the Ministry of Finance of Russia) almost at the prerecession level due to repayment of loans owed by banks to the Bank of Russia and a favorable foreign economic situation. The size of the National Wealth Fund stabilized at a level of USD 85–90 bln. It was only the Reserve Fund that saw a substantial reduction in funds due to the fact that the state had to finance the federal budget deficit which resulted from a rapid growth in social security expenditures of the Government of Russia. The Fund reduced in size to a maximum of USD 142,6 bln in August 2008, USD 26,0 bln in January 2011. The international reserves totaled USD 484,7 bln in January 2011 while a maximum of USD 596,6 bln was reached in July 2008.

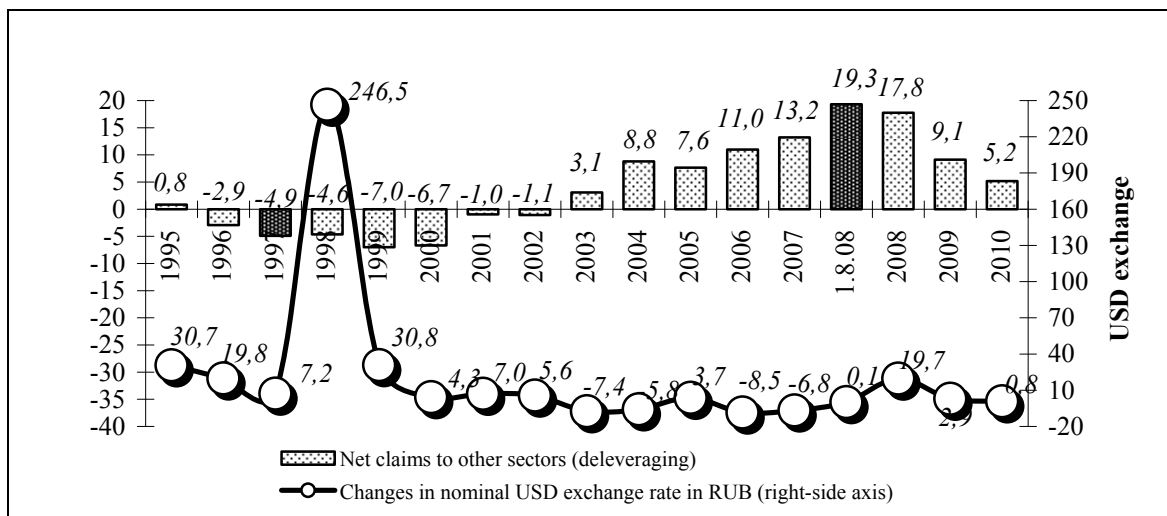
Considerable volumes of international reserves is an important factor for macroeconomic stability in this country. It is important, however, that the method of investing in the international reserves also allow modern competences of Russian financial institutions to be increased, because weak domestic financial institutions fail to allow the existing surplus of finances in the country to be utilized effectively for economic growth. This is why it would be

reasonable in perspective to engage the largest Russian financial institutions in management of the international reserves portfolios.

3.3.4. Deposit Base Growth and Banks Deleveraging

The fact that the state assumed obligations for increasing the amount of retail deposit from RUB 400 K to RUB 700 K which is guaranteed for repayment, as applied to a deposit per bank, was one of the most effective antirecession measures aimed at supporting the banking system было принятие. When individual investors began to dispose of risk-bearing assets such as shares, units of unit investment funds and junk corporate bonds, this measure resulted in heavy inflow of retail deposits to banks amidst recession. Retail deposits increased from RUB 5850 bln to RUB 5907 bln or by 1.0% when the recession was in full swing between August 1, 2008 and January 1, 2009. As of the 2009 year-end, retail deposits reached a total of RUB 7485 bln, i.e. increased by 26.7%; in 2010 retail deposits totaled RUB 9818 bln, or grew by 31.2%.

Amidst decline in 2009 and slow growth in the credit portfolio in 2009 – 2010 (see *Table 3*) deleveraging of the banking system took place (see *Fig. 23*), i.e. decrease in the value of banks' net claims to individuals and businesses against total bank assets from 19.3% on the eve of the recession on August 1, 2008 to 9.1% in 2009 and 5.2% in 2010. On the one hand, such a rapid deleveraging means lower liquidity risks in the banking system. On the other hand, however, it means that banks became less capable of investing deposits in loans, because borrowings became more expensive than in the prerecession period.



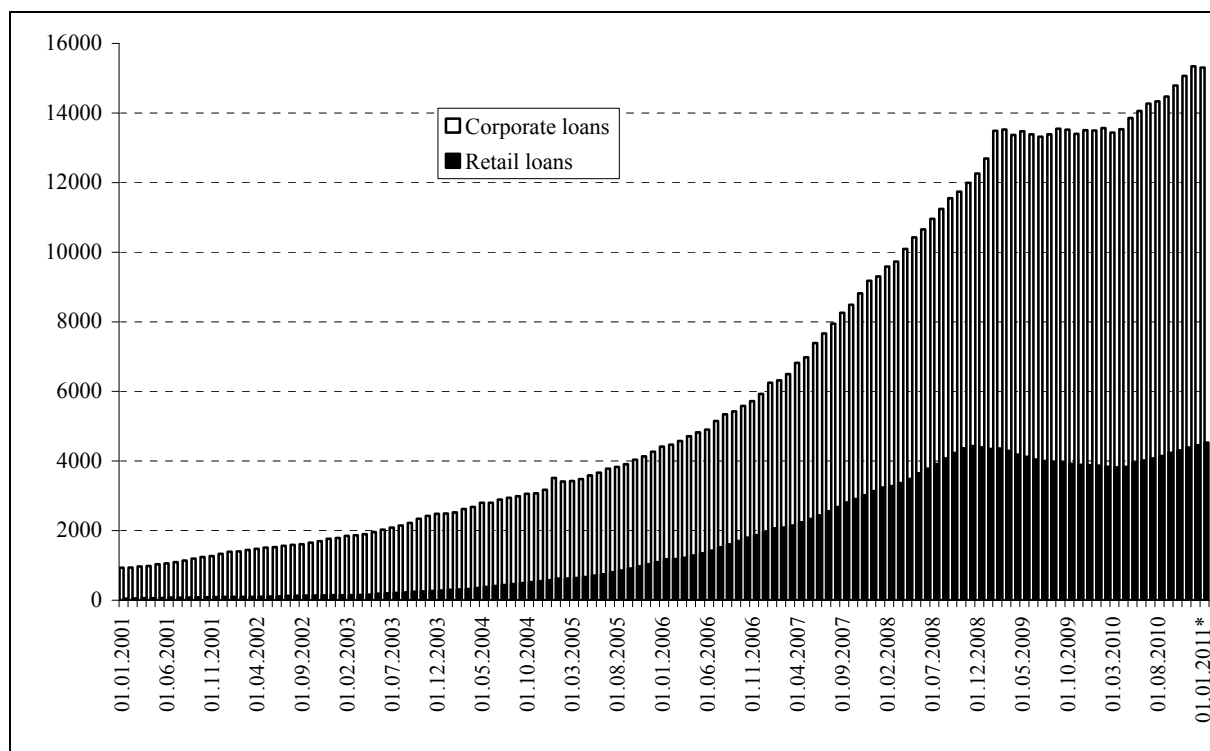
Source: based on the data published by the Bank of Russia.

Fig. 23. Deleveraging (as % of banks' assets (liabilities) value)

3.3.5. The Issue of Converting Liquidity into Loans

As seen in *Fig. 24* and *Table 3*, the credit portfolio of banks resumed growth in 2010. Loans to non-banking businesses increased by 12.8% whereas retail loans by 14.3%. In 2009, the non-banking credit portfolio increased by mere 0.3%, whereas retail credit portfolio reduced by 11.0%. However, it is too early to say that the tool of banking loans recovered. In the period between 2009 and 2010, the credit portfolio recovered at slower rates than after the

financial crisis of 1998. Corporate and retail loans increased by 48.3% and 37.6% in 1999 and 71.5% и 61.9%, respectively in 2000. After 1998, devaluation of the national currency resulted in rapid growth in competitive position of Russian businesses, and business environment was more favorable than today in terms of corruption, direct intervention of the state in the business and ownership structure. In 2010, the credit portfolio increased at much slower rates than in the pre-recession years. In 2006 and 2007, growth rates of corporate loans accounted for 38.6% and 64.3%, retail loans – 75.1% and 43.9%.



Source: based on the data published in Credit Institutions Review of the Bank of Russia.

Fig. 24. Loans granted, bln RUB

Growth in the credit portfolio in 2010 was less than the monetary authorities expected. For example, as early as May 28, 2010, Head of the Bank of Russia S. Ignatyev said that the credit portfolio was estimated to grow by 15% in 2010. In fact, total growth in the corporate and retail credit portfolios was 13.1%. It should be taken into account that as of the beginning of 2011, the relaxed monetary policy represented by leveled down requirements to reserves, refinancing rates and interest rates on interbank lending, continued in the economy in spite of visible risks of inflation growth.

The reasons for slow recovery of the credit portfolio after the recession of 2008–2009 against the recession of 1998 can be found among the factors such as low business investment demand, slow economic recovery and global nature of the recent recession (crisis).

Table 3

Corporate and Retail Loans in 1998–2010

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Loans to non-banking businesses:													
RUB bln	300	445	763	1 191	1 613	2 300	3 189	4 188	5 803	9 533	12 844	12 879	14 530
% of growth against the previous year		48,3	71,5	56,1	35,4	42,6	38,7	31,3	38,6	64,3	34,7	0,3	12,8
Share in GDP,%	11,4	9,2	10,4	13,3	14,9	17,4	18,7	19,4	21,6	28,7	31,1	33,2	32,7
Retail loans:													
RUB bln	20	28	45	95	142	300	619	1 179	2 065	2 971	4 017	3 574	4 085
% of growth against the previous year		37,6	61,9	111,6	50,2	110,8	106,5	90,6	75,1	43,9	35,2	-11,0	14,3
Share in GDP,%	0,8	0,6	0,6	1,1	1,3	2,3	3,6	5,5	7,7	8,9	9,7	9,2	9,2

Source: the estimates were made based on the data published in the Banking Statistics Bulletin of the Bank of Russia for a period of several years and the data published by Rosstat.

The reasons for slow recovery of the credit portfolio after the recession of 2008 – 2009 against the recession of 1998 can be found among the factors such as low business investment demand, slow economic recovery and global nature of the recent recession (crisis).

3.3.6. Carry Trading Outlooks as a Growth Driver for the Banking System

On the eve of the recession 2008 – 2009, like the previous financial crisis in Russia, the key driver of bank growth was a speculative strategy called carry trading (CT), when credit institutions were involved in active foreign-exchange borrowings in the developed foreign markets at low interest rates, which were invested in high-yield ruble holdings. On the eve of the financial crisis of 1998, such holdings were represented as public short-term bonds (PSTB), and prior to August 2008 – retail loans, ruble cooperative bonds and loans to the largest corporations¹.

The CT strategy is a very risk-bearing strategy; should the national currency is devaluated, stock jobbers' ruble holdings would devaluate instantly while foreign-exchange liabilities owed to non-residents become hard to discharge. A bank would get into the “liquidity trap” or become insolvent. According to IMF experts, banks involvement into CT for the purpose of funding growth in retail loans in developing countries is one of the main risks in the financial markets of such countries².

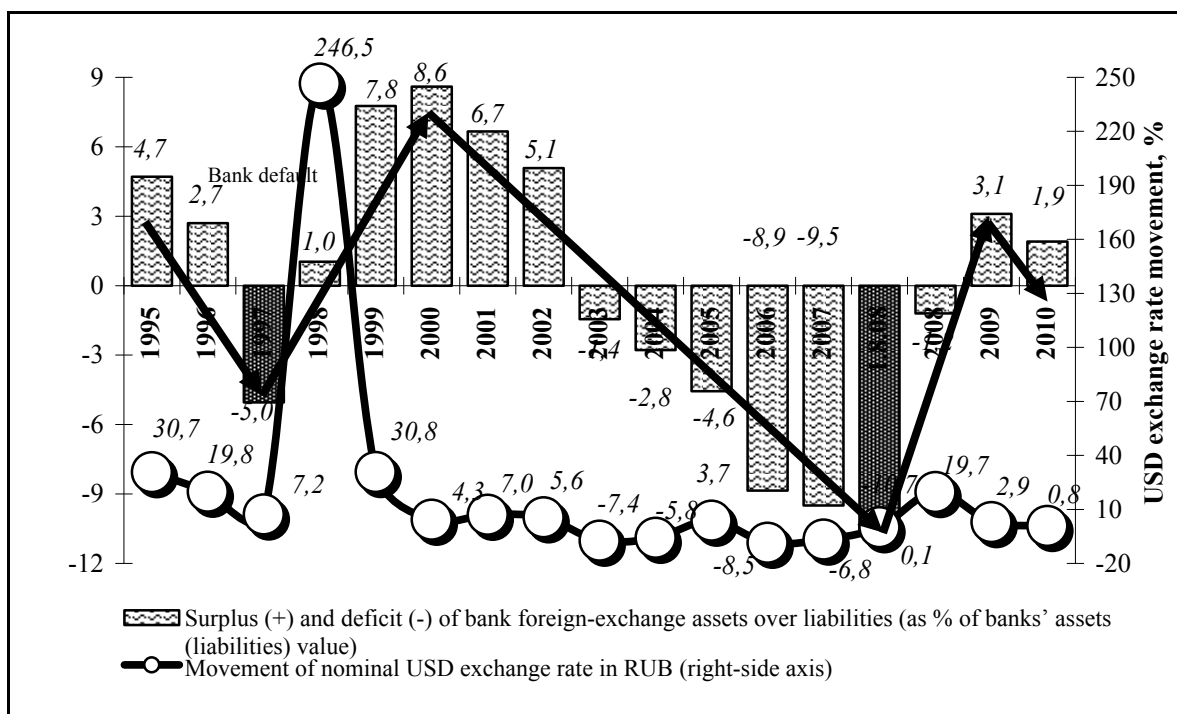
What are the carry trading strategy threats for Russia? First, it provides less incentives for bankers to make lower-yield investments in the real economy. Second, the banking system is exposed to a huge risk which eventually results in misbalance between banks' foreign exchange assets and liabilities as an earnest of their liquidity crisis, as was evidenced on the eve of both financial crises. Third, carry trading results in financial bubbles in the market of ruble

¹ Carry trading strategies, including their preconditions and risks in the Russian market, were discussed in our previous publications. The Russian Economy in 2008. Trends and Outlooks. (Issue 30) – M.: IET, 2009, pp. 524-534; Recessionary Economy in Modern Russia: Trends and Outlooks / A. Abramov, E. Apevalova, E. Astafiyeva [et al.]; sc. editor. E.T. Gaidar. – M.: Prospect, 2010, pp. 524-534].

² IMF. Global Financial Stability Report. Financial Market Turbulence: Causes, Consequences, and Policies. September 2007, pp.22-25.

corporate obligations and overload in the field of retail lending. Forth, the strategy may result in securitization of financial relations thus turning “smart lending” banks into investors in the bond market and “credit factories”, where borrowers are qualified by machines rather than human beings. The banking system becomes less experienced in lending which requires skilled personnel and knowing the borrowers. As a result, banks can lose their potential for modernization. Finally, carry trading undermines the internal saving system, making it unprofitable for borrowers which are “funded in rubles” (individuals, unit funds, non-government pension funds, insurance companies, etc.) to invest in ruble bonds, because such investments often generate a negative real yield.

The scope of bank involvement in the CT strategy is well illustrated by the deficit (–) and surplus (+) figures of foreign assets held by banks against the value of non-residents’ rights to claim against banks, as compared with total value of bank assets, as shown in *Fig. 25*. In 1997, on the eve of the banking crisis of 1998, liabilities to non-residents exceeded the value of banks which is equal to 5.0% of the balance-sheet total of the banking system. One-time triple devaluation of the national currency made banks insolvent. The balance was restored through bankruptcy of some of the largest private Russian banks and freezing (or, in other words, default) discharge of liabilities owed to non-residents, which the government had to legalize by adopting a regulation which prohibited banks from discharging their liabilities owed to non-residents. As a result, the balance of foreign-exchange assets and liabilities was restored, an excess amount of banks’ foreign-exchange assets over liabilities accounted for 1% of the value of banks’ assets in 1998. However, the reputation of the national banking system remained damaged abroad for years to come.

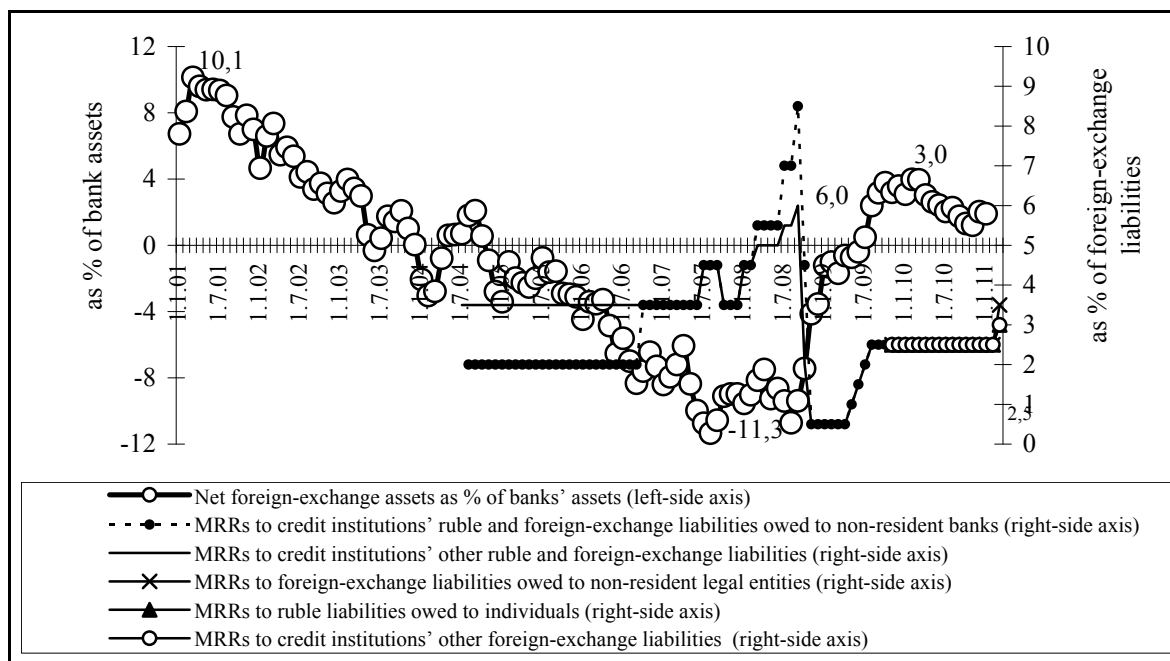


Source: the estimates were made based on the data published by the Bank of Russia.

Fig. 25. Surplus (+) and deficit (-) of bank foreign-exchange assets over liabilities

As of August 1, 2008, deficit of bank foreign-exchange assets against claims reached 10.7% of the balance-sheet total of the banking system, which is doubled the level preceding the August banking crisis in 1998. The carry trading strategy was booming at Russian banks in the period between early in 2004 and July 2008. Had it not been for the public support to banks, devaluation of the national currency, which began in the fall of 2008 and resulted in a 50% devaluation (see Fig. 9), would have repeated the 1998 collapse scenario of the banking system. Owing to the loans from the Bank of Russia and public agencies, as well as a policy of smooth devaluation of the national currency, banks were provided with the money and time required to restore the misbalance between their foreign exchange assets and liabilities.

This is not to say that all these years regulators, namely the Bank of Russia, have been watching indifferently how the CT was leading the banking system to a new crisis. In 2004 the Bank of Russia introduced mandatory reserves requirements (MRR) for credit institutions' ruble and foreign-exchange liabilities owed to non-resident banks в размере (2.0%) and other credit institutions' ruble and foreign-exchange liabilities (3.5%) (Fig. 26). As the misbalance in foreign-exchange assets and liabilities increased in the banking system these MRRs increased up to 4.5% each on July 1, 2007, 5.5% and 5.0% on March 1, 2008, 7.0% and 5.5% on July 1, 2008. However, these regulations failed to stop CT growth which in part can be explained by the fact that CT-related borrowings served as main drivers of heavy credit expansion in 2004 – H1 2008 and one of the key sources of financial soundness of the banks.



Source: the estimates were made based on the data published by the Bank of Russia.

Fig. 26. Regulation of carry trading by the Bank of Russia

The banking crisis which began in August 2008, made banks and the Central Bank of Russia balance assets and liabilities which happened because solution of this issue was the matter of survival for each bank amidst the crisis rather than introduction of any new regulations and requirements. To avoid collapse of the banking system, executive authorities and the Bank of Russia had to create economic conditions so that banks can resolve the issue. Nevertheless,

upon the crisis the state adopted a whole system of economic countermeasures against CT. Three new MRRs to foreign-exchange liabilities owed to non-resident legal entities, to ruble liabilities to individuals and other foreign-exchange liabilities, each 2.5% of the value of liabilities, were adopted on November 1, 2009 instead of the two previous MRRs.

On October 13, 2010 the Central Bank of Russia extended the floating operational corridor for the value of the dual currency basket from RUB 3 to 4 and reduced the amount of accumulated interventions (symmetrically, by 50 kopeks for the lower and upper limits), which shifted by 5 kopeks the limit of operational interval, from USD 700 mln to USD 650 mln. This meant that a wide fixed currency rate corridor of RUB 26 to 41 per dual currency basket was officially abolished. On March 1, 2011, the Bank of Russia expanded the limits of the dual currency basket to RUB 1, setting the lower and upper limits of the corridor at RUB 32,45 and RUB 37,45, respectively. These measures were aimed at making foreign exchange rate less predictable whereby making it hard to apply CT.

On July 16, 2010, the State Duma adopted an amendment to Article 269 of the Tax Code of the Russian Federation which was intended to make external borrowings less attractive for companies and banks. In 2011 – 2012, the upper limit for foreign exchange loans which are regarded as costs incurred on reducing the profit tax, will be reduced from 15% to 0.8% of a refinancing rate set by the Bank of Russia (6.4% p. a. from February 28, 2011)¹. The upper rate on ruble loans is planned to be increased from the current 1.1 to 1.8 of the refinancing rate, i.e. up to 14.4%. Lawmakers and executive authorities believe that this would increase the private business demand for ruble loans and limit application of the CT strategy. It should be noted, however, that in applying the CT strategy in practice, borrowings from non-residents are obtained at an interest rate less than 6%. In 2010 a system of monitoring over external liabilities owed by state-owned corporations was launched, and today decisions on large borrowings from foreign entities by state-owned companies should be made subject to approval by public representative participating in management bodies of such companies.

Realizing the threat of carry trading, but due to changes in their previous opinion on that developing countries must not prevent inflow of foreign capital, IMF experts recommended that these countries apply different tools designed to limit inflow of short-term foreign investments in order to prevent financial bubbles in the stock market and real estate market². Among other countermeasures against CT, the IMF recommends to apply a flexible foreign exchange rate policy, accumulate foreign exchange reserves in sovereign national wealth funds, reduce interest rates as adjusted to inflation, harden the fiscal policy, strengthen prudential supervision³.

Russian financial and monetary authorities followed in part these recommendations. On the one hand, after the crisis a range of CT countermeasures was markedly widened. However, no effective measures such as reduction of inflation and hardening of fiscal policy were taken. The higher internal inflation, the wider the spread between internal loan rates and the value of borrowings from foreign countries, and the more effective is CT for financial specu-

¹ Visloguzov V. The State Duma Suggests to Obtain Ruble Loans; Foreign-Currency Loans Will be Made Less Attractive for Companies. July 16, 2010.

² Osty J., Ghosh A., Habermeier K. Capital Inflows: The Role of Control. IMF Staff position note. February 19, 2010, SPN/10/04. <http://www.imf.org/external/pubs/ft/spn/2010/spn1004.pdf>.

³ IMF. Global Financial Stability Report. Chapter 4. Global liquidity expansion: effect on “receiving” economies and policy response options. April 2010, p.1.

lations. A trend towards strengthening of the national currency amidst growth in oil prices which emerged at the end of 2010, will also encourage this process.

Even if the Ministry of Finance and the Bank of Russia manage to effectively resist CT, an equally knotty problem arises as to what should replace cheap foreign borrowings, even risk-bearing, short-term, but still popular in promoting lending and economic boost. A new, third wave of CT became more visible in the economy as early as mid-2010. In spite of the already existing debt load, Rosneft borrowed RUB 52,5 bln from China Development Bank in Q2 2010 thus increasing its total outstanding debt to RUB 346,3 bln. The oil company pays 3.62% p. a. on the Chinese loan and generates a substantial profit from financial speculations by allocating the money to bank deposits at 6.22–8% p. a. According to the US GAAP reports, Rosneft held 3,12 bln USD on bank deposits as of June 30, 2010.¹ Another example is related to subsidiaries of foreign banks, which, according to the bank deposit market review in H1 2010 published by ACB, reduced interest rates on ruble and foreign currency retail deposits to 4–5% p. a. and 0.6% p. a., respectively. According to a manager from Nordea Bank, “financing by the parent company ... is much cheaper than retail deposits”².

Hence the risk that the financial system may go back to CT remain very high. As shown in *Fig. 25*, the banking system avoided this strategy for 5 years after the crisis of 1998. As early as 2002 the value of bank foreign-exchange assets exceeded liabilities owed to non-residents by a factor of 5.1% of the value of assets of the banking system. After the recession of 2008, the excess amount of foreign-exchange assets over liabilities was found to be much less. As early as 2010, this indicator decreased to 1.9% of the total bank assets against 3.1% in the preceding year. These changes demonstrate that the banking system is ready to go back to the previously applied risk-bearing forms of funding and growth.

Another potential source of growth in the financial system is increase in the level of monetization of the Russian economy. Money growth in the economy promotes lending and economic growth. According to the concept of long-term socio-economic development of the Russian Federation for a period till 2020, which was approved by the Order of the Government of the Russian Federation on November 17, 2008, No. 1662-r (Long-Term Development Concept 2020), monetization of the economy is supposed to increase from 28.3% in 2006 to 60–65% in 2015 and 70–75% of GDP in 2020. As a result, credit expansion of banks would increase, enterprises would generate more money as net profit and amortization, savings and investment potential of the state and households would increase. This implies transition to new monetary tools designed to provide economic demand for money which is based on growth in liquidity through refinancing of banks by the Central Bank of the Russian Federation. According to the Scenario-Based Conditions-2030, it is retail deposits growth as well as refinancing operations that are going to be the main resource base for banks³.

The advantage of CT is that it is habitual for the financial system, offers less inflation risks, because it provides short- and medium-term investments at interest rates better than inflation rate. However, CT will not offer long-term resources sufficient for modernization. Fur-

¹ Derbilova E. Bankers from Rosneft. *Vedomosti*, August 17, 2010.

² Dementiyeva S., Deventiyeva K. A Back-Breaking Contribution: Subsidiaries of Foreign Banks Need no Retail Deposits any More. *Commerzant*, August 16, 2010.

³ The Ministry of Economic Development and Trade. An explanatory note on scenario-based conditions and basic parameters of the long-term forecast of social and economic development of the Russian Federation for a period till 2030. Posted on the website of *Vedomosti* as an attachment to the article “Grow and Save” published by Kuvshinova O., Tovkailo M. *Vedomosti*, February 10, 2010.

thermore, it results in regular, serious financial crises and hampers the development of internal financial institutions and personal investments. Though the accelerated monetization strategy implies orientation on internal resources, it is exposed to serious inflation risks which can be avoided by adopting a policy aimed at developing business environment and improving rapidly the quality of state governance. CT is likely to be resumed with renewed vigor unless a clear development strategy appears in Russia in a year or two.

3.4. Ruble Bond Market

Fig. 27 shows monthly data on volumes of issues and turnovers in the secondary market of ruble corporate obligations in the MICEX from 2001 till January 2011. The figure also shows data on bank liquidity as bank balances on correspondent accounts and deposit accounts with the Bank of Russia, as well as shows how the onset of the financial crisis of August 2008 resulted in visible decrease of bank liquidity, stock market trading volumes and placement of corporate obligations. In September 2008, the lack of risk management system for REPO deals in the MICEX resulted in a temporary crisis caused by defaults on REPO deals by a few large players. Nevertheless, the bond market managed to avoid a system crisis, because the Bank of Russia intervened in settlements and rehabilitation of the banks which were found to be insolvent.

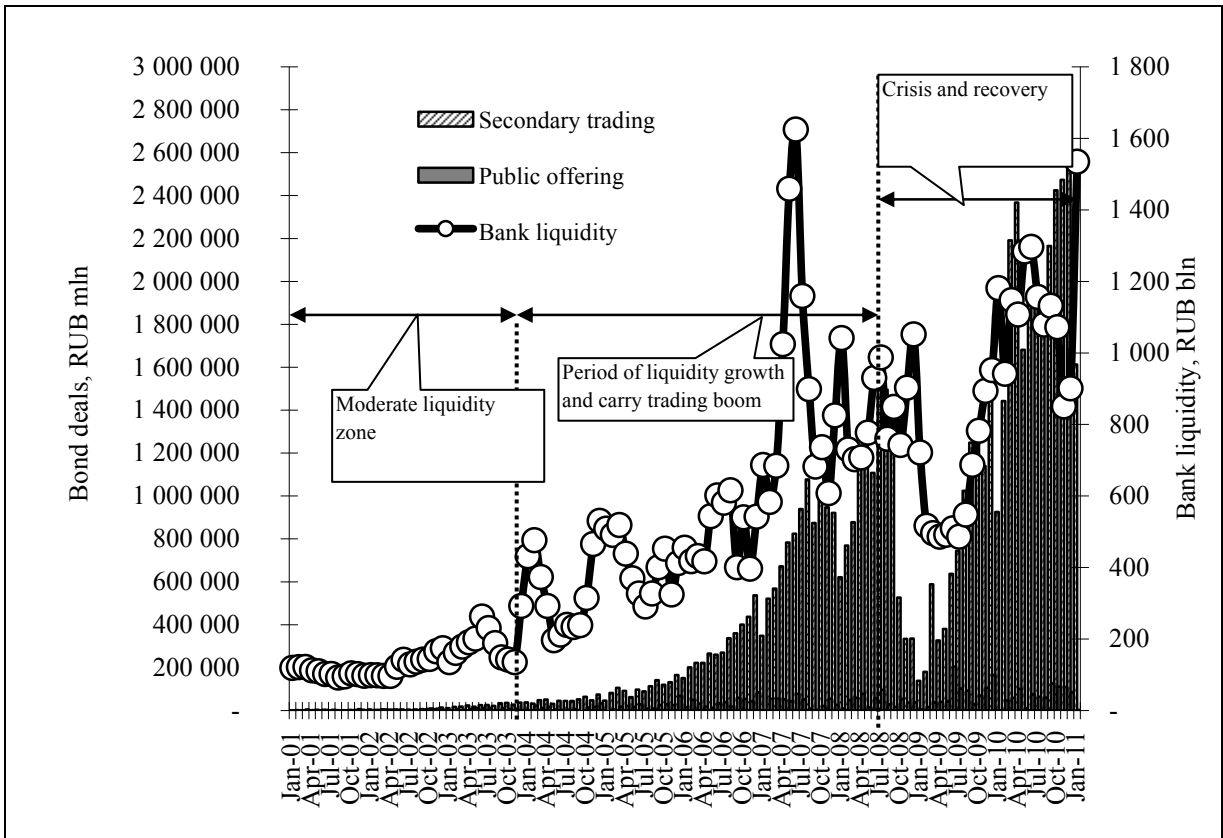
The market of corporate obligations recovered in full in 2010. Floatation of corporate obligations in the domestic market totaled RUB 917 bln in 2009 and RUB 854,9 bln in 2010, thus exceeding substantially the prerecession levels: RUB 465,3 bln in 2006 and RUB 457 bln in 2007. During the recession period and post-recession recovery, corporate bonds allowed the non-financial sector to compensate for stagnation and slow growth of the corporate loan portfolio in 2009 and in 2010 (*Table 3*). The number of new defaults in the market of corporate obligations decreased from 26 in 2008 and 76 in 2009 to 9 in 2010¹.

In 2010, volumes in the secondary market of corporate obligations increased up to RUB 23,0 t against RUB 9,3 t in 2009 and RUB 11,3 t in 2008. Given the restrictions imposed on application of the CT strategy, this means a new factor of rapid growth in liquidity in the ruble bond market. In 2010, rapid growth in short-term liquidity of the banking system as a result of accelerated growth in monetization of the Russian economy became such a factor.

A share of banks in the structure of sources of financing of corporate bonds increased from 31.9% in 2008 to 41.5% in 2009 and 41.4% in 2010. However, further growth in the market of long-term ruble bonds through short-term internal liquidity seems to be a very risk-bearing strategy. Should the monetary authorities have to reduce monetization of the economy due to inflation, it may cause serious problems in the corporate bond market.

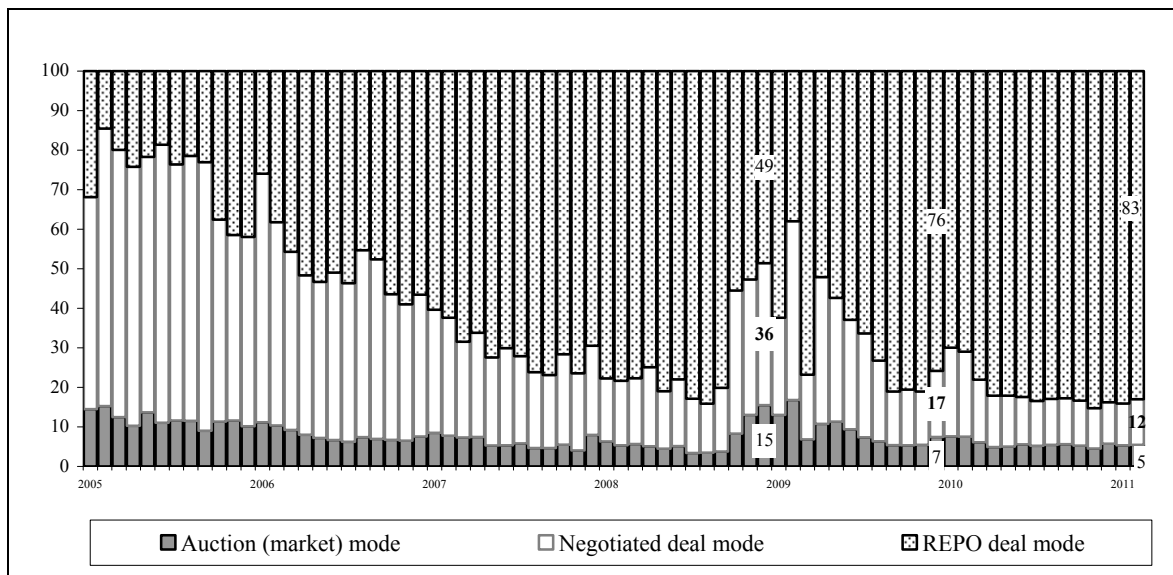
The fact that most players use the corporate bond market to invest idle cash or obtain short-term loans rather than make long-term investments makes itself evident in the structure of deals with corporate bonds in the MICEX (*Fig. 28*). From the beginning of 2005 till August 2008, a share of REPO deals grew rapidly to reach 84% of the trading turnover. Due to the crisis in the REPO market in September 2008 – February 2009, the share reduced markedly but then began to grow as the securities market recovered, to reach 83% in February 2011. A share of market deals accounted for mere 5%.

¹ Department of Surveys and Information of the Bank of Russia. Financial Stability Review. 2010, p.13. Posted on the website of the Bank of Russia: www.cbr.ru.



Source: based on the data published by the Bank of Russia and the MICEX Stock Exchange.

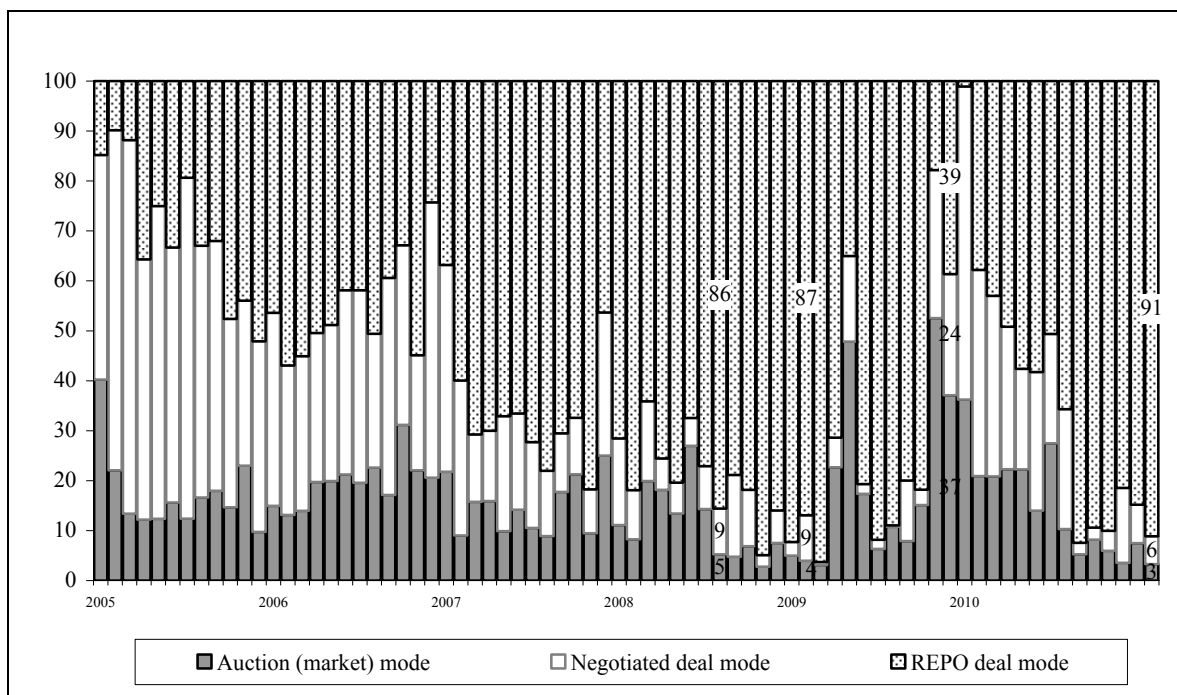
Fig. 27. Corporate bond operations and bank liquidity in 2001 – Jan. 2011



Source: based on the data published by the MICEX Stock Exchange.

Fig. 28. Structure of deals with corporate bonds in the MICEX Stock Exchange, %

Even more eloquent are the figures in the structure of stock-exchange deals with regional securities, as shown in *Fig. 29*. In February 2011, 91% of all the deals with regional securities were accounted for REPO operations in the stock exchange. With REPO deals, multiple pledge of bonds banks can use a credit leveraging of nearly 1:1 or 1:2, i.e. per RUB 1 of initial investments in bonds they can borrow from RUB 1 to RUB 2 of loans secured by bonds.

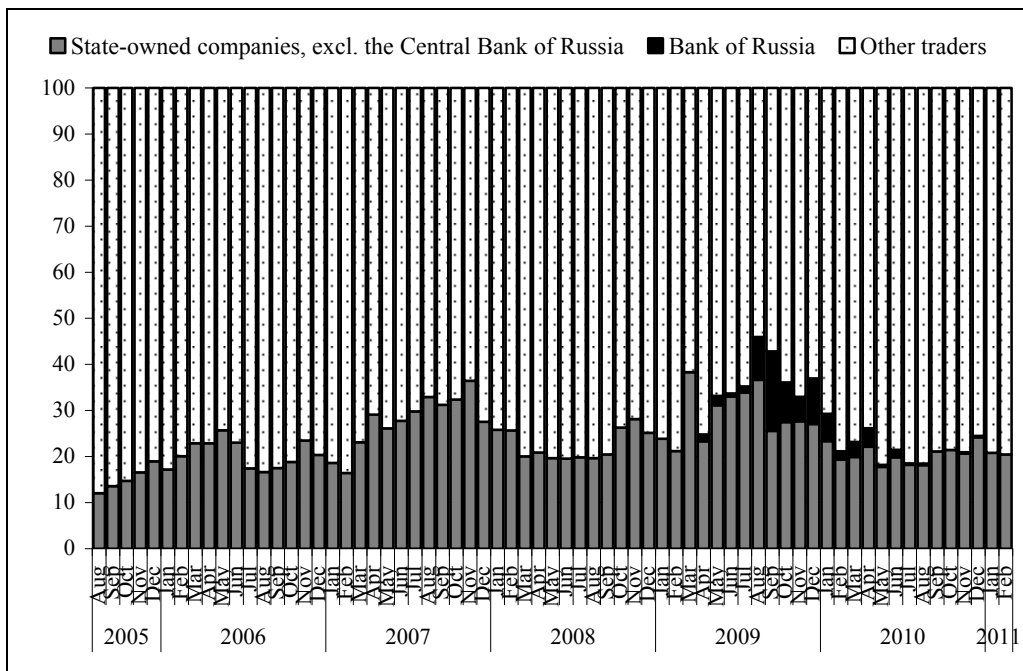


Source: based on the data published by the MICEX Stock Exchange.

Fig. 29. Structure of deals with regional bonds in the MICEX Stock Exchange, %

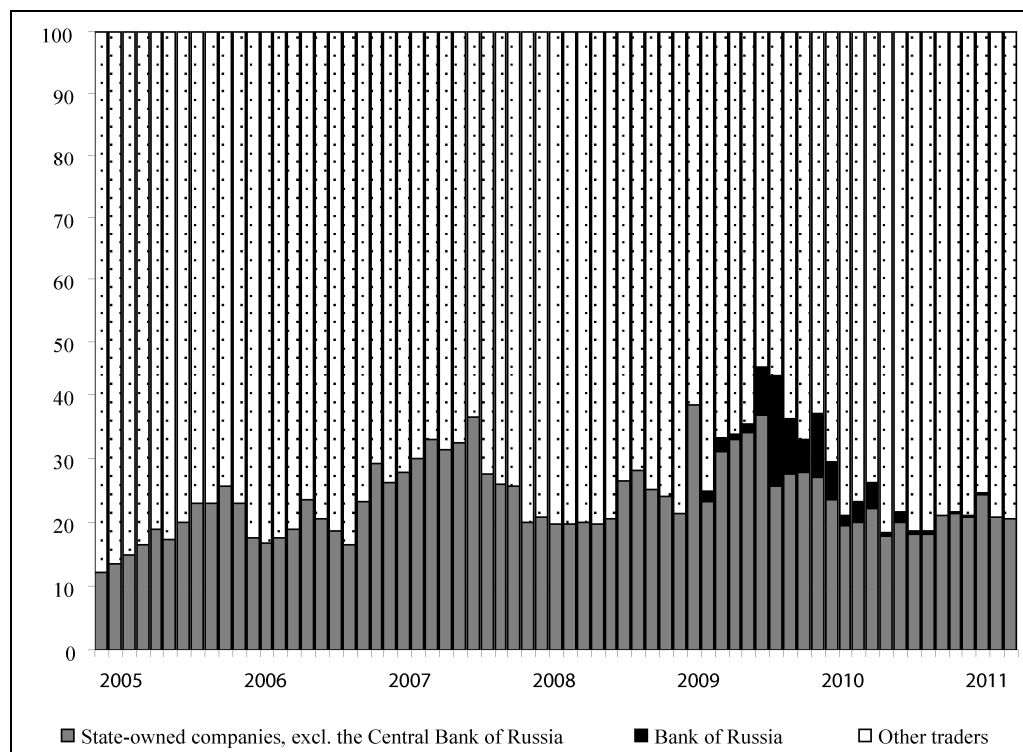
Fig. 30 shows analysis of a share of different groups of traders (private financial companies, state-owned companies, and the Bank of Russia) in stock-exchange deals with corporate bonds in the MICEX in all modes, including market negotiated deals and REPO deals. Beginning with March 2009, a share of state-owned companies increased visibly in the volume of corporate bonds trading; the Bank of Russia as a large supplier of liquidity trough REPO and other deals joined in April. Between April 2009 and January 2010, the Bank of Russia accounted for 0.7% to 14.3% of trading volumes with corporate bonds in the MICEX. From January 2011 MICEX ceased to include the Bank of Russia into monthly its reporting on trading volumes, which might mean that the Bank of Russia discontinued operations with securities in the MICEX Stock Exchange. On May 2010, a composite share of state-owned companies in volumes of deals with corporate bonds reached the pre-recession level.

Fig. 31 shows a share of state-owned companies and the Bank of Russia in trading volumes with regional securities. Though no the market saw no serious changes in a share of state-owned companies and the Bank of Russia in the period between August 2008 and January 2010, we can see that the share accounted for nearly 35–40% of the total volume of deals with regional securities, which was very important for supporting this segment in the bond market.



Source: based on the data published by the MICEX Stock Exchange.

Fig. 30. A share of private and public brokers in trading volumes of deals with corporate bonds in the MICEX Stock Exchange, %

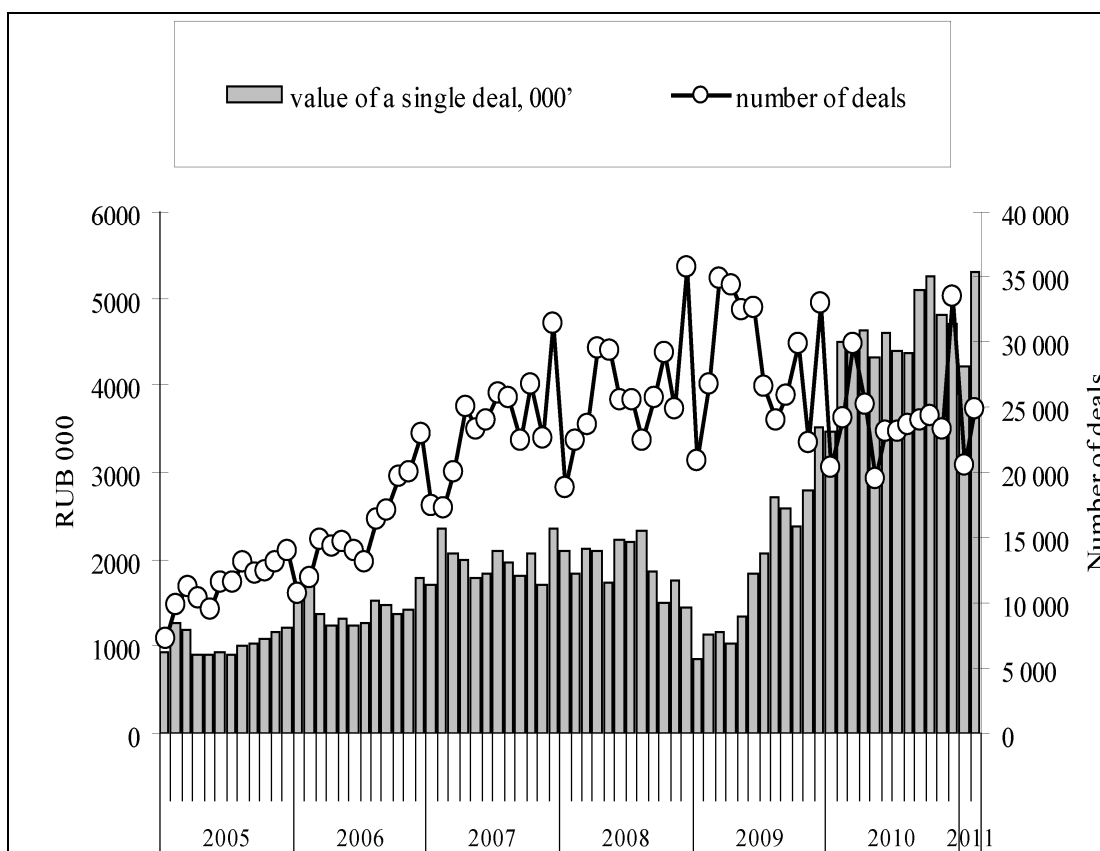


Source: based on the data published by the MICEX Stock Exchange.

Fig. 31. A share of private and public brokers in trading volumes of deals with regional bonds in the MICEX Stock Exchange, %

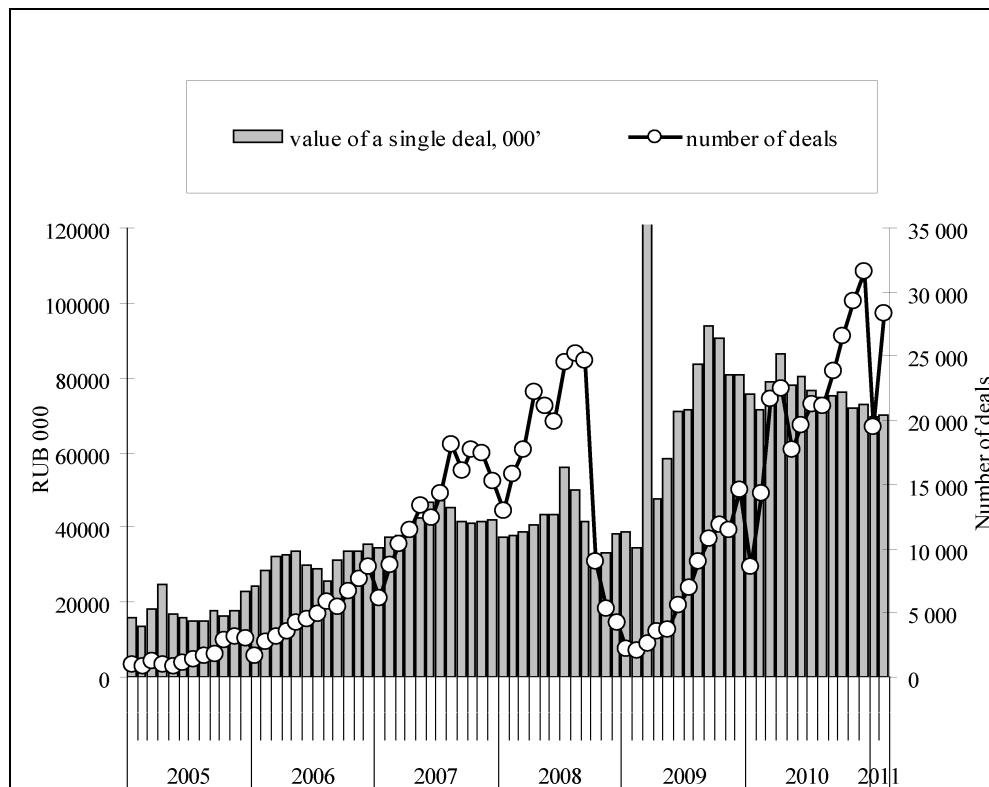
Fig. 32 shows data on the number of deals and the value of a single deal with corporate bonds in stock-exchange (order-driven) trading mode in the MICEX Stock Exchange. As opposed to the market segment of stock trading (*Fig. 15*), a downward trend in the number of market deals with corporate bonds was observed as the average volume of deals increased in 2009 – early in 2011, which means that this market segment, unlike stock trading, provides at least less developed algorithmic trading and trading robots. On the other hand, growth in short-term liquidity allows volume of deals to be increased. Inflow of foreign portfolio investors who become more interested in the ruble bond market, as it offers a higher yield against global market interest rates amidst an acceptable macroeconomic stability in Russia, also may become a growth factor in volumes of deals in this market segment.

Fig. 33 shows analysis of REPO deals with corporate bonds in the MICEX Stock Exchange. Unlike the market trading mode in the REPO segment, deals grew rapidly in 2009 – early in 2011 with a decrease in the average deal size beginning with mid-2009. This means that the REPO market became a more popular source of short-term funding as the economy recovered. The number of participants in this mode grew constantly.



Source: based on the data published by the MICEX Stock Exchange.

Fig. 32. Market deals with corporate bonds in the MICEX Stock Exchange

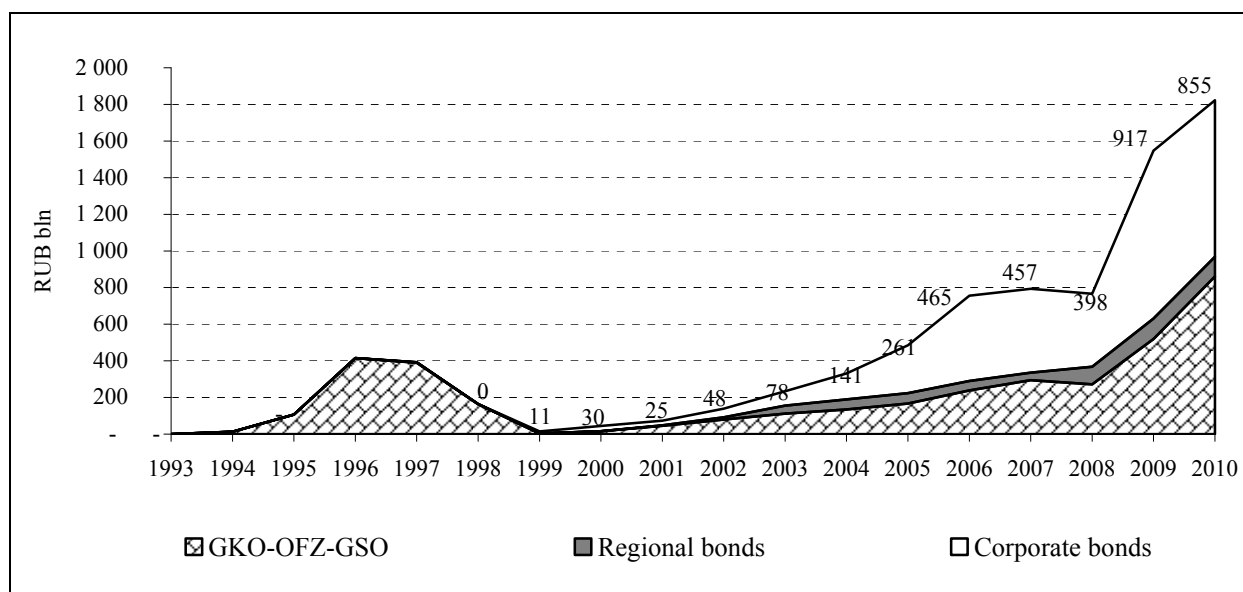


Source: based on the data published by the MICEX Stock Exchange.

Fig. 33. REPO deals with corporate bonds in the MICEX Stock Exchange

Fig. 34 shows analysis of placement volumes of not only corporate obligations, but also regional ruble bonds, as well as federal securities. Until 2010, placement volumes of corporate obligations exceeded visibly volumes of issues of federal securities. For example, a total of RUB 457 bln of corporate obligations and federal loan bonds (OFZ) and RUB 271 bln of state saving bonds (GSO) were placed in the 2007 pre-recession year. The situation began to change beginning with 2009, when the gap between corporate bonds and federal bonds began to narrow. В этом году было размещено of A total of RUB 917 bln of corporate obligations, RUB 519 bln of OFZs and GSOs were placed at the same year. It was for the first time over the recent years when in 2010 the volume of issue of federal bonds – RUB 861 bln – exceeded the volume of placement of corporate obligations – RUB 855 bln. In general, this is a positive phenomenon for the Russian stock market. The existence of a liquid government securities market is important not only for financing a moderate federal budget deficit. Making federal securities a main tool to service the interbank loan market could make the latter more stable as well as strengthen the position of corporate obligations as a tool of long- and medium-term fundraising.

With regard to issues of regional obligations, Fig. 34 shows that they fall behind the corporate and federal bond market. Nevertheless, their role may become more important in the future, because the state will have to engage more actively regional authorities in modernization of the economy, which would inevitably make the regions more economically and financially independent thereby strengthening their activity in the bond market.



Source : based on the data published by RTS OJSC and IMF.

Fig. 34. Volume of placements of ruble bonds

Amendments to the pension legislation, в результате которых a part of the funded pension accruals can be invested in non-government bonds were an effective measure of support to the ruble corporate bond and regional bond markets in 2009. The Federal Law No. 182-FZ “On Amendments to the Federal Law “On Non-Government Pension Funds” and Federal Law “On Investments to Finance Funded Work Pension in the Russian Federation” became effective on 18 July 18, 2009. Under this federal law, Vneshekonombank (VEB), being in the capacity of public asset manager, is entitled to invest pension accruals in an extended investment portfolio which also includes Russian corporate bonds, state-insured ruble and foreign exchange deposits with credit institutions, mortgage securities, bonds of international financial institutions. At the 2009 year-end, a total of RUB 12,9 bln of pension accruals were invested in corporate bonds, including 7,8 bln RUB from the VEB managed portfolio. At the end of 9 months in 2010, these investments increased up to 57,8 bln RUB and 45,9 bln RUB, respectively.

The largest state-owned companies became the offer-drivers in the ruble corporate bond market due to amendments to the legislation on securities, which made it easier to issue stock-exchange bonds by using simplified listing procedure for securities in stock exchanges instead of the Federal Financial Markets Service Russia. To strengthen stability of the corporate bond market, the maturity on stock-exchange bonds was extended from one year to three years. Not only open joint-stock companies, but also other economic agents, including state-owned corporations, were allowed to issue stock-exchange bonds.

Table 4 shows data on placements of corporate bonds by specific issuer in 2009 and 2010. Because of numerous defaults the bond market was closed for “third-echelon” issuers. The largest public and private companies became primary issuers of corporate obligations in the post-recession period. For many of them the domestic bond market became a tentative replacement for external borrowings which were hard to obtain because of credibility crisis in this market segment.

Table 4

The largest issuers of ruble corporate obligations in 2009

Issuers		2009		2010		
		RUB bln	%	Issuers	RUB bln	%
1	2	3	4	5	6	7
1	RZHD	145	15.8	FGC UES	50	5.8
2	Transneft	135	14.7	Rosselkhozbank	35	4.1
3	Vneshekonombank	60	6.6	Rosnanotech	33	3.9
4	Lukoil	50	5.5	EurazHolding	30	3.5
5	Atomenergoprom	50	5.5	AIZHK	29	3.3
6	Bashneft	50	5.5	Vneshekonombank	27	3.2
7	AFK Systema	39	4.3	Alrosa	26	3.0
8	MTS	30	3.3	MTS	25	2.9
9	AIZHK	28	3.1	Mechel	25	2.9
10	VTB (VTB 24)	23	2.5	Wimm-Bill-Dann	24	2.8
11	SIBMETINVEST	20	2.2	VTB (VTB 24)	20	2.3
12	Gazpromneft	18	2	Gazpromneft	20	2.3
13	VTB-Leasing Finance	15	1.6	VypelCom-Invest	20	2.3
14	Mechel	15	1.6	RZHD	15	1.8
15	MMK	15	1.6	Severstal	15	1.8
16	Gazprom	15	1.6	Globex Bank	15	1.8
17	NLMK	15	1.6	Norisk Nickel	15	1.8
18	Severstal	15	1.6	Unicredit	15	1.8
19	NIA VTB 001	14	1.6	EBRD	14	1.6
20	Bank Petrocommerce	11	1.2	MMK	13	1.5
21	MBPP	10	1.1	Bank St. Petersburg	13	1.5
22	Rosbank	10	1.1	Aeroflot	12	1.4
23	Rosselkhozbank	10	1.1	Transcredibank	12	1.4
24	VypelCom-Invest	10	1.1	Atomenergoprom	10	1.2
	Other issuers	113	12.3	Other issuers	342	40.0
	Total	917	100		855	100

Source: based on the data posted on www.cBonds.ru , www.rusbonds.ru and published by the MICEX Stock Exchange.

In 2009, 24 largest issuers accounted for 87.7% of the value of corporate bond issues whereas only 60% in 2010, which means that a wider range of issuers offer bonds in the market. In 2007, however, of a RUB 476,7 bln of placements of corporate bonds, the 24 issuers accounted for mere 42.1% whereas other issuers for 57.9% of the value of issue. In other words, the primary market of corporate bonds was not recovered yet to reach the pre-recession levels in terms of accessibility of corporate bonds for a wide range of companies.

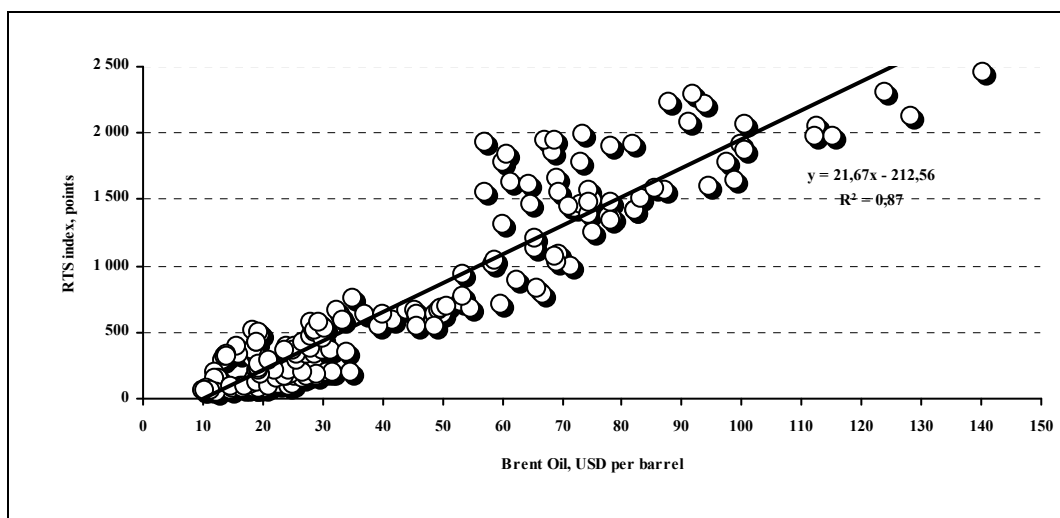
3.5. Key Risks in Financial Market

The key risks of financial market crisis as per results of 2008-2009 are based on the following factors: the strong dependence of the economy in general and the stock market in particular on oil prices; outstripping growth of external borrowings by banks and non-financial sector; risks of foreign capital outflow; RUR devaluation; the growth of trading volumes in the futures market at the background of an insufficient level with transactions, increase of the risks in the REPO market ; small capacity of financial security services market, preventing the capitalization of financial intermediaries.

3.5.1. Dependence of the stock market on oil prices

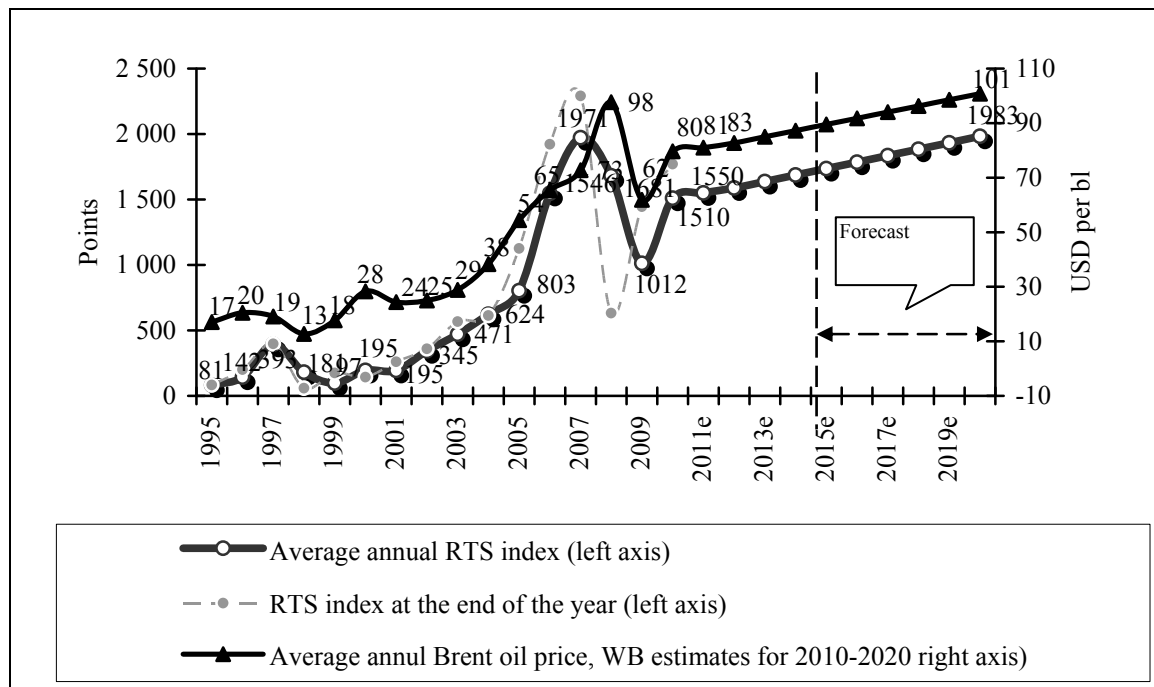
As shown in the comments to *Fig. 7* and *8*, the Russian stock market depends on oil prices. Inflow or outflow of the short-term portfolio investments from abroad only occasionally suspends the interdependence between the dynamics of changes in the stock indices and prices. However, the flow of foreign investments ultimately depends on the dynamics of oil prices in the world. Dependence of the stock market on oil prices is illustrated in *Fig. 35*, which reflected the coefficient between the absolute monthly value of the RTS index and the price of Brent crude oil for the entire period of existence of the stock index for December 2010. Coefficient of determination (R^2) between these parameters is 0.87, what indicates a very close relationship between them.

The current level of dependence of the Russian stock market on oil prices is one of the main sources of investors' risk. According to the scenario conditions of 2030, an average price of Urals crude oil in 2020 will reach 101 dollars per barrel, and in 2030 - only USD 140 per barrel (See *Fig. 36*). Basing on the regression equation, demonstrating the relationship of the RTS index and the annual oil price, we can estimate the average value of RTS index for the future 10 years. The average annual value of the RTS index in this case will reach 2000 points, which is only slightly above the average level recorded in 2007. It means that the domestic stock market is expected to stagnate for 10 years, which however, does not preclude its high volatility, if modernization and diversification of the Russian economy does not take place.



Source: estimates on the FS IMF and RTS stock exchange data.

Fig. 35. Dependence of the RTS index on Brent crude oil price from September 1995 to December 2010



Source: estimates on the basis of MED forecast for the Concept of long-term development - 2030 and RTS stock market data.

Fig. 36. Forecast of the RTS index up to 2020 based on the World Bank estimates for oil prices

In the previous survey, basing on the links formula of the RTS index and oil prices, we were estimating an average annual value of the index at 1,503 points, but in fact it is equal to 1 510. That is, this relationship is working and can help to predict the average annual values of stock indices very accurately. At the same time, we would like to recall once again, that oil prices predicting is an extremely difficult task, which is still unresolved.

3.5.2. Risks of foreign capital outflow

During the last two or three years, various foreign capital flows were moving in opposite directions in the Russian market. As shown in the comments to Fig. 8, according to the EMPR, from April 2009 to February 2011 overseas investments have been steadily growing mainly in speculative funds, investing in Russia. As a result, the Russian stock market is quickly recovering after the crisis. There is a risk that the inflows of foreign funds investing in Russia is unlikely to continue all the time, especially in view of the fact that in February 2011 the oil prices have already grown close to their limit. Any shock in the global financial markets associated with the insolvency of one or two countries in Europe, natural disasters, the collapse of a major financial institution or a slowdown in global economic recovery that inevitably will deploy the flow of funds investing in Russia. This was the case in May 2006, when at the very first signs of the crisis in the market of unsecured bonds, foreign capital flows to Russia turned the other way for virtually 2–2,5 years. A similar scenario with a change of direction of speculative capital in Russia is very likely in the second half of 2011,

which can provoke a long-term correction in price correction in the stock market of the Russian companies¹.

Another flow of foreign capital is recorded by the bank in Russia. They are portfolio, foreign direct and other investments in different segments of the financial market. In 2008-2010 and in the first two months of 2011 there is a predominating tendency of foreign capital export, including FDI (foreign direct investments). The tendency is decaying, which gives us a hope that in 2011 we will experience a net inflow of capital or a zero balance in capital inflows. In 2008, capital outflow from Russia amounted to USD 133.9 billion, in 2009 - USD 56.9 billion in 2010, according to the Bank of Russia estimates – USD 22.7 billion. In this case, for two consecutive years, there was recorded a negative balance of FDI amounting to 7.7 billion dollars in 2009 and 7.4 billion dollars in 2010.

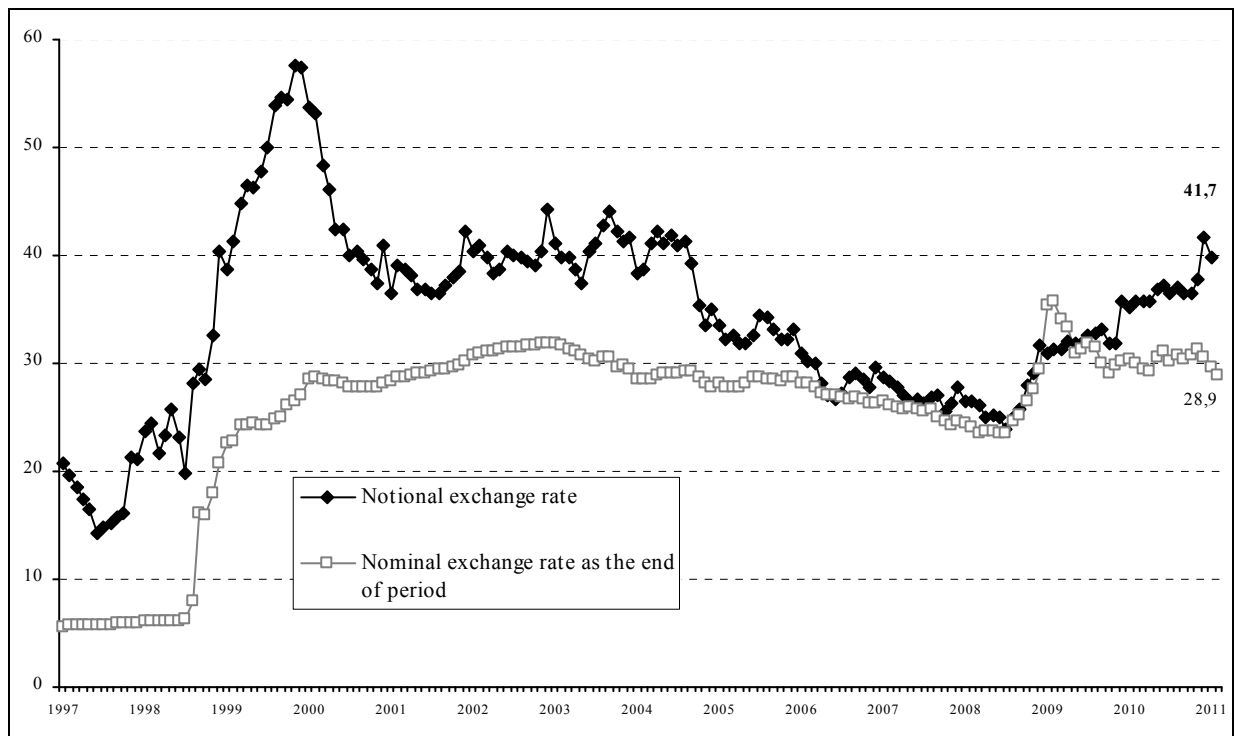
According to the estimates for January-February 2011, the Bank of Russia also notes the outflow of capital level of USD 13 billion². Fixed by the Bank of Russia level of foreign capital outflow in 2009-2010 and early 2011 did not prevent the steady growth of the stock market and the ruble-denominated bonds. However, the risk of continuing outflow of portfolio investments and FDI from Russia is that it will hinder the growth and modernizing of the economy, increasing its dependence on the prices of exported raw materials. In this case, the risks of depending on the stock market of oil prices and short-term capital will only increase.

3.5.3. Ruble devaluation risk in the medium term

Since February 2009, ruble strengthened from RUR 35.72 to RUR 28.94 for USD 1. However, in the medium term, there is a risk of its devaluation. *Fig. 37* shows that since mid-2009 there began a rapid growth of M2 monetary base as compared with an increase in international reserves in the economy. As a result, the official exchange rate became more and more deviate from the estimates, which can be determined by dividing the M2 by the value of international reserves. The long-term history of financial market demonstrates that the more rapid growth of the ruble money supply as compared with the international reserves in Russia often serves as a sign of the national currency devaluation. Foreign investment funds are always sensitive to the risks of currency devaluation. Expectations of devaluation in addition to adverse events for investors in global financial markets may cause long-term outflow of foreign investors from funds that invest in Russia. This may entail a new stock market collapse.

¹ The probability of a positive trend in the dynamics of the Russian stock market may be confirmed by March 2011 weekly review of the futures market SmartFORTS made by investment company ITinvest, where a rare for a stock index futures on the RTS phenomenon of Backwardation was noted, when the values of stock indices in calculating the price of futures contracts are lower than the data values of stock indices in the spot market (A. Berezin. Concentration of liquidity. Weekly Review of futures market SmartFORTS of March 9, 2010. Published on the Internet site of the investment company ITinvest).

² A. Shapovalov A. Oil does not cover the risks, Kommersant, March 9, 2011.



Source: estimated based on the Bank of Russia and Ministry of Finance data.

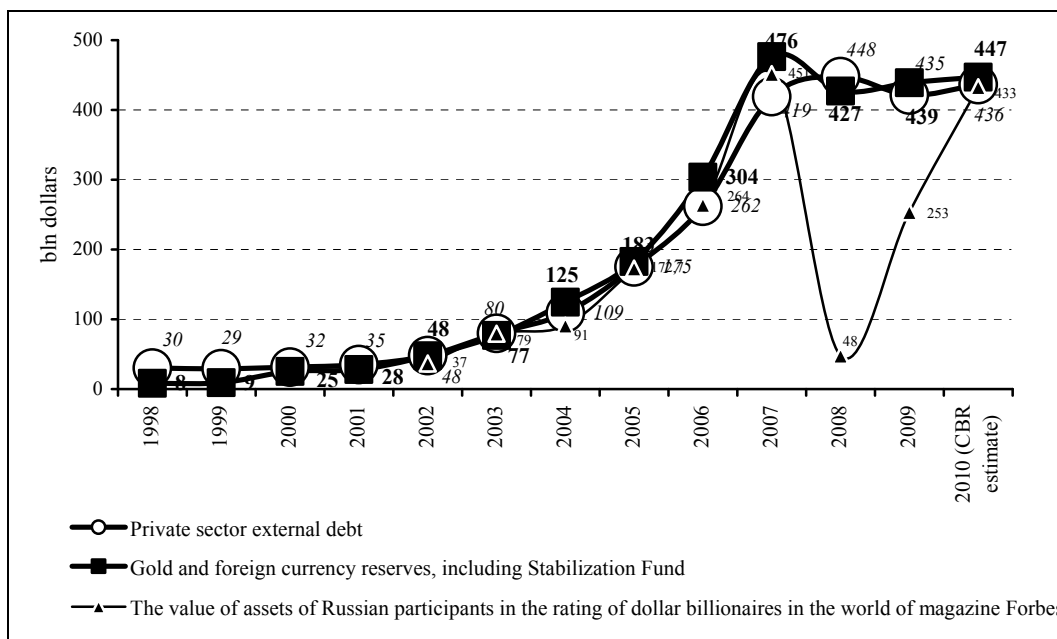
Fig. 37. Relationship between the nominal and notional (estimated) RUB exchange rates against USD

3.5.4. Risk of excessive foreign borrowings accumulation by banks and real sector companies

The foreign indebtedness of the private sector is practically equal to the total foreign exchange reserves of the Russian Federation (see Fig. 38) and remains one of the significant risks for the national financial system. Herewith, the amount of external debts of Russian business, with the exception of 2008-2009., was roughly equal to the value of assets of Russian participants in the rating of dollar billionaires in the world of magazine Forbes.

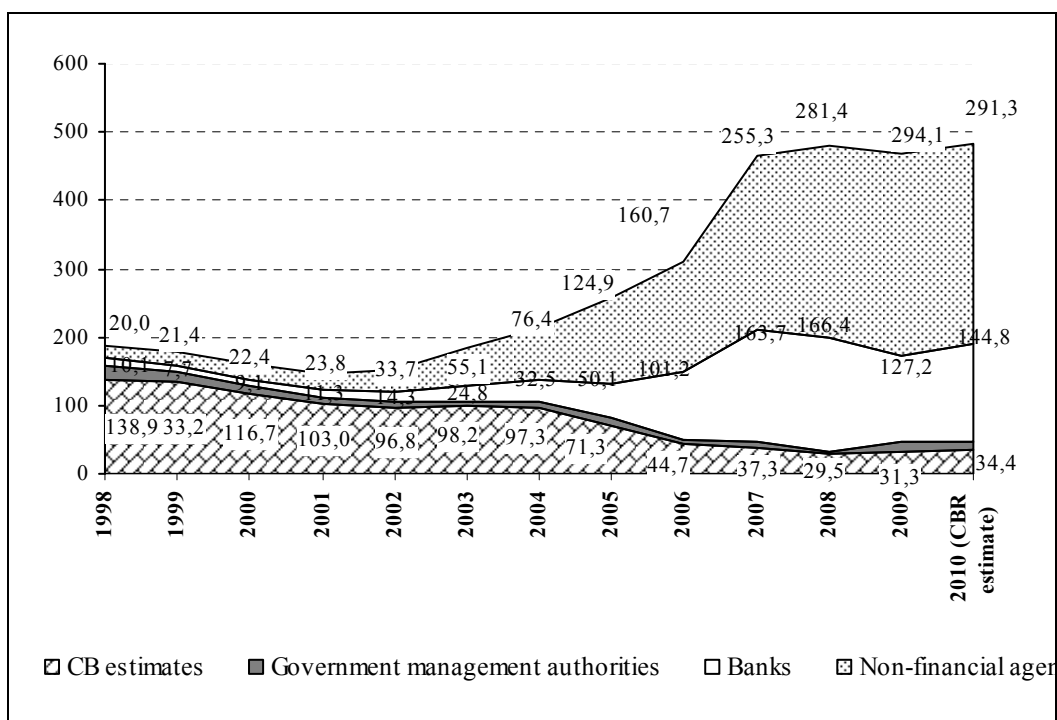
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Source: balance of payments data for a number of years.

Fig. 38. Growth in private sector debt, public excessive financial reserves and assets of the Russian participants in the rating of dollar billionaires in the world of magazine Forbes

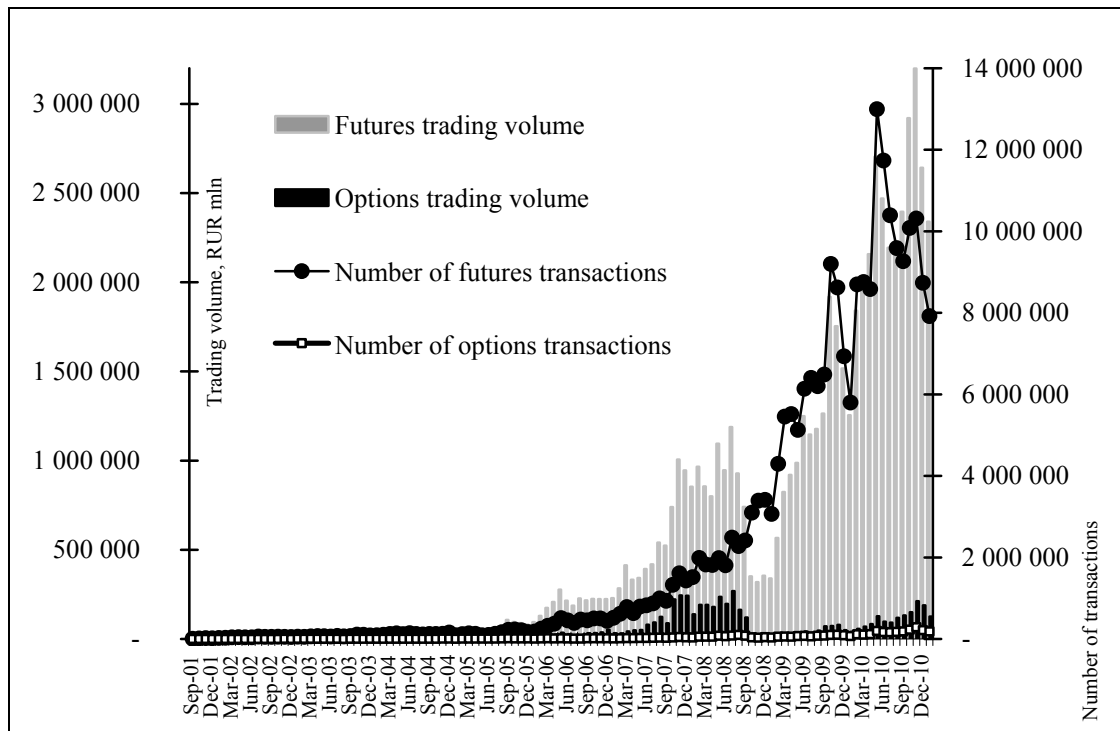


Source: balance of payments data

Fig. 39. Foreign debt of the Russian Federation, 1998-2010, billions of dollars

3.5.5. Operational market and algorithmic trading risks

Fig.15 and comments thereto show that in response to the growing number of transactions in the exchange market, as a result of trading robots and application of algorithmic trading, government institutions and infrastructure agencies are taking measures aimed at limiting the growth of small transactions. This is justified, because such activity increases the operational risks of the bidders as a result of disruption of trade and settlement systems.



Source: OAO "RTS" trading system.

Fig. 40. Trading volumes and number of transactions at the RTS futures market from September 1, 2001 to December 31, 2011

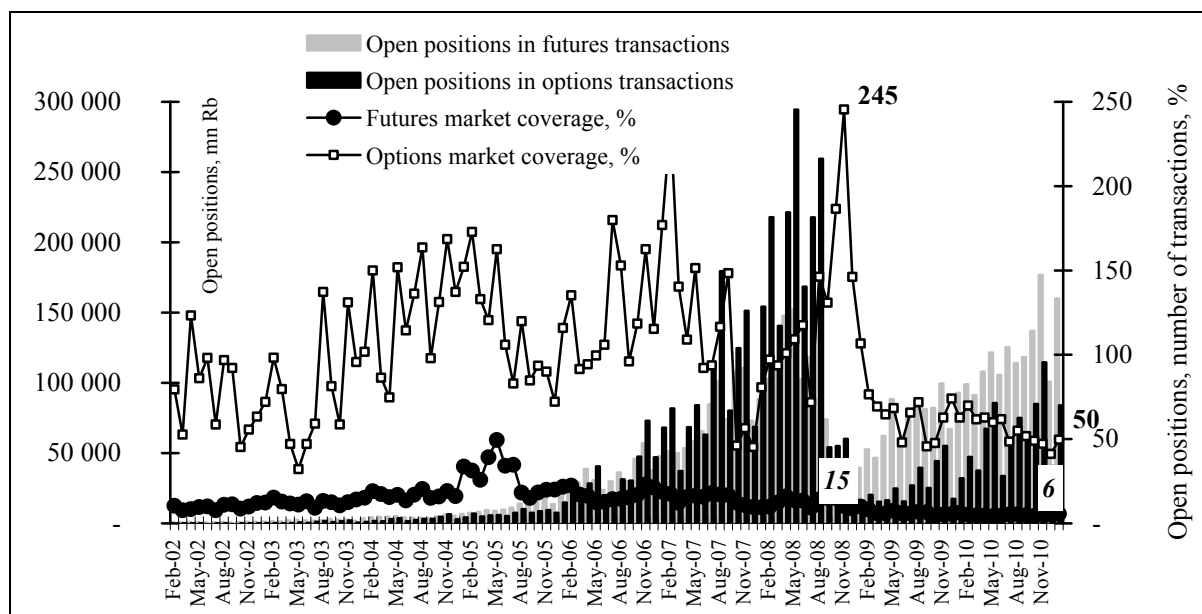
In addition to the operational risk, an advanced growth of trade volume, as compared with customers' assets, means compulsion of often not prepared for this client to excessive operating activity. Unfortunately, commercial systems currently do not disclose the value of clients' assets, reserved before the trading session. Brokers are not accountable for the value of the assets of their clients as well. Meanwhile, occasionally published in the media volumes of customer transactions and the values of client assets are sometimes astonishing. For example, here is a short message from "Interfact" on BCS plans. In 2009, the aggregate brokerage company turnover amounted to RUR 9.2 trillion, and client assets of the company were worth RUR 46.8 billion. In 2014 it is planned that that data will achieve RUR 30 trillion and about RUR94 billion¹. This means that the rate of portfolio turnover of an average customer of this company will grow from 197 times per year in 2009 to 320 times per year in 2014. Similar figures of portfolio turnover allow customers to calculate the publication in the media investment bank "Discovery": in 2008, the average client portfolio was turned over about 250 times

¹ BCS plans. Vedomosty, June 22, 2010.

a year in 2008 and 126 times a year in 2009. For comparison, the largest actively-managed unit investment trust funds shares portfolio turnover in 2009 is 1–2 times per year.

RTS futures market raises concerns of a similar nature. The number of trades and trading volumes in it are growing rapidly, customers' assets are growing more slowly. As shown in Fig.40, the Russian futures market, concentrated mainly in the RTS stock exchange, having survived the fall of cost volumes, started to recover quickly. In 2009, the increase in the volume of futures contracts amounted to 45.4%, in 2010 - to 104.9%; options trading volume decreased by 7.1%, in 2009 and in 2010 increased by 168.0%. The number of transactions in the futures market has grown by 162.2% in 2009 and by 56.5% in 2010; in options, the corresponding figures were 18.3% and 136.1%

Herewith, there was reduction in security of futures and options contracts, as evidenced by data in Fig. 41. Here are the details on the amount of open positions in futures and options markets, as well as the security of transactions on each market segment, which is calculated by dividing the average monthly volume of open positions in the trading volume by the respective futures contracts. Recovery of trading volume in futures and options markets since March 2009 was accompanied by a decline in security futures transactions with 10% of trading volumes in December 2008 to 5% in December 2010 in the options market over the same period from 146% to 74%.



Source: OAO "RTS" trading system.

Fig. 41. Open positions and transaction coverage in the RTS forward market from February 1, 2002, to January 31, 2011

In 2010, we have expressed concerns about the rise of operational risks of trading systems in relation to the faster growth of the operating activity of the participants, which are fully justified. The first failure in the RTS occurred on March 9, 2010. From June 8 to 22, 2010, there happened 4 operational failures in the trading and clearing system of the RTS¹. Major operational failure in the RTS also occurred on October 18, 2010. According to A. Shcheglov,

¹ Zhelobanov D., G. Gubeydullina FORTS with butter. Vedomosti, June 22, 2010.

CEO of Zerich Capital Management, such problems arise because "the system of exchange market works on the core, which is overburden for many years". According to his words, the exchange market is fascinated by the development and does not stop in order to improve the reliability and quality¹. According to "Vedomosti" to V.D. Milovidov, the Head of the Russian Federal Financial Markets Service, the massive influx of players and robots to the futures market has led to manifold increase in speed and load on the RTS market and trading system: "the exchange market does not manage to pay attention to its development"². Due to technical failures in the RTS, the Head of the Russian Federal Financial Markets Service was forced in October 2010 to send a letter asking to suspend the annual "Best Private Investor"³ to the exchange market.

3.5.6. Risk in repo transactions

The rapid development of the financial crisis in the stock market since August 2008, was marked by crisis, in repo market, during which several major market participants have failed to fulfill their obligation to repay the debts. Systemic payments crisis was avoided only thanks to the intervention of the Bank of Russia, which helped to resolve the problem of mutual non-payments. The cause of this crisis was that the conclusion of repo transactions on MICEX was not accompanied by creation of a mechanism of guarantees execution of the second part of the repo transactions, i.e., the return of funds by debtors. Financial community have been made in general the right conclusions, MICEX has established a system of guarantees on the obligations under repo agreements and transferred to settlements through a single counterparty.

However, improving the system of payments and guarantees under repurchase agreements does not remove from the agenda the question of the risks of over-development of this market segment. Outpacing growth of repo transactions has an economic explanation. This is an important tool for refinancing the banking system by the Bank of Russia and the banks that have excessive liquidity. Often, however, banks quite aggressively use this mechanism for refinancing, building up investments in bonds by a pyramid scheme, continuing repurchase transactions. In 2010, the second place in the largest circulation of securities in the MICEX took the Bank Centroccredit with a turnover of RUR 7.7 trillion, which was only a few steps back of the Sberbank of Russia, the sales of which amounted to RUR 8.9 trillion. That bank in 2010 accounted for nearly one-third of all deals with regional bonds. According to experts, these records were achieved by banks through the use of repo transactions. It is impossible to verify, what kind of papers is involved by bank through repo. In March 2010, the rating agency "Expert RA" has warned about the danger of a "pyramid repo agreements" in the banking sector: by the beginning of the year 17 Russian banks (including Centroccredit) the share of assets with encumbrance exceeded 20%⁴.

Thus, investments in long-term bonds are often funded with short-term loans. An increasingly narrow segment of the market trades in bonds does not allow to assess their real market value. For this reason, very conventional ways of assessing the value of bonds are used for repo transactions. This increases the systemic risks of investing in ruble-denominated bonds,

¹ Verzhbitsky A. Innovative failure. RTS can not keep up with its technologies. RBC daily, October 19, 2010.

² Askar-Zade. N., G. Gubeydullina RTS lagged behind the market. Vedomosti, June 25, 2010.

³ Federal Financial Markets Service suspended contest Rs. Kommersant, October 21, 2010.

⁴ RBC daily, March 23, 2010.

which in case of sudden insolvency of one or a group of large emitters could lead to a systemic crisis of defaults, which will not be in force to handle even the clearing. Perhaps, along with the repo market, the Bank of Russia should think about developing other ways to re-finance the banking system.

3.5.7. Low capacity of the internal market for financial services

To make the Russian financial intermediaries competitive so that they could provide financial services in compliance with the world standards, it is necessary that their market capitalization, i.e., their value of business, sought to meet the performance of similar foreign agencies. Attempts to solve this problem by increasing the administrative requirements to the own means of professional market participants are unlikely to be successful. The main problem here is the low capacity of the financial services market. Centralization of 70% savings at the level of sovereign wealth funds, inefficient system of pension savings, the lack of incentives for people to save and other factors not yet allow us to hope for a prompt solution to this problem.

In 2009–2010. HSE research university work has carried out the work on assessment the capacity of the Russian financial market in 2010-2020. Based on a variety of sources and expert surveys, there was assessed value of the assets, which are, by the estimates of different categories of individual and institutional investors, held at brokerage accounts, transferred to trust management, including mutual funds. There were also estimates of the market of investment services of offerings of various securities in the implementation of mergers and acquisitions. After that, the amount of income from the provision of intermediary non-bank financial services was made by years, which ultimately allowed for the DCF-model to identify potential business capitalization of investment banks, brokers and trust managers (see *Table 5*). These assessments were performed under three scenarios: optimistic, close to the Concept of long-term development of Russia-2020; the basic one, targeted at the current trend of GDP growth and market capitalization; moderate one, envisaging a virtual stagnation in the growth of economic and financial parameters.

Table 5

Capitalization forecasts for the Russian businesses involved in investment services on the basis of cash flow capitalization in 2010-2020

USD, mln	Scenarios		
	optimistic	basic	moderate
Capitalization of the retail business	8 190	4 930	3 254
<i>including:</i>			
Brokerage services	4,530	2,992	1,745
Individual trustees	1,877	998	806
Trustees of collective investment	1,661	857	652
Insurance brokerage	122	84	51
Capitalization of institutional business	19,457	15,601	8,561
<i>including</i>			
Underwriting and Consulting	9,530	8,090	4,299
Trust and Brokerage	9,928	7,511	4,263
TOTAL CAPITALIZATION	27,647	20,531	11,815
<i>For reference:</i>			
NPF capitalization	1,687	968	631

Source: estimates made by HSE research university experts.

Thus, the whole business of Russian investment banks, brokers and trust managers is valued at USD 27.6 billion under an optimistic scenario, at USD 20.5 billion under the basic sce-

nario and at USD 11.8 billion under a moderate scenario. Summary data on the quantitative parameters of the Russian financial market in 2010 suggest that its development is carried out on a trajectory close to the moderate scenario. This is the source of the increased risks for investors, emitters and the economy in general. The solution to this problem requires the government and businesses to achieve breakthroughs in the field of strategic management, innovation, incorporation of Russian financial institutions in the global chain of international financial markets, decision-making that will provide a real impact on the capacity of the domestic financial market.

Therefore, gradual recovery of the stock market, record levels of liquidity and the volume of domestic bond offerings in 2009-2010 do not remove the issue of the risks inherent in the Russian financial market. It remains vulnerable to external shocks and domestic risk factors.

3.6. Problem of attracting conservative institutional investors

The Russian stock market remains unattractive to the most highly capitalized conservative investors, especially to foreign pension funds. To understand the reasons for this, one may refer to the experience of the largest U.S. pension fund, California Public Employee's Retirement System (CalPERS), the value of which reserves is approximately USD 200. Before 2007 for many years, CalPERS applied the methodology for ranking emerging markets in terms of the possibility of investing in the assets of the fund. This technique was public and was based on the studies of reputable organizations, including Freedom House, World Economic Forum, Oxford Analytica, the Heritage Foundation, as well as Wall Street Journal and many other research centers.

The technique involved the assessment of CalPERS investment opportunities in emerging markets is based on two groups of factors - country risks and the risks inherent to a particular financial market.

Country risks were estimated by CalPERS under the following criteria:

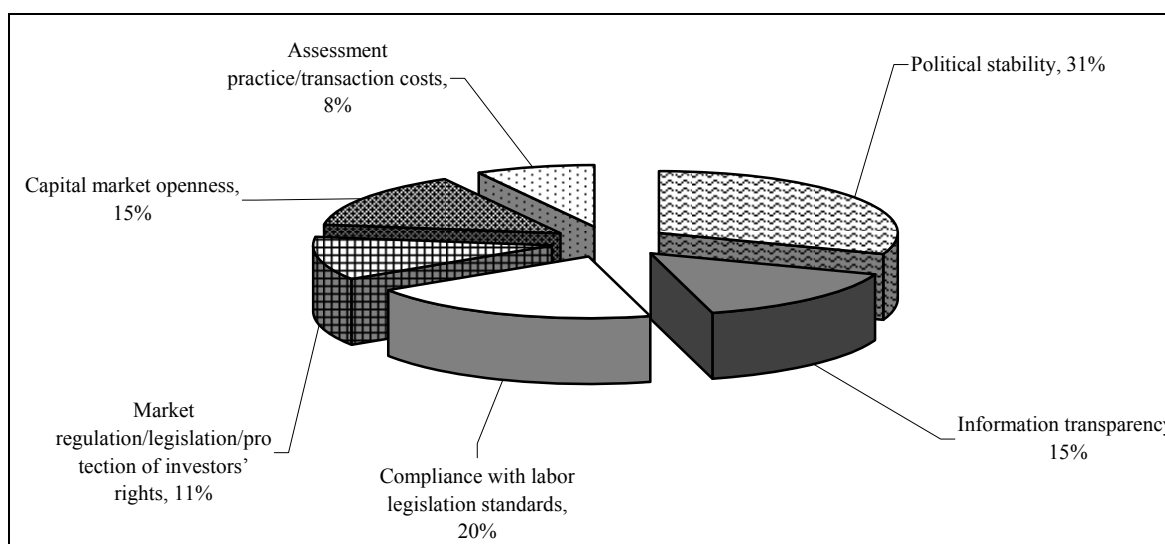
- political stability - a state of civil liberties, the independence of the judicial system and political risk;
- information openness, including an assessment of press freedom, the level of disclosure of information on monetary policy and budget, quality of stock exchange listings and the effectiveness of international financial reporting standards (IFRS);
- compliance with labor laws with international standards of labor relations - the ratification of ILO Convention, compliance with labor laws with ILO standards, the effectiveness of law enforcement.

In other words, the assessment of country risks involves the investment climate and institutions as the fundamentals of the financial markets. The second group of criteria involves the assessment of quantitative and qualitative parameters of developing capital markets, including the following indicators:

- liquidity and volatility of the stock market, including an assessment of market capitalization and its growth rates, coefficient characterizing the ratio of monthly turnover of exchange trade to market capitalization, number of companies included in the listing, the volatility of the stock market and the coefficients of the risk/returns on investment;
- evaluation of banking supervision effectiveness and enforcement in the stock market, the level of the rights of creditors and shareholders protection;

- assessment of the degree of openness to foreign investments, regulations liberality of banks and financial institutions, restrictions in the purchase of securities;
- assessment of the stock market settlement mechanisms effectiveness and the level of transactions cost, primarily in terms of tax liabilities, in the securities market and in regard to payments to the owners thereof.

The maximum score for this or that market, is three. If the country obtains 2.0 or more points, it was entered in the list of markets admissible for CalPERS assets. Otherwise, the market of a country was classified as prohibited to invest the assets of that pension fund. In 2007, according to CalPERS approach, the Russian stock market was rated at 1.91, i.e., less than two points, which made it impossible to invest in reserves of the pension fund. *Fig. 42* provides an analysis of key factors that have prevented the Russian market to reach the maximum assessment in three points by the method of CalPERS.



Source: www.calpers.ca.gov.

Fig. 42. Factors that interfere with the investment in the Russian pension fund maximum assessment by CalPERS (USA) techniques in 2007

Country risk factors, including political stability, information transparency and compliance of labor legislation with international standards, accounted for 66% shortage Russia estimation points. Political stability in the country received a score of 1 out of three possible ones. The main reason for such a low rating are associated with a low estimates of civil liberties, judicial independence and security of property rights, as well as the stability of the political system in Russia. The level of transparency in Russia is estimated at 2.0 points. In this regard, the main claims to Russia were imposed in terms of media freedom and the efficiency of application of IFRS (or US GAAP).

In contrast to the conservative evaluation of the effectiveness of institutional factors, quantitative and qualitative characteristics of the Russian stock market look quite respectable. However, Russia did not reach 34% of the required up to two points in this factor as well. Here the following problems occurred. The quality of market regulation in banking activity and stock markets in Russia is estimated at an average level of 2.0 points. Obtaining a higher score in this area prevent a lack of effective banking supervision and law-enforcement in the

stock market, as well as shortcomings in the protection of creditors' rights. According to the criterion of openness of capital markets, a low score of 1.7 points was obtained due to the restrictions in entering the market for banks and insurance companies.

In 2007, CalPERS has changed the methodology for making decisions about investing in emerging markets. Portfolio Managers were granted the right to choose companies from emerging markets for investment on their own, with regard to the risks inherent to the different countries and stock markets. In 2008 and 2009, CalPERS implemented a series of investments in the shares of the Russian companies (*Table 6*).

Table 6

CalPERS investments in the Russian companies, USD mln

	2008*	2009*
Gazprom	144.7	46.0
Lukoil	189.1	93.5
Mechel	9.1	1.0
GMC "Norilsk Nickel"	4.6	1.4
Novatek		20.6
Novorossiysk Commercial Port	10.3	8.4
Rosneft	11.4	31.4
Police Gold		5.5
Rostelecom		3.4
Sberbank of Russia	5.5	30.8
Severstal	7.0	4.7
AFC System	9.7	3.8
Surgutneftegas	4.5	20.5
Wimm-Bill-Dann		20.2
Magnet		7.3
MMC		6.1
VTB	31.6	6.9
LSR		2.9
Shares of Russian companies , total	427.4	314.4
Shares in foreign and domestic markets	122 281.2	80 728.6
The proportion of shares of Russian companies in CalPERS portfolio	0.35	0.39
The proportion of shares of Russian companies in the world capitalization	1.21	1.85

*fiscal year, ending in June.

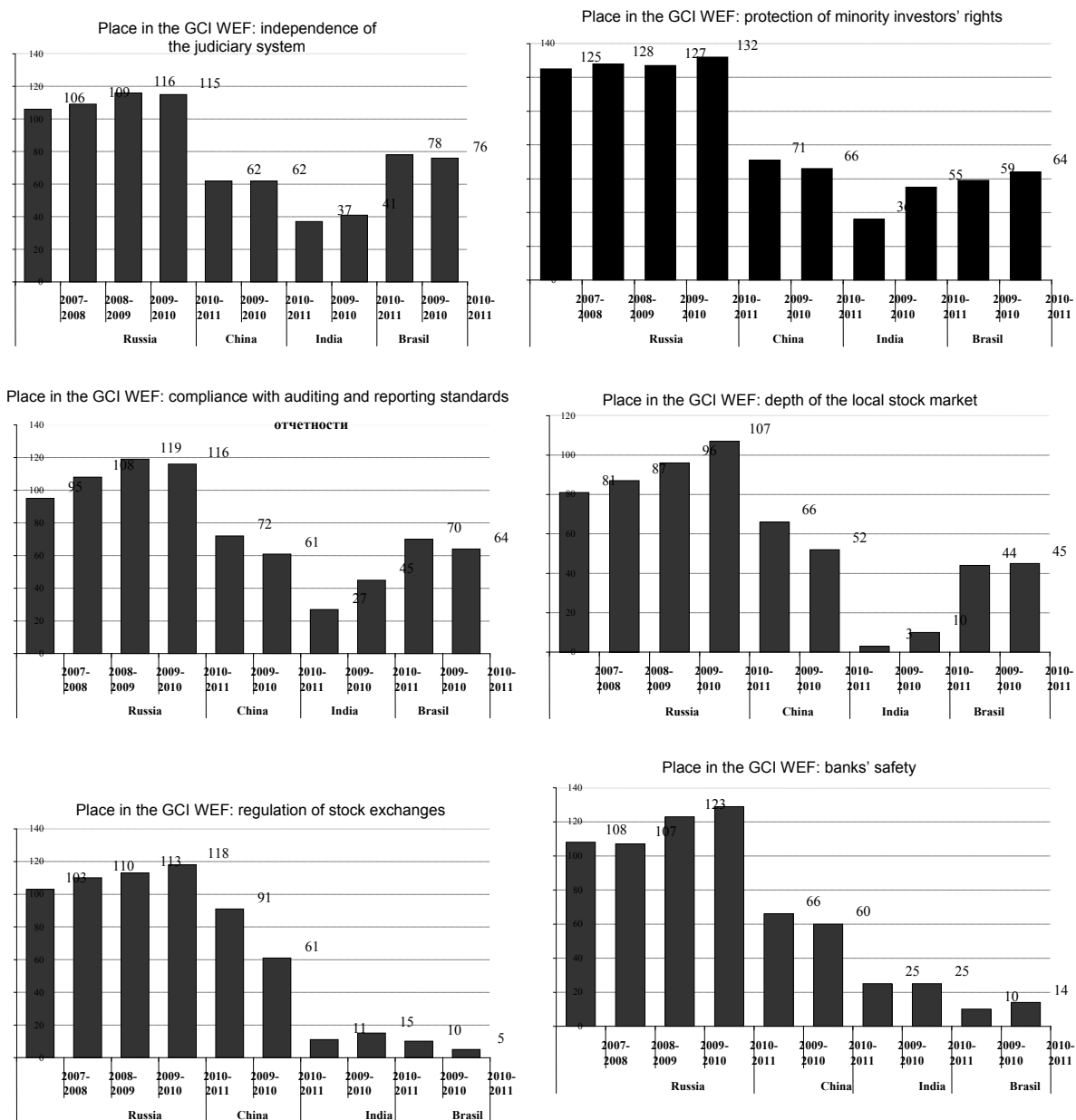
Source: CalPERS investment reporting for a number of years.

The values of CalPERS investments in the shares of Russian companies are symbolic. As of June 2008, they were estimated at USD 427 million, or 0.35% of the value of a portfolio of shares, in June 2009 - USD 314 million, or 0.39% of the value shares portfolio. For comparison, the share of Russian companies in the world capitalization amounted to 1.21% in 2008 and to 1.85% in 2009.

However, there are no positive changes in the main criteria, which prevented CalPERS from investing in the Russian equities at the time when they officially declared the selection criteria of emerging markets for investment. *Fig. 43* shows the global competitive ratings for several years, highlighting the areas where Russia received the lowest evaluation in terms of the old method of CalPERS.

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Source: Global competitiveness of the World Economic Forum rating over the years

Fig. 43. Places of the BRIC countries in the global competitiveness ratings under a number of criteria, essential for decision-making by conservative portfolio investors

In terms of the most problematic issues, i.e., the independence of judiciary system, the level of protection of minority investors' rights, the compliance with audit and reporting standards, the depth of the stock market, effective regulation of stock exchanges and banks' safety, Russia is far behind other BRIC markets. Herewith, the majority of these criteria are steadily deteriorating over the past four years, including the rating of evaluation of the Russian market as of October 2010.

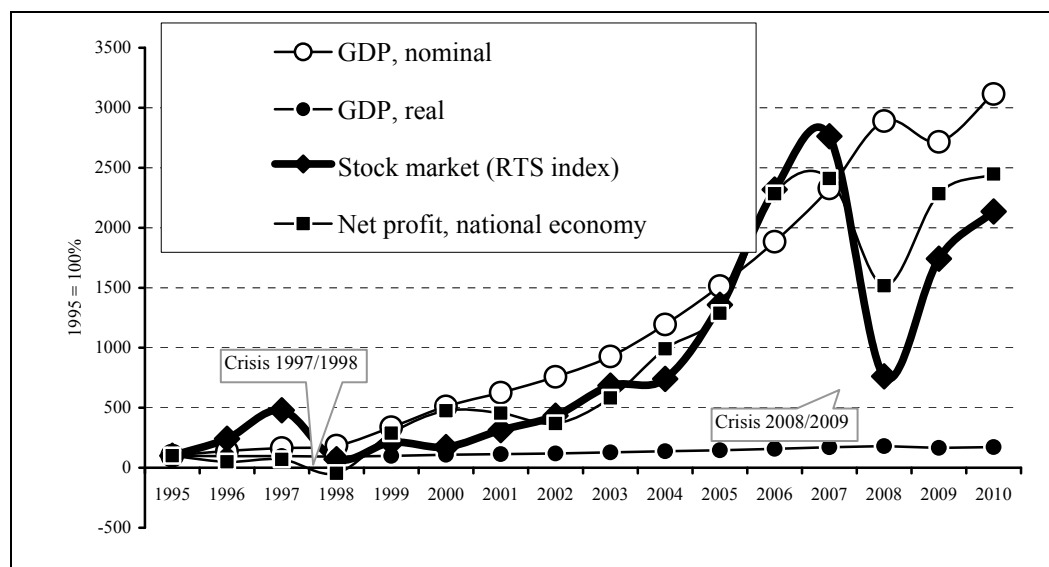
3.7. The role of the stock market in the economy modernization and innovation promotion

The crisis has exposed deep problems and contradictions of the Russian economy, its lack of readiness for the challenges of globalization. By the end of 2009, the country's leadership and society in an explicit form have formulated policy of economic modernization. A key role in its implementation has to play the financial market, but is it ready for such ambitious goals?

3.7.1. Yield of financial and non-financial investments

In the long-term, the growth of capital markets follows the dynamics of basic indicators, such as net earnings of companies and gross domestic product. For example, our estimates of the growth in the dynamics of the stock markets and leading economic indicators in 12 developed capital markets over the past 50 years demonstrate that the average growth of stock indices tend to match the average growth rate of nominal GDP¹. In emerging markets, equity markets as a rule, tend to grow somewhat faster than nominal GDP growth due to attracting investments from abroad.

Fig. 44 shows the ratio of the rate of growth of the RTS index, GDP and profits of the Russian companies. They show that on the eve of both the Russian crises, the growth rate of stock indices were sharply away from GDP growth. Then, as the market recovered, the stock indices were trying to catch up with production and profit indicators.



Source: RTS and Russian Statistical Service.

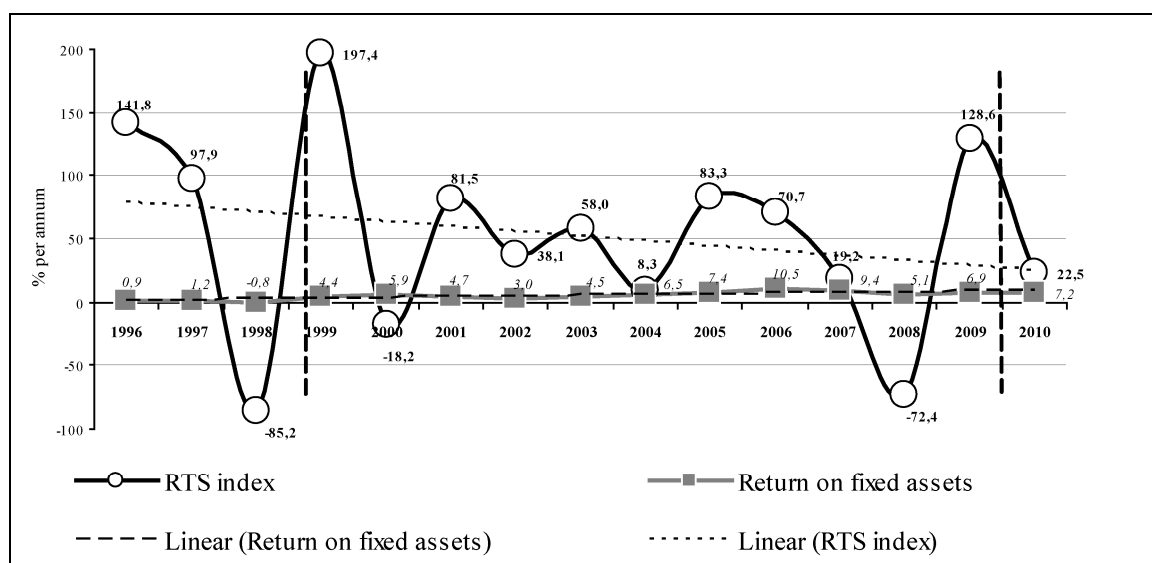
Fig. 44. The growth of the stock market compared with the growth fundamental indicators

The most vulnerable point of the Russian stock market is that earnings on investments are substantially higher than the profitability of productive assets - fixed assets and current assets.

¹ Section 1.3. Report of National Securities Market Participants. The Russian stock market and creation of an international financial center. Ideal model of the Russian stock market over the long term (until 2020). Moscow, 2008. Published on the website www.naufor.ru.

As a result, instead of attracting investments to create new production capacity, the stock market from time to time starts to play the role of "pump", sucking resources from the real economy. High yield of investments in such market is ensured mainly by the resources of the new-coming investors to a lesser degree of profit growth issuers. Meanwhile, emphasizing the link between investment and economic growth, Paul Samuelson, Nobel laureate in economics, noted that "investments will only occur when a real capital is available"¹ In other words, the generator of economic growth is the real capital, but Russia contributes very little in the accumulation of the Russian stock market.

Fig.45 shows the profitability of investing in the stocks of the portfolio as the RTS index and the profitability of productive capital that can be used as a criterion for making investment decisions on the effectiveness of investments in the growth of productive capacity.



Source: RTS and Russian Statistical Service.

Fig. 45. Profitability of investments in shares and return on assets in the economy

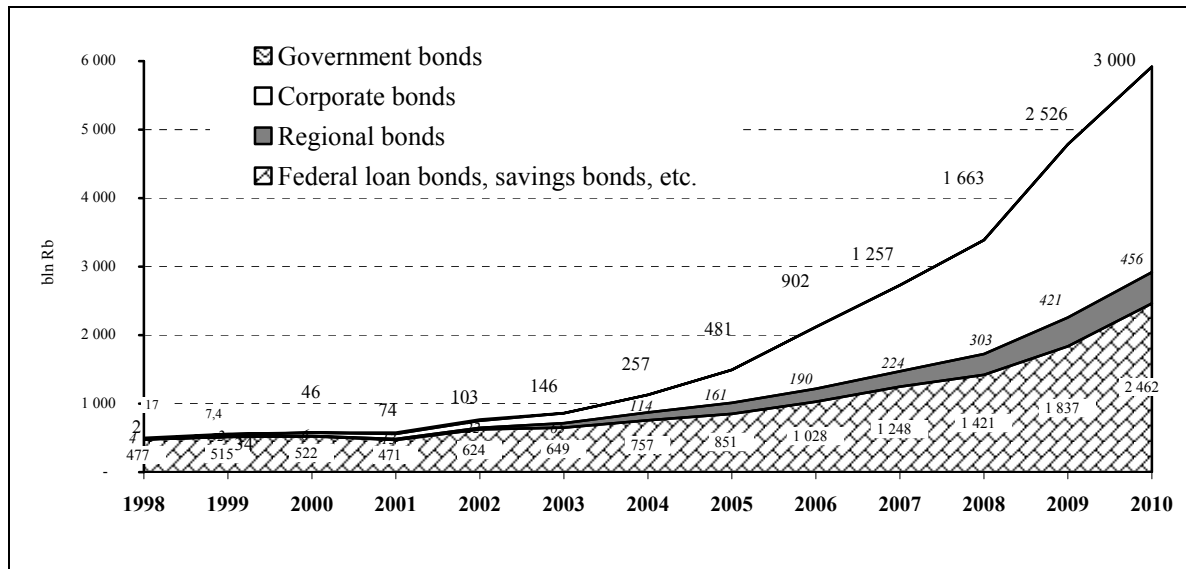
In 1996-2010, in only three years out of 15 years (1998, 2000 and 2008-m), the return on investment in shares is substantially lower than the return on fixed assets. And, despite the fact that the linear trends of profitability of investments in the RTS index and manufacturing assets converge, the gap between these rates is still significant, which creates a substantial risk of outflow of domestic capital in the real economy in the short-term investments in the financial market.

3.7.2. Contribution of the corporate bond market in real capital growth

A surprising phenomenon of 2000. was the rapid development of the ruble bond market (Fig. 46). Capitalization of the ruble bond market grew from 0.6 trillion rubles in 2000 to 5.9 trillion rubles in 2010, or nearly 10.0 times. Corporate bonds market was the fastest in growth

¹ Samuelson, Paul E., William D. Nordhouse, Economics: translation from English: 16 ed.: Publishing house "Williams", 2005. - P. 389.

among all ruble bonds. Their combined market capitalization has grown from 46 billion rubles in 2000 to 3.0 trillion rubles in 2010, or 65.2 times.



Source: Russian Ministry of Finance and Cbonds.ru.

Fig. 46. Volume of ruble-denominated bonds in circulation

The rapid growth of the corporate bond market relies heavily on various external and internal of growth mechanisms. Underlying growth in the corporate bond market since the beginning of 2004 to July 2008 lay strategy «carry trading», carried out by Russian banks and foreign hedge funds. From August 2008 to the present growth of the ruble bond market is based on monetary liquidity is concentrated in banks, first by providing them with support for anti-crisis state, then with a significant mitigation of monetary policy. One of the factors of growth of the corporate bond market in 2009-2010 was also slow recovery of the loan portfolio, which allowed the last shift of resources from the loan market in bonds. Catalyst for the growth of the ruble bond market since the mid 2000's was playing the market repo with the Bank of Russia and interbanking repo, through which banks could borrow short-term resources for long-term investments in bonds.

One of the prerequisites for corporate bonds in most cases was a guarantee of emitters in the form of an offer, granting the owners of bonds the right to present them for redemption by the issuer within one to three years from the date of placement. Similar offers essentially changed the nature of long-term bonds, turning them into instruments of relatively short-term financial resources. Resources attracted by issuing bonds that are actively used by issuers to implement the financing of mergers and acquisitions, credit refinancing, active business expansion and other relatively short-term objectives. Because of the short-term bond financing and low profitability of investments in new fixed assets and other productive assets, the role of bonds in the financing of real capital has been and still remains minimal.

Table 7 demonstrates the parameters of the ruble corporate bond market in 2000-2010, recalculated in dollar terms. Despite the rapid growth in placements of corporate bonds from 1.1 billion dollars in 2000 to 28.2 billion dollars in 2010, the volume of resources addressed

to basic capital formation was very low. For example, if the total placements of bonds in 2010 amounted to 28.2 billion dollars, only 0.03 billion dollars of this sum, or 0.1% of the placed bonds was addressed to the purchase of fixed assets. Overall, in the 2000-s the share of the volume of corporate bond addressed to fixed assets, ranged from 0.00% to 6.7%.

Table 7

Structure of the ruble corporate bonds market (USD billion)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Capitalization	1,6	2,5	3,3	4,8	8,9	17	33,2	49,2	67	79,7	98,8
Secondary market, including repurchase	0,2	1,1	2,3	8,2	14,7	44,2	134,9	371,1	457,4	293	756,8
Allocation	1,1	0,8	1,5	2,6	4,9	9,2	17,1	17,9	16,1	29,0	28,2
Fixed capital	0	0	0,1	0,1	0,1	0,3	0,1	0,2	0,2	0,1	0,03
Same, as% of capitalization			3,0	2,1	1,1	1,8	0,3	0,4	0,3	0,1	0,03
Same, in% by volume placement			6,7	3,8	2,0	3,3	0,6	1,1	1,2	0,3	0,1

Source: estimates based on the MICEX, cBonds, the Bank of Russia and the Federal State Statistics Service.

3.7.3. Effect of IPO shares on the economy

More effective tool for raising funds to finance capital assets than the issue of corporate bonds, are public offerings in the form of an IPO and SPO. This is due to the fact that the proceeds from the IPO are more long-term. Table 8 shows the parameters of the market shares of Russian companies. They show that the most active IPO shares were held in 2006 and 2007, when companies raised 17.0 billion dollars and 33.0 billion dollars respectively. From the amount of proceeds from IPO-SPO in 2006, 18.8 % was addressed by the companies for acquisition of fixed assets, and in 2007, this indicator fell down to 10.9%. In some years, for example, in 2008, 110.5% was allocated in the fixed assets, and in 2009 - 117.6% of the volume of IPO. This is due to the fact that some investments in fixed assets the companies received through a private placement of shares, rather than through IPO-SPO. In 2010, Russian companies, including those registered offshore RUSAL and Mail.ru, attracted 6.3 billion dollars with IPO-SPO, whereas in total through the issuance of shares, 2.6 billion dollars were invested in fixed assets, or 46. 0% of the volume of IPO-SPO. A significant portion of the resources involved in the stock market has been addressed to purchase the business from their former owners, refinancing of debt service and mergers-acquisitions, including acquisition of major shareholdings. Meanwhile, volumes of IPO and investments in real capital by issuing shares are much smaller than mergers and acquisitions¹. From 2000 to 2010 the total amount of IPO-SPO of the Russian companies amounted to 70.7 billion dollars, while the volume of mergers, acquisitions made 564.3 billion dollars, which is 8 times more.

¹ For example, here is the comment of Prime Minister Vladimir Putin at a meeting on the problems of energy on Feb. 24, 2010: the use of utilities (JAG and TGK), assets from the additional emission amounting to 450 billion rubles. Of the total amount it is invested about 270 billion rubles, nearly 100 billion rubles are still kept at the accounts, and 66 billion rubles "are addressed at the ongoing activities, the purchase of non-core assets and simply "consume" or, frankly, were aimed at speculative purposes". Malkov I., A. Peretolchina. "Investors are accelerated". Vedomosti, February 25, 2010, p. 1.

Therefore, it is early to say that the major part of proceeds from the IPO, and from corporate bonds are contributing to the modernization of economy and sustained economic growth¹. The amount of funds that companies are attracting by placement of shares and corporate bonds, and then address at the purchase of fixed assets, make only a tiny portion of fixed assets financing.

Table 8

Structure of the Russian companies' corporate bonds market (USD billion)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Capitalization	40,7	74,6	105,5	176,3	230,0	548,6	1057,2	1503,0	397,0	861,4	938,3
Secondary market, including foreign exchange	46,7	49,4	86,8	188,3	541,3	374,0	914,2	1687,1	1982,5	1155,7	1430,5
IPO	0,5	0,2	1,3	0,6	3,0	5,2	17,0	33,0	1,9	1,7	6,3
Fixed capital	0,2	0,1	0,2	0,2	0,1	3,2	3,2	3,6	2,1	2	2,9
Same, as% of capitalization	0,5	0,1	0,2	0,1	0,0	0,6	0,3	0,2	0,5	0,2	0,3
Same, in % to IPO volume	40,0	50,0	15,4	33,3	3,3	61,5	18,8	10,9	110,5*	117,6*	46,0
The volume of mergers, acquisitions	5,0	12,4	17,9	32,3	27,0	60,4	61,9	125,9	110,4	56,1	55,0**

* - value greater than 100% because some share of investments in fixed capital could be made through private placements;

** estimated by www.mergers.ru.

Source: estimates based on the MICEX, the Bank of Russia, the Federal State Statistics Service, www.mergers.ru

The main sources of fixed assets financing remain the property accumulated by the company, budget assets, extra-budgetary funds and bank loans. Their share in 2010 accounted for 69.6% of all sources of investments in fixed assets. The share of bank loans in the sources of fixed assets financing in 2009-2010 was steadily declining, from 11.8% in 2008 to 10.3% in 2009 and to 8.7% in 2010. This suggests that, despite the increased liquidity, the banking system has not yet recovered from the point of credits in the economy.

During the 2000-s. the share of funds attracted by bonds and shares issues in the funding sources of capital ranged from 0.1% in 2001 to 3.4% in 2005. In 2009 and 2010 this indicator amounted to 1.1% and 1.4%.

¹ For some reason the rule «q-Tobin» works badly in Russia, according to which in case of high coefficient characterizing the ratio of market capitalization to recovery price of business, then it becomes more profitable to invest in the real capital. (Mishkin F.. Economic Theory of Money, Banking and Financial Markets. 7th edition: Translation from English. – Moscow.: JSC «I.D. Williams», 2006, p. 738. It is interesting that from other developing countries, according to the IMF Report on Global Financial Stability, we differ by lower coefficient P/BV (ie, ratio company's capitalization to its balance value), which does not promote investment in real capital. Russia's problem is dual: first, shares' price is overvalued, second, great value of inefficient assets.

3.7.4. Private equity and venture capital funds

Problem of the Russian economy from the perspective of modernization is the weakness of the industry of private equity funds and venture capital funds. These categories of funds, working with Russian companies can be divided into funds established offshore abroad (Svarog Capital Advisors, Russia Partners, Delta Private Equity Partners, Baring Vostok Capital, etc.) and closed investment funds, carrying out activities on the basis of Federal Law "On Investment Funds". As of mid-2009, according to the magazine "Finance", the value of the first group of funds was about USD 3 billion¹, and the second one, according to the National League managers - about RUR 75 billion².

The causes of the weak level of direct investment funds in Russia are shown in the results of a survey among global investors of 72 private equity funds, performed by international audit company KPMG from December 2008 through February 2009³. To the question whether Russia looks more attractive to you than other BRIC countries, 58% of respondents gave a negative answer. Among the main reasons preventing the transactions of these funds in Russia in 2009-2010, investors mentioned: macroeconomic instability - 89% of the respondents, legal / regulatory constraints - 30%; unrealistic price expectations of vendors (from the English. vendor - dealer, trader) - 23% political risk - 16%, the lack of qualified managers - 16%. One has only to add that the market for private equity deals is currently being "monopolized" by large oligarchic corporations, which makes entry into it independent of market structures, including the largest global private equity funds that artificially restrain competition in this area and attraction of foreign advanced technologies.

With respect to private equity investment funds, the prospects for their development are in doubt yet. In accordance with the law on private investment funds, any information on mutual funds as private equity funds that are intended only to qualified investors at the end of 2009, ceased to be public. As required by Federal Financial Markets Service of Russia, stock exchanges establish specialized sections of trades for qualified investors, the members of which will have an access to information on these funds.

In this situation, it is unclear what information will be available on existing and new equity mutual funds to potential investors who do not have the status of "qualified", including foreign investors. These funds were out of view of analysts and experts from academic institutions. In our opinion, artificially imposed by Russian Federal Financial Markets Service information barriers on the activities of mutual funds of direct investments will only lead to a sharp decline in interest in them to potential investors, which will negatively affect the development prospects of these funds in Russia.

Currently in the country, according to the Ministry of Education and Science, there registered more than 80 technological parks, and even more - innovation and technology centers, more than 100 technology transfer centers, 10 national innovation and analytical centers, 86 centers of scientific and technical information, more than 120 business incubators, 15 centers of innovation consulting, as well as other organizations of the innovation infrastructure. Such abundance of innovative structures is difficult to accept as reasonable. Further development of

¹ A. Golovin Direct investments are dying. Finance, № 27-28 (310-311), 27.07.-16.08.2009.

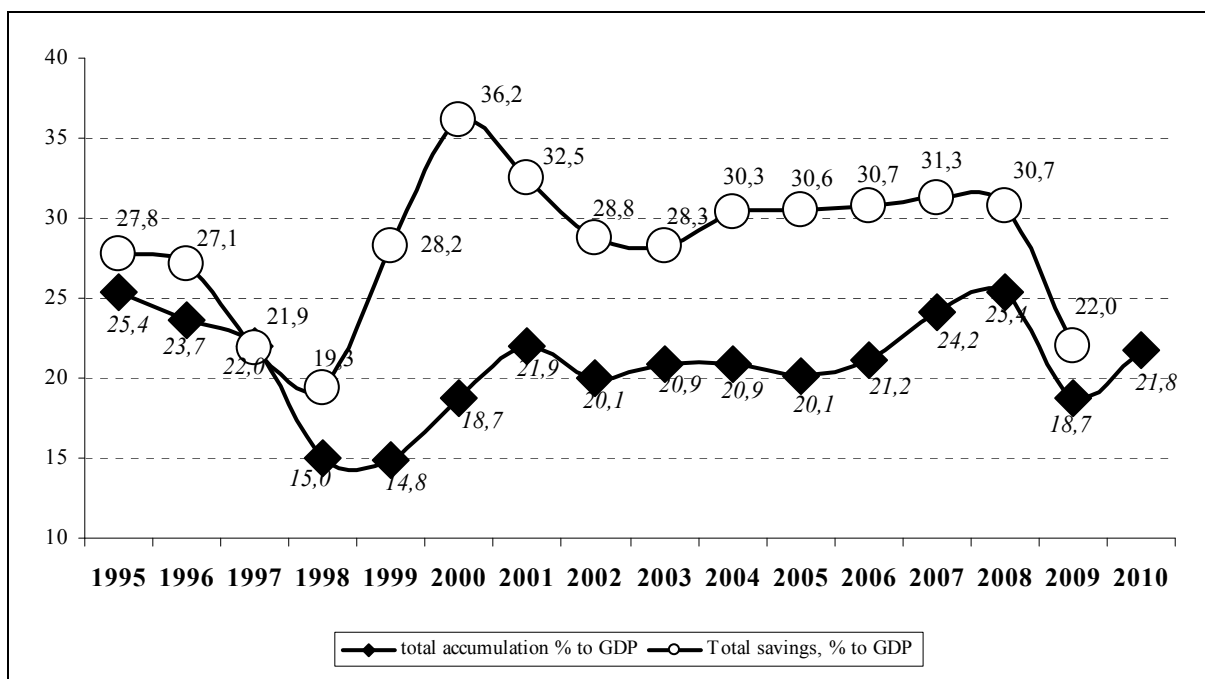
² To date, according to requirements of FSFR of Russia PIFs direct investments are assigned to the category of funds for qualified investors, whose advertising is banned. Due to this fact, public information resources on PIFs www.nlu.ru и www.investfunds.ru stopped publishing statistics on this category of PIFs.

³ A. Golovin Direct investments are dying. Finance, № 27-28 (310-311), 27.07.-16.08.2009.

innovation requires the establishment of centralized structures with their regional representatives, who would have assumed responsibility for coordinating the efforts of numerous structures on promotion the advancement of new technologies in the economy, as well as for disclosure of information about opportunities for business innovation organizations in different fields.

3.8. Impact of the crisis on the system of domestic savings

To maintain high growth and modernization rates of the Russian economy should maintain a high domestic savings rates. However, if the savings rate in Russia is relatively high and second only to individual countries in the Asian region, the rate of savings, i.e., investment in fixed assets and inventory are significantly lower than in many developing and developed countries. Fig. 47 shows the rate of savings in Russia in 1995-2010.



Source: estimates based on the Federal State Statistics Service.

Fig. 47. The rate of savings in Russia in 1995-2010 years,% of GDP

The difference between the rate of savings and accumulations from year to year is 5-10 percentage points. The main reason for the fact that a part of domestic savings in the country turns into a real capital, lies in the fact that the bulk of the surplus savings falls into sovereign funds, which are located abroad. This is a forced phenomenon, because at present the Russian financial system is incapable to ensure the level of development of financial institutions and investment climate in the country, these provisions make it work for economic growth and modernization. The system itself needs to be modernized, acquiring new knowledge and skills. This problem should be the focus when developing a new long-term strategy development for the period up to 2020. In addition, the accumulation of these funds should be implemented to reduce the dependence of the Russian economy on external economic conditions.

Other reserve growth stocks is to increase the savings rate of households. According to official statistics, Russia's Federal State Statistics Service of households are saving 14-15% of their income (see Fig. 48). In the leading countries in economic growth and modernization of the rate of household savings to disposable income is much higher. According to the information resource Euromonitor International, the average for 2000-2009, in Singapore, it made 33.9%, in China - 31.9%, in Hong Kong - 30.7%, in India - 30,1%. Social and demographic situation in these countries, of course, different from Russia, but it must be recognized that any large-scale modernization involves reliance on domestic financial resources. Besides, the high rate of consumption in Russia in the current environment actually means stimulating the expense of domestic demand by foreign manufacturers.

We are not talking about enforcement measures to improve the savings rate of the population. To accomplish this, as well in the case of the reserves of the state, we need effective financial institutions and reducing inflation. This problem was hardly solved in previous years, as evidenced by the *Table. 9*.

Table 9

A summary of the development level of institutional investors in Russia

	The number of countries in the sampleICI ¹ and OECD	Russia's place in the samples	The share of assets, % of GDP	
			average for2000–10	2010
Assets of the open-ended investment funds*	45	44	0.3	0.3
Reserves of private pension funds**	47	43	1.0	1.4
Assets of insurance companies***	32	32	1.0	1.1

*Russia - open and interval mutual funds.

**Russia - NPFrossiya - NPFreserves

***Russia - insurance provisions

Against those countries where there is domestic stock market, Russia is the only country that is a world outsider in terms of development of all three forms of collective investments. Among 45 countries, for which statistics is kept on the assets of open-ended investment funds, Russia has occupied the 44 seat; according to the criterion of the relative level of development of private pension funds, It is the 43-th place out of 47 countries; assets of insurance companies - 32 place out of 32 countries. In 2010 the share of assets of open and interval mutual funds to GDP in Russia was 0.3%, reserves NPF – 1.4%, the assets of insurance companies - about 1.1%. This suggests that in Russia, there is almost no working mechanism of savings through institutional investors. In contrast to all other countries, in the world of the main ways of saving the Russian population are housing and bank deposits.

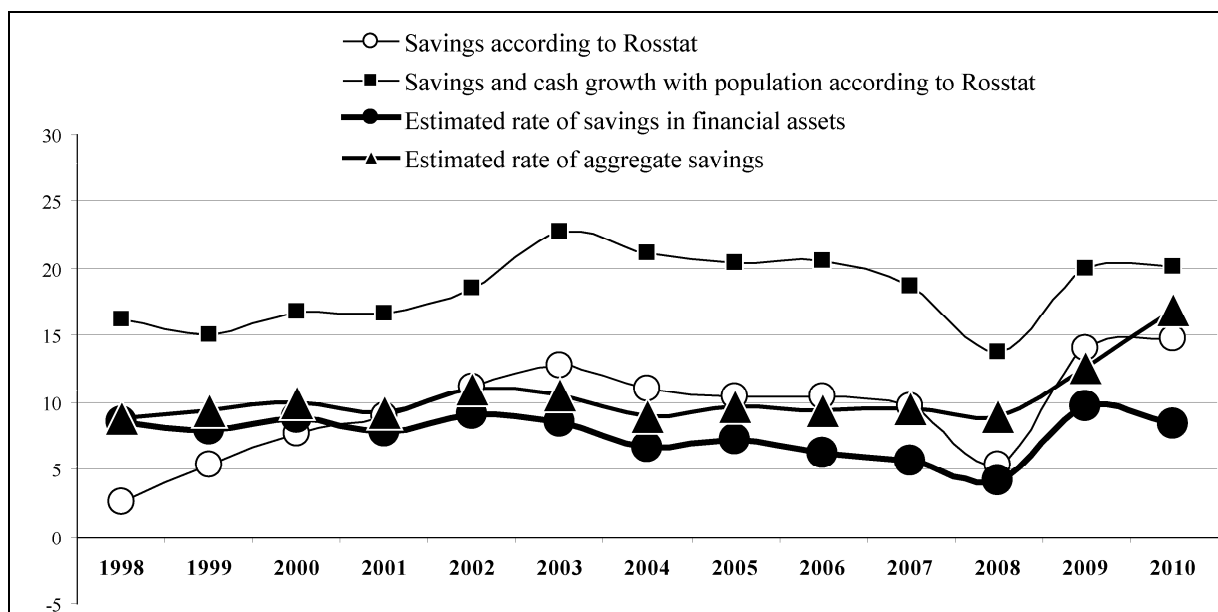
Therefore, in order to increase the rate of accumulation, it is necessary, on the one hand, gradually to build new and modernize old institutions of development, ensuring that they receive current knowledge, investment, technology, skills and technologies, as well as to achieve real progress on improving the business climate. On the other hand, it is necessary to establish the financial mechanism, which would create real incentives for people to voluntarily increase the savings rate by limiting the consumption and export of savings abroad. To this end, it is necessary to create a technologically effective system of private pension funds, based on corporate pension plans and individual investment (retirement) accounts, to achieve

¹ Investment Company Institute.

a lower cost per square meter of housing under construction through the elimination of administrative corruption and rent, and encourage competition among the construction companies, to make available to the public mortgage credits, when the purpose of principal repayment and servicing for individuals will be no more than 30% of their monthly income.

Fig. 48 analyzes various indicators of population trend to save. *The overall rate of household savings* is assessed on the basis of published Rosstat balance income and expenditures. These savings include the increase (decrease) in ruble and foreign currency bank deposits of population, purchase of securities, changes in the accounts of individual entrepreneurs, the change in the debt of individuals on credits, real estate acquisition. This rate increased from 7.6% of household income in 2000 to 14.7% in 2010.

If these articles of savings are replenished with additional disclosed by Russian Statistical Service item of purchasing foreign currency and growth of cash rubles kept by the population, then we obtain the *total rate of savings and cash growth with population*. This savings rate increased from 16.8% in 2000 to 20.2% in 2010. The determined by us *estimated rate of savings in financial assets* consist of the increase (decrease) in ruble and foreign currency bank deposits, purchase of securities from the population, growth (decrease) in reserves of foreign currency and rubles cash on hand, changes in the debts on personal loans. This savings rate fell from 8.8% in 2000 to 8.4% in 2010. Finally, the *estimated rate of aggregate savings* includes savings in financial assets and purchase of real estate. This indicator increased from 10.0% in 2000 to 16.9% in 2010.

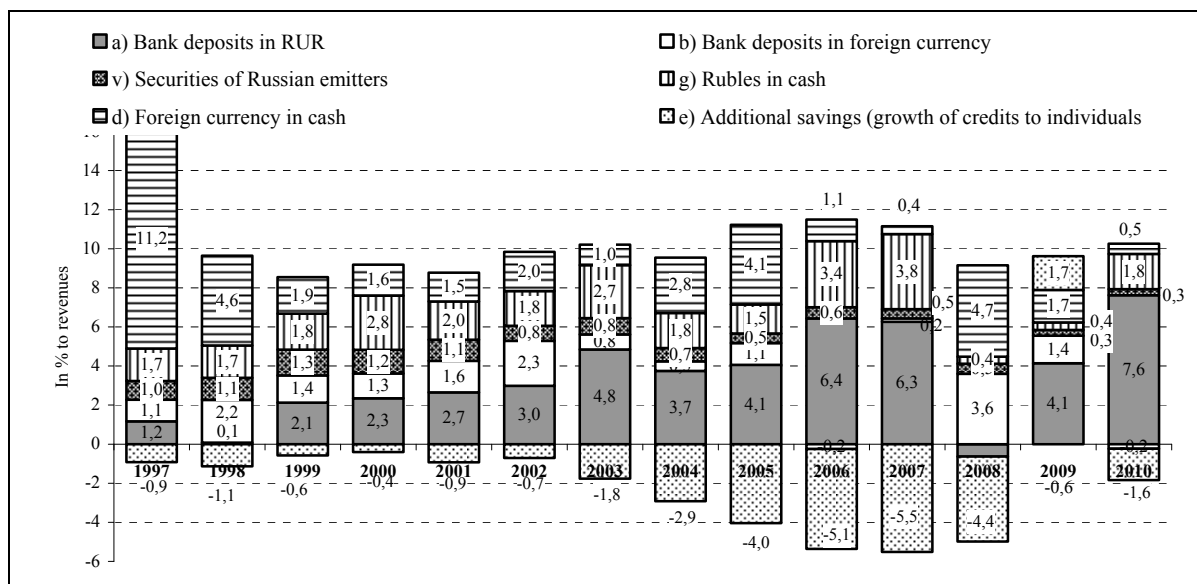


Source: Estimates based on data from the Bank of Russia and the Federal State Statistics Service

Fig. 48. Disposition of population to save in 1998-2010,(% of income)

Structure of financial savings in financial assets is shown in *Fig. 49*. Crisis of 2008-2009 has significantly changed the structure of citizens' savings. At the beginning of the crisis in 2008, inspired by the sharp fall in equity prices and the devaluation of the ruble, population has reduced the amount of the stored rubles and even reduced the ruble-denominated savings deposits in the banks. At the same time, cash reserves and deposits in foreign currency have

significantly increased. With the decrease of the devaluation and the resumption of the ruble significant growth in the ruble bank deposits, decreased propensity to save in the form of foreign currency deposits and foreign currency. In 2010, the main form of household savings were denominated bank deposits, constituting 7.6% of population income.



Source: Estimates s per Central Bank and the Federal State Statistics Service.

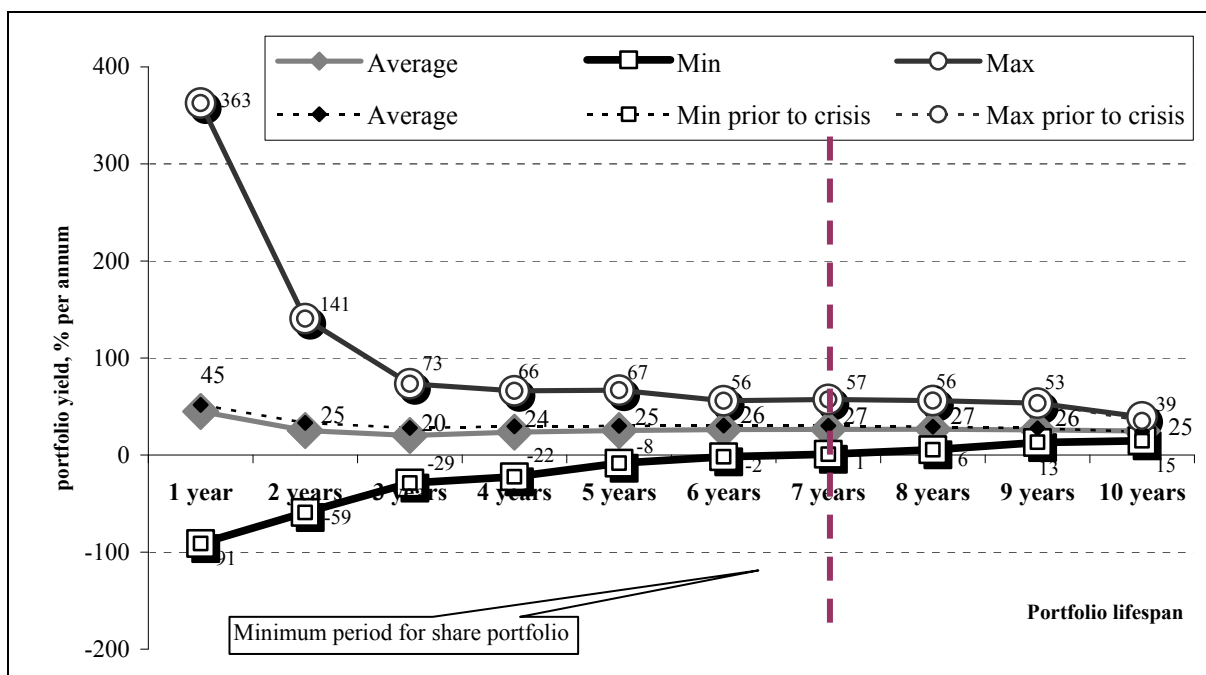
Fig. 49. Disposition to save in financial assets in 1997-2010

Unlike bank deposits and real estate investments, other forms of savings do not work in fact. Propensity to save in securities, even during the crisis has not significantly changed and remains at a low level of 0.3-0.5% of population income. The main reason for this situation is not that the Russian stock market is excessively volatile, but that people do not trust the financial institutions that provide non-banking investment services.

The financial crisis has not changed the investment quality of shares. Shares of the Russian companies, along with real estate investments, now remain the only investment assets in the domestic market, which bring a positive real rate of return to long-run investments. According to our estimates, the average annual real return on investments in equity portfolio of the RTS index for 2000-2010 is amounted to 25.4% per annum in residential real estate in Moscow (index IRN) 8,3%. Unchanged after the crisis are the parameters of maximum, minimum and average nominal yield of the portfolio of the RTS index for different investment horizons. Fig. 50 shows the portfolio returns of different maturity during the period from September 1995 through December 2009. For comparison, the dashed lines show similar curves for the period from September 1995 to July 2008, i.e., prior to the latest financial crisis.

The most risky of an investment portfolio are the investments in the RTS index for the term of one year. Over 16 years under review, the maximum return on this portfolio amounted to 363% per annum, and the worst result was the reduced cost of the portfolio by 91%. On average, over the entire period of investments in the annual portfolio, there were brought 45% per annum. As can be seen on the chart, as prolongation of the average annual investment yield of the portfolio got stabilized, the gap between the worst and the best results in portfo-

lios yield were shrinking. When investing in a 7-year portfolio of the worst-case scenario, which the investor reaches with investments in the RTS index, is positive, equal to 1% per annum, the average yield on this portfolio is 27% per annum. This means that only when investing in the RTS index for 7 years and more investors would be faced with the fact of reducing the market value of the portfolio. It is for this reason that the minimum reasonable term of investment in a diversified portfolio of stocks in the Russian market should be 7 years or more. Herewith, as seen in Fig. 50, the dotted curves, showing assessments for a similar portfolio for the period preceding the crisis of 2008-2009, practically coincide with the curves, showing the crisis impact. This suggests that the current crisis did not affect the minimum requirements for the term of investments in the Russian market and the key indicators of profitability of long-term portfolios.



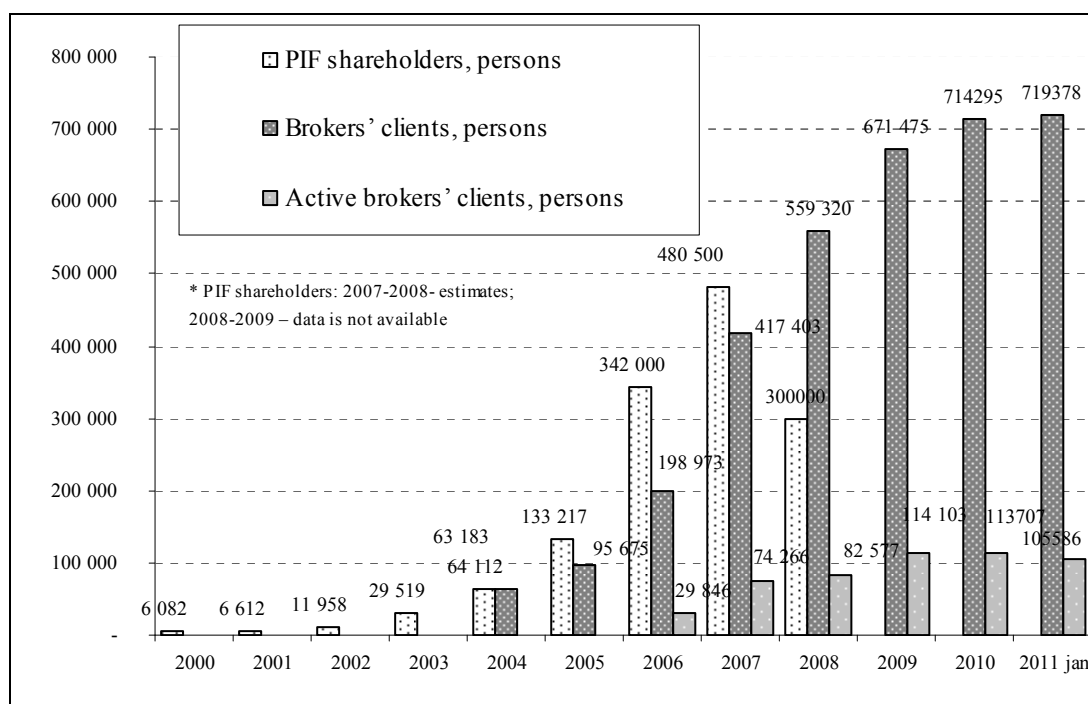
Source: Estimates of RTS.

Fig. 50. Yield (% per annum) portfolios of "RTS Index" of different maturity for the period from September 1995 to February 2011

Unfortunately, the benefits of long-term investment in the Russian stock market remains virtually out of demand. The bulk of investors are guided by relatively short-term strategy. When entering into agreements with financial intermediaries, using brokerage services and asset management in the securities market the minimum acceptable timeframes for individual investors to invest in instruments with high market risk are not taken into account.

Fig. 51 demonstrates available data on the number of accounts of individual investors with brokers and the number of personal accounts in registries of Privatization Investment Funds (PIF). Unfortunately, currently the National League does not disclose the number of market-based mutual PIF shareholders. However, if we assume that the number of shareholders of PIFs in 2009-2010 has not significantly decreased as compared with 2008, then we can assume that the number of individual investors who trade in securities directly or through collective investments in 2010 reached one million. Herewith, 2010 is distinguished by a mani-

fested trend of reduction of the number of brokers' clients registered in the MICEX trading system. If in 2009 the growth in the number of registered customers during the year amounted to 112.2 thousand persons, the relevant figure in 2010 was only 42.8 thousand. The number of active clients and brokers declined from 114.1 thousand to 113.7 thousand. This may reflect the fact that the model to attract customers to the Russian stock market, effective up to now, begins to exhaust itself. The number of people involved in the stock exchange speculation in any country is limited. The new growth model requires the involvement in the market the long-term investors, which cannot be done without an effective system of retirement savings and restructuring the model of service delivery by financial institutions.



Source: estimates based on the MICEX, National Securities Market Participants and National League .

Fig. 51. Number of market-based retail customers of management companies and brokers

3.9. Banking System in the Russian Federation

3.9.1. Key Macroeconomic Figures which had an Impact on the Russian Banking Sector in 2010

The year 2010 was of paramount importance for recovery and qualitative transformation in the Russian banking system following the financial crisis and economic downturn. In 2010, owing to a favorable foreign economic situation and gradual recovery of the domestic demand, Russian banks resumed lending to the real sector as the quality of credit institutions' assets improved. The problem of liquid assets deficit in the banking sector was overcome in the previous year: deposits of the Central Bank of Russia decreased rapidly in the banking sector as corporate and retail deposits increased. It is the growth in the real household disposable income, recovery processes in the production sector and retail sale that can be attributed

to the key macroeconomic preconditions which governed the recovery dynamics in the banking business. Growth rates in the construction industry and dynamics of investments in fixed assets contributed as much to recovery in non-financial institutions' demand for borrowings. It is worth mentioning briefly the values of the macroeconomic indicators which had an impact on the development of the banking sector in the past year.

According to the data published by the Federal State Statistics Service (Rosstat), real household disposable income increased by 4.3% as of 2010 year-end, which, on the one hand, promoted decrease in overdue accounts under previous loans and the number of new credit products sold by banks in the past year, and, on the other hand, increase in retail deposits.

Industrial production increased at a level of 108.2% in 2010 against 2009. Enterprises of the processing industry contributed most, 11.8%, in annual terms. Recovery of the processing industry had a great impact from the point of view of diversification of the corporate credit portfolio at banks. According to the data published by the Central Bank of Russia, as of January 1, 2011, ruble-denominated loans issued by banks to companies in the processing industry accounted for 19.7%. This category of business activities was ranked number one in terms of weight in the industrial production sector (e.g., enterprises operating in the mineral extraction industry and production and distribution of gas and water accounted for mere 2.1 % and 4.2% of the portfolio, respectively) and number two in terms of aggregate corporate credit portfolio after retail sales companies which accounted for 23.5% of the ruble-denominated loans issued by banks to the real sector (as % of the aggregate ruble-denominated corporate portfolio of the banking system with due account of loans from VEB (Vnesheconombank)).

Retail turnover, which governs directly the need of households for short-term loans and sales companies for working assets, increased by 4.4% in 2010 against the figures reported in 2009 which was hit by recession.

Fixed capital expenditures create the demand for "long" loans in the banking sector. Bank loans accounted for 9.1% of the structure of capital investments of non-financial institutions in January – September 2010. Fixed capital investments at the 9-month period-end was reported to grow at a level of 3.7% y-o-y. It is noteworthy that large banks, which can borrow inexpensive assets in international markets, continued to grant most of investment loans.

Before proceeding with analysis of banking aggregates in the past year-end, let's describe most remarkable events which in our opinion had a material effect on the development of the sector in 2010.

The regulator reduced intensively the refinancing rate. Throughout the entire 2010 the Bank of Russia made four decisions on reduction of the refinancing rate which finally decreased to a historical minimum of 7.75%.

From July 1, 2010 the Central Bank of Russia abolished recession-related benefits for creation of provisions for losses while maintained the moratorium on excluding banks from the deposit insurance system.

Following the Central Bank of Russia, banks began to intensively reduce deposit rates.

In 2010 the Bank of Russia intensively rolled back the recession counter package designed to support the banking system. The following events can be regarded as most remarkable. First, unsecured loans for a period of more five weeks decreased in volumes; second, the Lombard list of securities which the Central Bank of Russia accepts as security for loans was shortened.

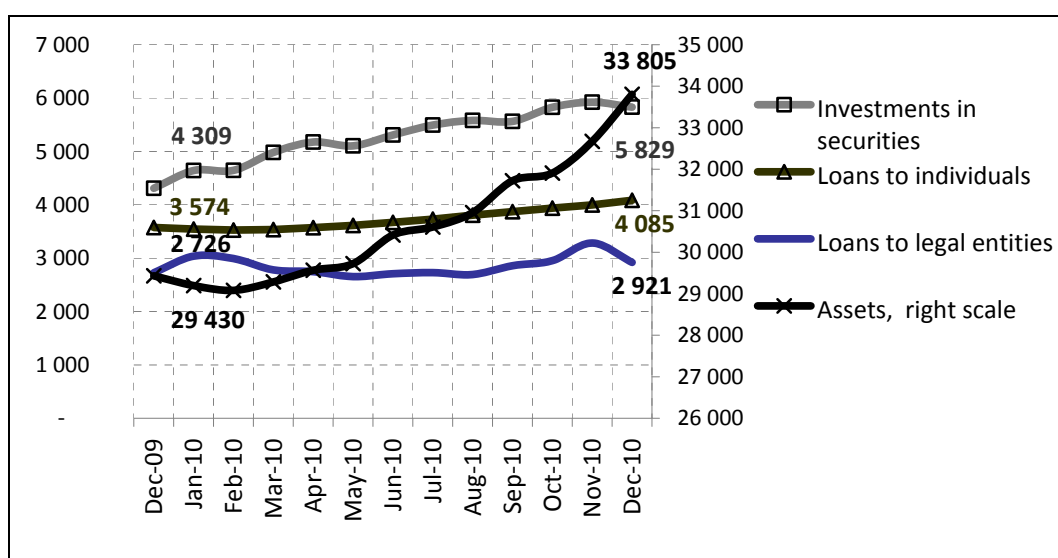
From January 1, 2010, the minimum capital requirements to credit organizations were increased up to RUB 90 mln, which, however, failed to result in any visible reduction in the

number of existing banks. From 2012 the requirements are expected to be strengthened once again, up to RUB 180 mln, whereby promoting a trend towards consolidation in the Russian banking sector.

Upcoming partial privatization of the largest banks in which the state holds an interest, through sale of a part of the block of shares held in VTB and Sberbank, can be regarded as a remarkable event of the past year.

3.9.2. Analysis of Annual Data on the Banking System: Balance Sheet

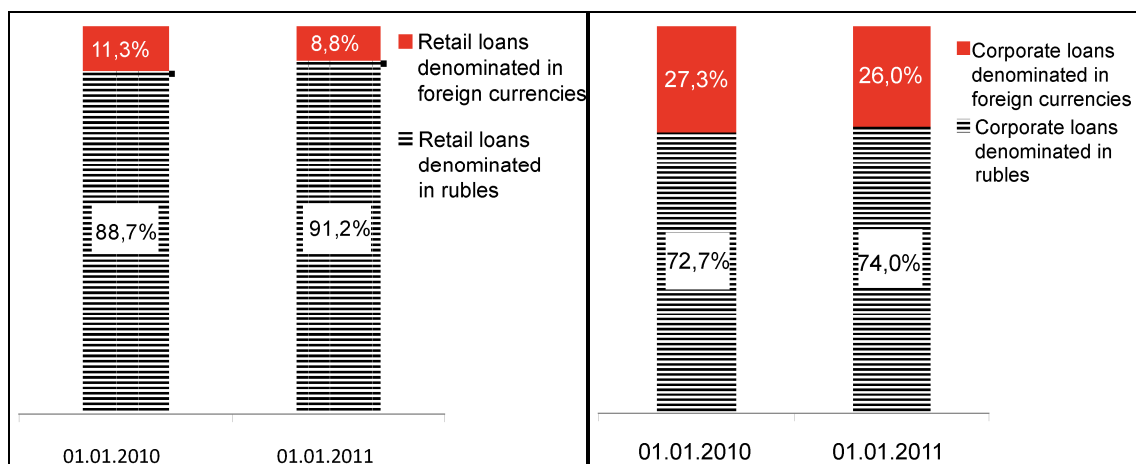
According to the data published by the Central Bank of Russia, the assets of the Russian banking system increased by 14.9% in 2010, thus exceeding the most optimistic expert expectations. However, the structure and quality of the increase was found to be very heterogeneous. Banks increased volumes of corporate lending, which contributed most to the growth of assets in the banking system in 2010. The corporate credit portfolio increased by RUB 1,5 tln in nominal terms during the same year, thereby resulting in a 34.8% cumulative growth in assets. A share of corporate lending in the assets decreased by 1 p.p., from 42.6 to 41.6%, in the past year-end. It is an intensive growth in bank investments in securities in 2010, that was most responsible for reduction in loans to non-financial institutions amidst remaining high credit risks, this type of investing in the banking system of Russia became the second, in order of importance, in terms of promoting annual growth in the assets. According to the published data, the banks' portfolio of investments in securities increased by RUB 1,5 tln in 2010. Investments in bonds developed most intensively. Increase in the bond portfolio resulted in an annual growth of 23.8% in the assets of Russian banks. Retail lending was the third in order of importance driver of growth in the assets of the banking system in 2010, which developed at outstripping growth rates against corporate lending: 14% against 7.2% as of 2010 year-end. However, the portfolio of loans to individuals was found to contribute much less, a mere 12%, to a total growth in the assets in terms of volumes. Dynamics of the assets in the banking system in 2010 are shown in *Fig. 52*.



Data Source: the Central Bank of Russia.

Fig 52. Dynamics of assets in the banking system of the Russian Federation, bln RUB

Foreign exchange structure of the corporate and retail credit portfolios changed insignificantly in 2010. In both cases, banks increased ruble-denominated retail and corporate loans by 2,5 and 1,3 p.p. respectively. Foreign exchange loans decreased for the two basic reasons: due to negative revaluation of the foreign exchange portfolio as a result of strengthening of the Russian ruble against other currencies (the RUB average weighted exchange rate decreased against the dual currency basket from RUB 35.96 to 35.16 in 2010) and low demand for foreign currencies from the private sector due to uncertainty of currency risks that might arise in the post-recession economy (*Fig. 53*).



Data Source: the Central Bank of Russia.

Fig. 53. Structure of corporate and retail credit portfolios denominated in foreign currencies and rubles

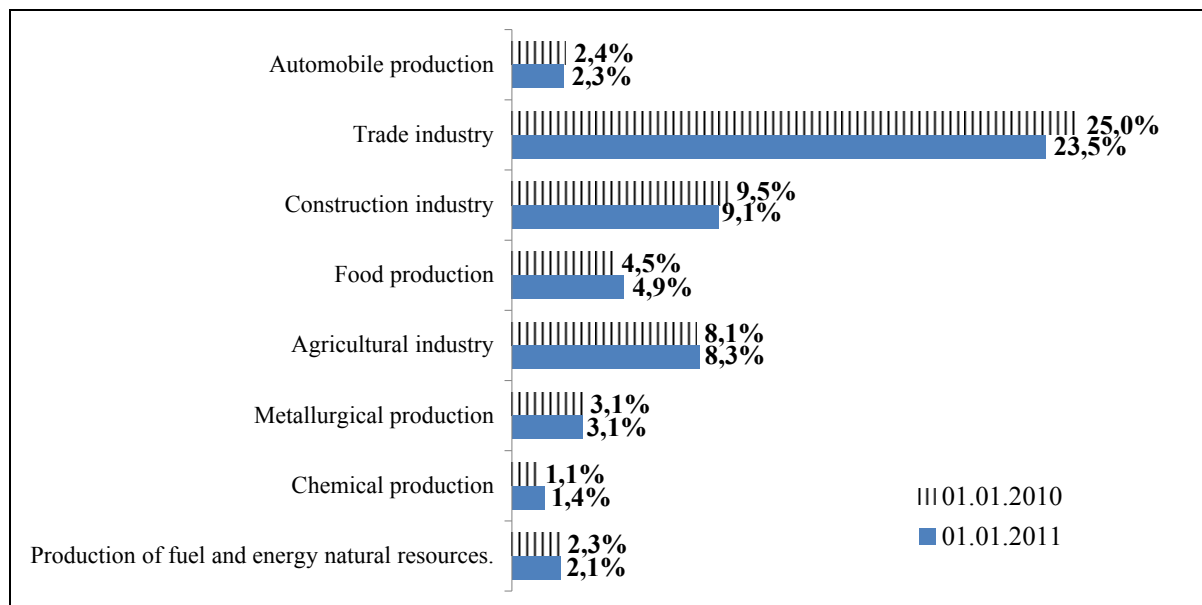
Bank lending also differed in intensity in the sectoral structure. Traditional lending drivers – fuel and energy and metal mining industries – showed no substantial demand for credit resources yet, which, on the one hand, can be explained by the ongoing cost optimization policy, and, on the other hand, growth in prices of primary commodities.

The chemical, food production, metallurgical, pulp and paper industries, as well as public utilities sector (including power engineering) are the most active borrowers. The processing industry, though it is ready to show demand for credit resources, has no high credit potential due to unstable growth and low profitability (*Fig. 54*).

In 2010, the Government of the Russian Federation also linked the decrease in retail lending to the recovery of mortgage lending. The remaining credit risks and lack of acceptable interest rates on long money borrowings, whose principal source was the international money market prior to the recession, became the key factors which constrained returning to the pre-recession growth rates in mortgage lending in 2010. As of 2010 year-end, however, the average weighted mortgage rate decreased from 14.6% as of January 1, 2010 to 13.4% as of December 31, 2010.

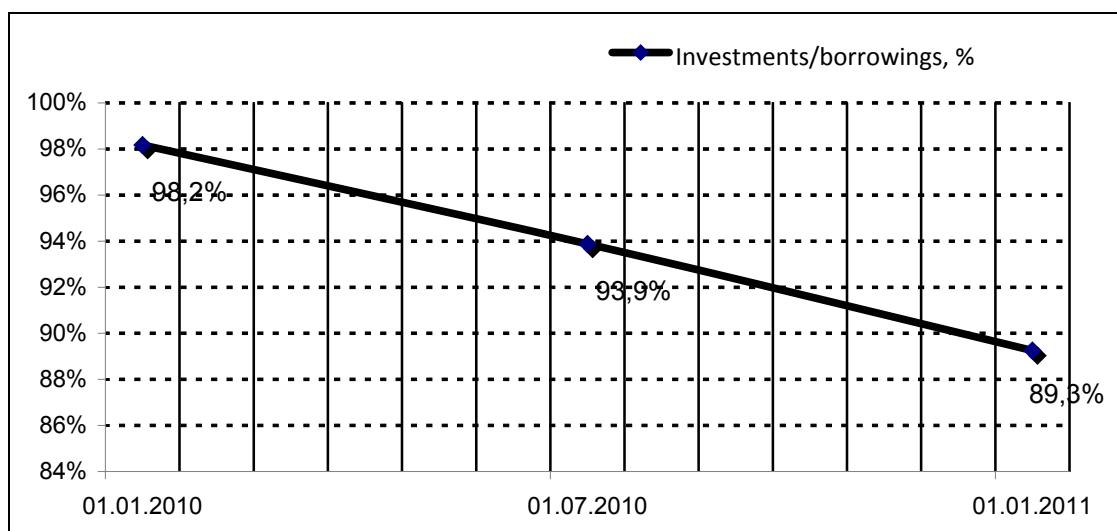
In 2010 the issue of insufficient liquidity in the banking sector ceased to be relevant. Bank borrowings obtained from individuals, corporate customers and interbank market were sufficient to cover lending transactions. In addition, investment of borrowings in alternative sources given the remaining credit risks in the real sector, became a relevant issue. The ratio

of loans to investments in the banking system of Russia in 2010 (Fig. 55) is shown in the figure below.



Data Source : the Central Bank of Russia.

Fig. 54. Specific types of business activity in the RUB corporate credit portfolio of the Russian banking system with due regard to loans issued by VEB, в %



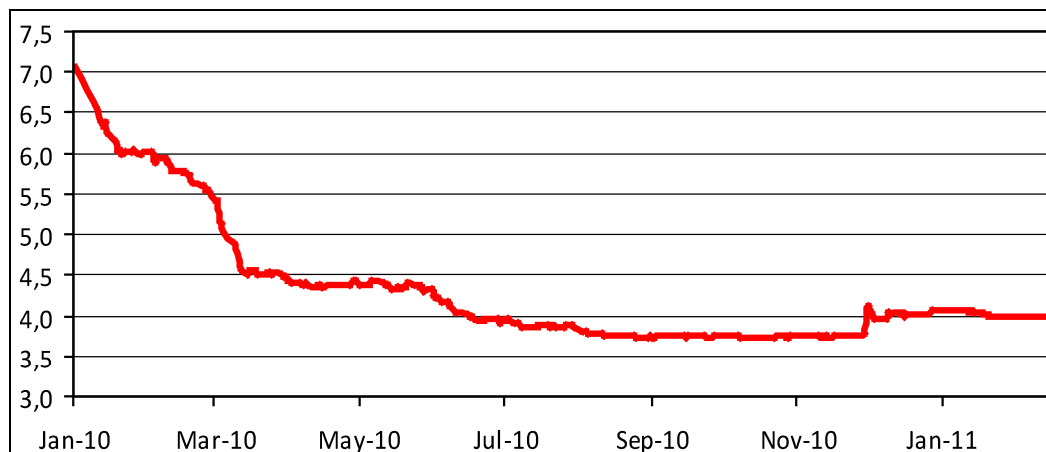
Data Source: the Central Bank of Russia.

Fig. 55. The aggregate investments to aggregate borrowings ratio in the banking system, %

Retail deposits remain the principal resource base for banks. It is the RUB 2,333 bln growth in retail deposits that resulted in a 53% cumulative growth in liabilities of the banking sector in 2010. Two reasons are responsible for a 31% increase in retail deposits. First, re-

maintaining uncertainty in the economy maintains a high level of supports thrift propensity of individuals, whereas the domestic demand is only beginning to recover. Second, a considerable growth in bank deposits in 2010 is related to the effect of a recession-driven growth in retail deposits. Bank deposits for a period of one year or beyond which were opened in the period of high interest rates, were intensively replenished in 2010. It is the higher interest of depositors in replenishing their “recession” deposits that resulted in material changes in the fixed-term structure of the deposit portfolio. In fact, replenishment of a deposit opened in the recession period replaced risky investments in the stock market, with growth being expected way ahead of the consumer price index. According to the data published by the Central Bank of Russia, retail deposits opened for a period of more than one year accounted for 65% of the total deposits as of January 1, 2011. Growth rates slowed down drastically in the fixed-term structure of foreign currency deposits, with even a decrease in balances being reported in specific cases. For example, in 2010 the volume of retail deposits for a period of up to 30 days and ruble-denominated call deposits increased by 46%, whereas the foreign exchange part of such deposits increased by only 9% and decreased by 27% in the structure of deposits for a period of 31 days to one year.

In general, a similar situation took place with the bank deposits placed by non-financial organizations, though volumes of such deposits are normally much smaller. According to the official data, corporate deposits in 2010 totaled a mere RUB 569 bln, accounting for 13% of total growth in the total balance on the liabilities side in the banking system. Like retail deposits, corporate deposits for a period of up to 30 days and for a period of more than one year were reported to become most intensive as of 2010 year-end. The former were mostly short-term deposits of free working capital, the latter mostly resulted from replenishment of long-term deposits by exporters (the foreign exchange part accounts for more than a half of nominal growth: RUB 259 bln of RUB 490 bln).



Data Source: National Foreign Exchange Association.

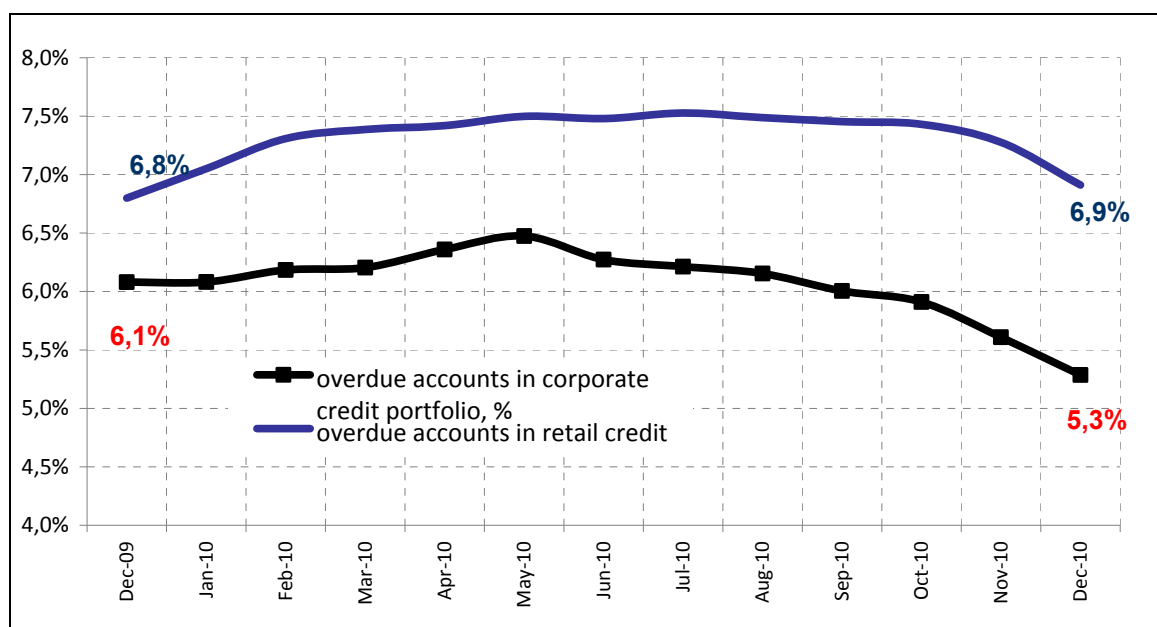
Fig. 56. Dynamics of MosPrime 3M rate in 2010

The volume of bank borrowings in the interbank loans market increased by 20% or RUB 637 bln in nominal terms in 2010. The two principal sources of borrowings became ruble-denominated deposits from resident banks, which increased by RUB 388 bln, and foreign exchange borrowings, an equivalent of RUB 152 bln, from non-resident banks.

Substantial reduction of the regulator’s money on deposits with commercial banks became one of the main trends describing post-recessional development of the banking system in the Russian Federation. Throughout the entire 2010 the Central Bank of Russia systematically reduced its balances from RUB 1,423 bln as of January 1, 2010 to RUB 326 bln as of January 1, 2011. Meeting the liquidity crisis at all levels of the banking system as well as a considerable decrease in interest rates in the interbank loans market were mostly responsible for decreased activity of the Central Bank of Russia. For example, the MosPrime 3M indicative rate decreased rapidly from 7 to 4% (Fig. 56) in 2010.

3.9.3. Quality of Assets

Expecting a potential, serious deterioration in the quality of the credit portfolio of the banking system was one of the key concerns which analysts expressed in 2010. A delayed negative effect of a large-scale deterioration in loan servicing could result from a campaign dedicated to restructuring of impaired loans which banks carried out in the H2 2009. In fact, the specifics of the Russian accounting system allowed banks to partially “hide” impaired assets and thereby hide the real situation with adequacy of provisions, potential growth of interest revenues, etc. Fortunately, no catastrophe took place. Economic recovery in 2010 slowed down drastically the process of creating provisions for losses at banks. In addition, record-breaking volumes of revenues were obtained through, including, but not limited to, split-up of the provisions across the entire banking system. Growth in overdue accounts in 2010 slowed down substantially in the retail credit portfolio and stopped in the portfolio of loans to non-financial institutions. According to the data published by the Central Bank of Russia, overdue accounts in the retail portfolio decreased from 6.8 to 6.9%, and in the corporate credit portfolio dropped from 6.1 to 5.3% as of 2010 year-end (Fig. 57)



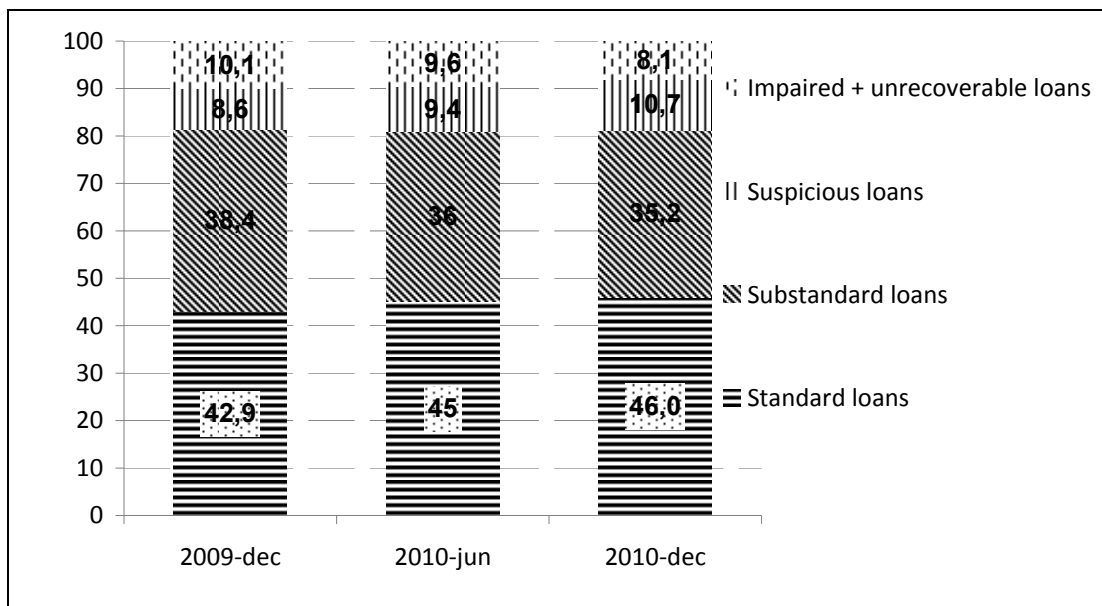
Data Source: the Central Bank of Russia.

Fig. 57. Dynamics of overdue accounts

Situation with the quality of loan servicing in the corporate sector was heterogeneous in 2010. A share of overdue accounts under loans to enterprises of the fuel and energy mineral extraction industry in the portfolio remained minimum in the banking system and even decreased from 1.4 to 1.3% in 2010. By the end of 2010, most of the problem borrowers, in terms of overdue accounts, were concentrated in the automobile industry (overdue accounts accounted for 19.2% of the portfolio), woodworking industry (18.8%), air transport sector (12.9%), retail and wholesale trade (9.7%). Manufacture of nonmetallic mineral products (+ 1.6 p.p.) as well as manufacture of machinery and equipment (+ 1.3 p.p.) were among the leaders in growth rates of overdue accounts in 2010.

The structure of the corporate credit portfolio by category of quality in the group of the 30 largest Russian banks can be another factor which supports the assertion of improved quality of the credit portfolio. In 2010 a share of standard loans increased by 3,1 p.p. here. A share of loans of 2nd category of quality – substandard loans – decreased by almost the same value. In turn, a share of impaired and unrecoverable loans (4th and 5th category of quality) decreased by 2 p.p. as a share of impaired loans increased by 2.1 p.p. Two conclusions can be made based on the afore described dynamics of changes in the structure :

- first, increase in a share of standard loans resulted mostly from new loans to financially reliable borrowers in 2010 ;
- second, decrease in a share of loans of the 4th and 5th category of quality resulted from “write-off” of bad loans from the banking system’s balance sheet due to both improved previously desperate conditions of specific borrowers and sale of impaired assets of special non-bank institutions (*Fig. 58*).



Data Source: the Central Bank of Russia.

Fig. 58. Structure of the credit portfolio at the 30 largest banks, by quality category of loans

Reduction in growth rates in provisions for impairment losses on loans had a direct impact on the improvement of the quality of bank assets in 2010. According to the data published by the Central Bank of Russia, on-balance residues of provisions in the banking system increased by only RUB 141,4 bln in nominal terms (+ 6.9%) in 2010, which was far below the growth

in the preceding year. During the recession in 2009 the stock of provisions increased by RUB 1,027 bln or 100% in the same year. Split-up of provisions was one of the factors which had a material impact on generation of a record-breaking profit in the banking system of the Russian Federation in 2010.

3.9.4. Profit and Loss in the Banking System

According to the data published by the Central Bank of Russia, pre-tax profit in the banking sector totaled RUB 581 bln in 2010, of which Sberbank of Russia OJSC generated about RUB 225 bln. Contribution of net interest income to the financial performance of the banking system decreased by RUB 31,5 bln against the preceding year. It is the decrease in the net interest income from retail lending that became most responsible for reduction in interest income at banks in 2010. As expected, a substantial growth in bank deposit rates in Q3 and Q4 2009 had a delayed adverse effect on the interest income of banks in 2010. Throughout the entire period in 2010 banks continued to pay “recession-driven” interest rates to depositors. The situation was aggravated by replenishment of high interest rate deposits which were opened for a period of more than two years. As a result, costs on interest payable on retail deposits increased by 23.5% in 2010 against the previous year, whereas costs on non-financial institutions decreased by 36% in the same year. Analysis of average weighted interest rates on borrowings and investments confirms that banks had an extra interest rate to pay to retail depositors in the H1 2010. For example, interest spread between ruble-denominated loans to individuals and deposits of up one year narrowed from 25.5 to 20.1 p.p. in the period between January and June 2010, and only in June began to show a stable upward trend. Replenishment of long-term bank deposits also slowed down growth in interest margin on retail loans and deposits for a period of more than one year. At the same time, an outstripping decreased in interest rates on ruble-denominated non-financial institutions’ deposits for a period of more than one year allowed interest margin to be increased by 2.5 p.p. on corporate loans granted for a period of more than one year (*Fig. 59*).

Net fee and commission income in the banking sector in the Russian Federation increased by RUB 35 bln or 8.5% in 2010, which was directly related with the number of newly granted loans. At the same time, the decision made by a series of large banks to charge no fees during loan administration became one of the key events which governed the dynamics of the fee and commission income in the banking system in 2010.

Banks’ income from foreign exchange operations was reported to decrease by RUB 113 bln in 2010, which can be explained by a relatively low volatility in the money market. Steady growth in the stock market allowed banks to earn RUB 360 bln from transactions with securities, which in general was comparable with the earnings (369 bln RUB) gained in 2009. By all means, split-up of provisions became one of the key sources of income for banks in 2010. According to the data published by the Central Bank of Russia, in 2010 banks reduced costs on creation of provisions down to RUB 233 bln against RUB 1,051 bln in the preceding year (*Fig. 60*).

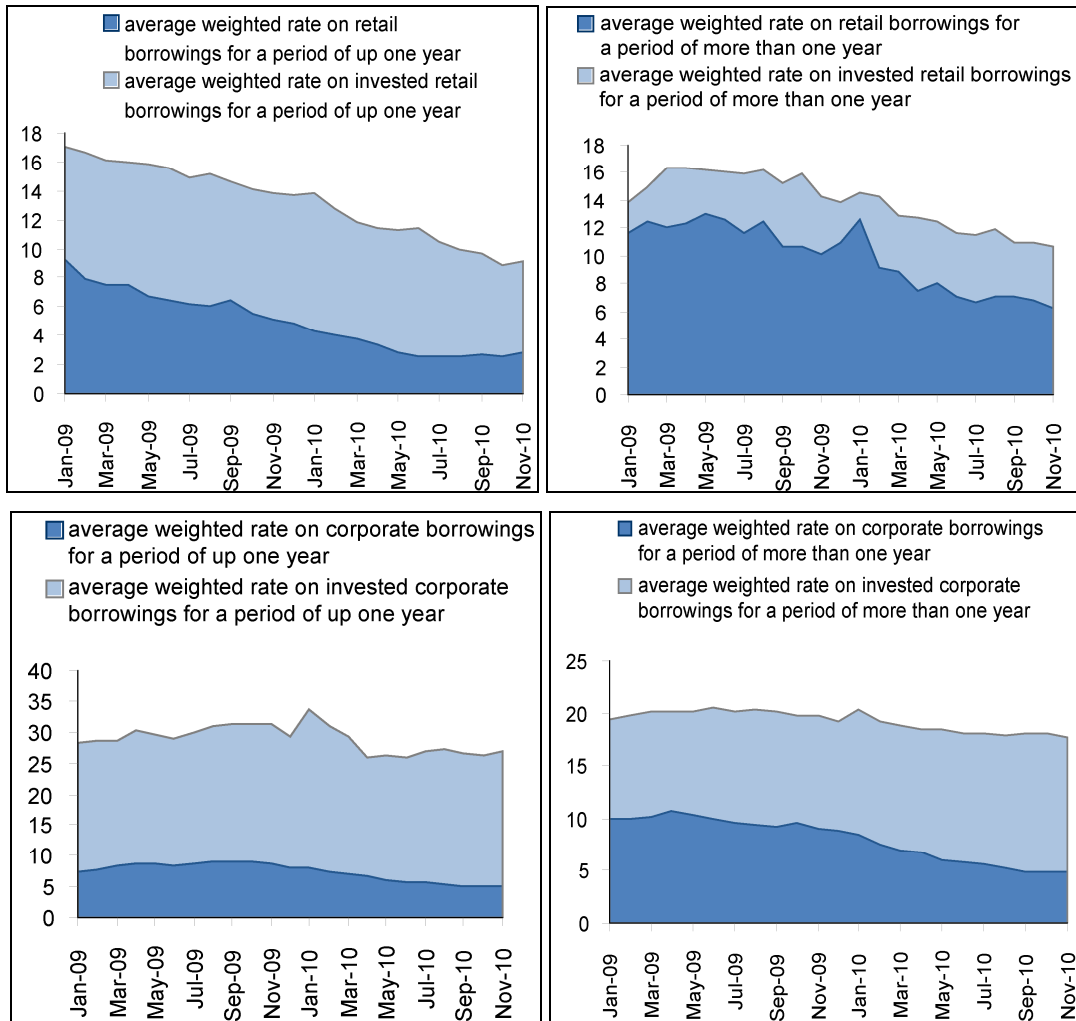


Fig. 59. Dynamics of interest margin on average weighted lending and borrowing rates, %

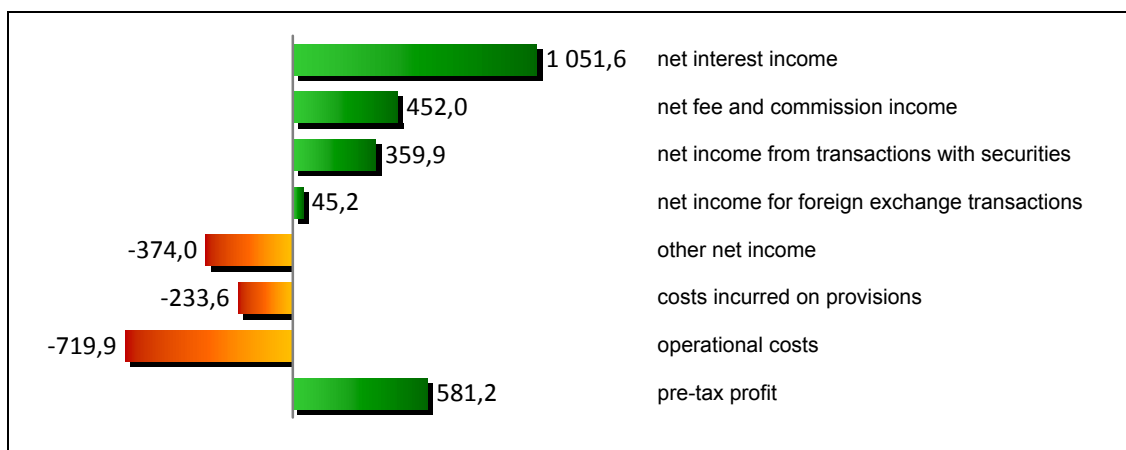


Fig. 60. Profit and loss in the banking system in the Russian Federation in 2010, bln RUB

3.9.5 Analysis of the 500 Largest Russian Banks

By banking specialization

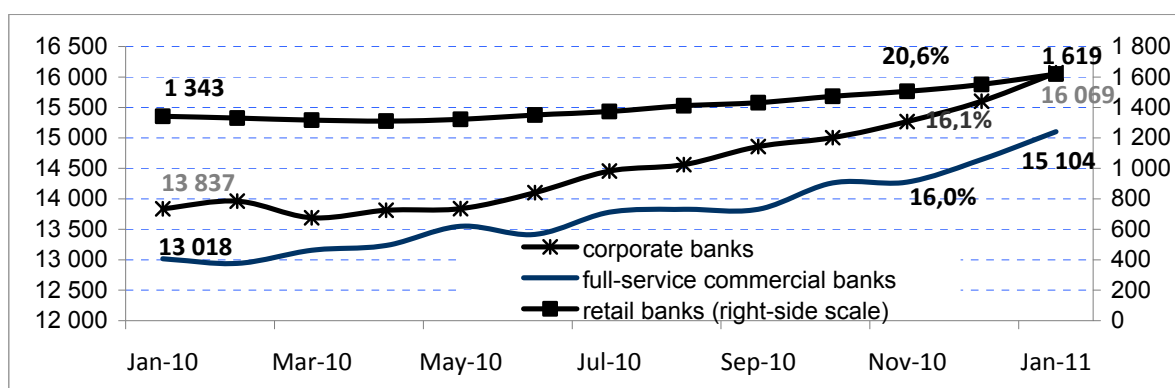
To be able to gain an insight into the processes which took place in the Russian banking system in 2010, let's analyze the 500 largest Russian banks by specialization in the banking market and by type of ownership banks.

We relied on a given bank's credit portfolio structure as of 1 July 2010 as the factor to identify the type of specialization of the bank. We employed the following method of identification of banking specialization: a bank was recognized as a corporate bank if loans to non-financial institutions accounted for or more than 80% of the aggregate credit portfolio of the bank; a bank was recognized as a retail bank if retail loans accounted for or more than 80% of the aggregate portfolio of the bank. For the purpose of this survey, the rest of the banks were recognized as full-service commercial banks.

As of January 1, 2011, the assets of the 500 largest banks of the Russian banking system totaled RUB 32,793 bln (accounting for 97% of the total bank assets). It is noteworthy that it was retail banks that increased their assets as of 2010 year-end, with annual asset growth accounting for 21% (Fig. 61). In spite of such a growth, the retail-group banks still had an insignificant effect on cumulative growth in assets in the banking system of the Russian Federation. Full-service commercial banks and corporate banks were found to be the key drivers for asset growth in the Russian banking system in terms of banking specialization.

As of January 1, 2011, corporate banks accounted for 49% of the assets of the 500 largest Russian banks, with a 16% annual growth rates. VTB, Gazprombank, Alfa Bank, Bank of Moscow were the key players in the corporate banking.

Sberbank of Russia OJSC, Rosbank, Uralsib, Raiffeisen Bank were the leaders among full-service commercial banks. Full-service commercial banks accounted for 46% of the total assets of the 500 largest banks as of January 1, 2011. Growth rates in the assets of this group of banks reached 16% in 2010.

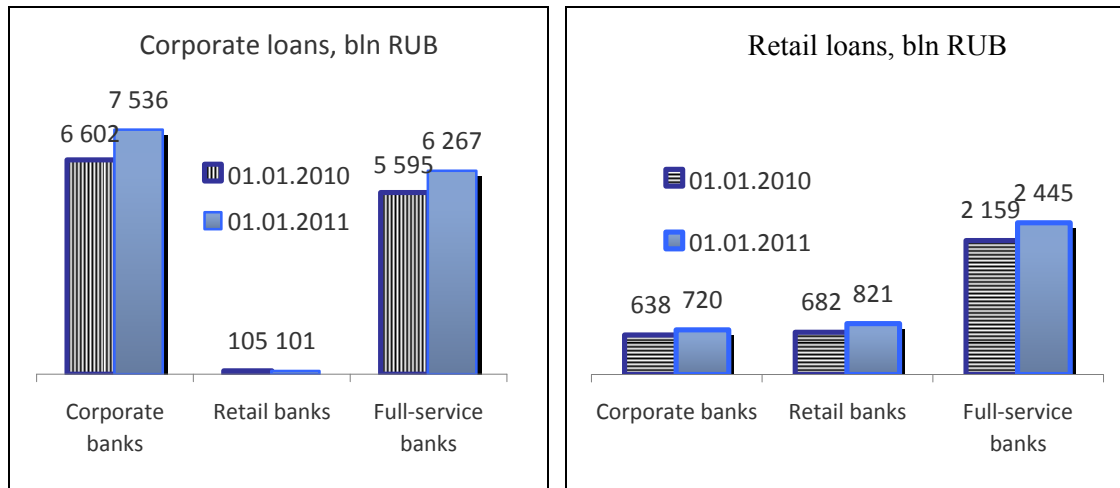


Data Source: the Central Bank of Russia, official financial statements published by banks (f-101).

Fig. 61. Assets the 500 largest Russian banks, by banking specialization, bln RUB

As of 2010 year-end, the corporate credit portfolio in the group of corporate banks increased by 14% (or RUB 934 bln), whereas the corporate portfolio of full-service commercial

banks increased by 12% (or 672 bln RUB) in the preceding year. Full-service commercial banks were leading in terms of growth volumes, especially owing to Sberbank (*Fig. 62*).



Data Source: the Central Bank of Russia, official financial statements published by banks (f-101).

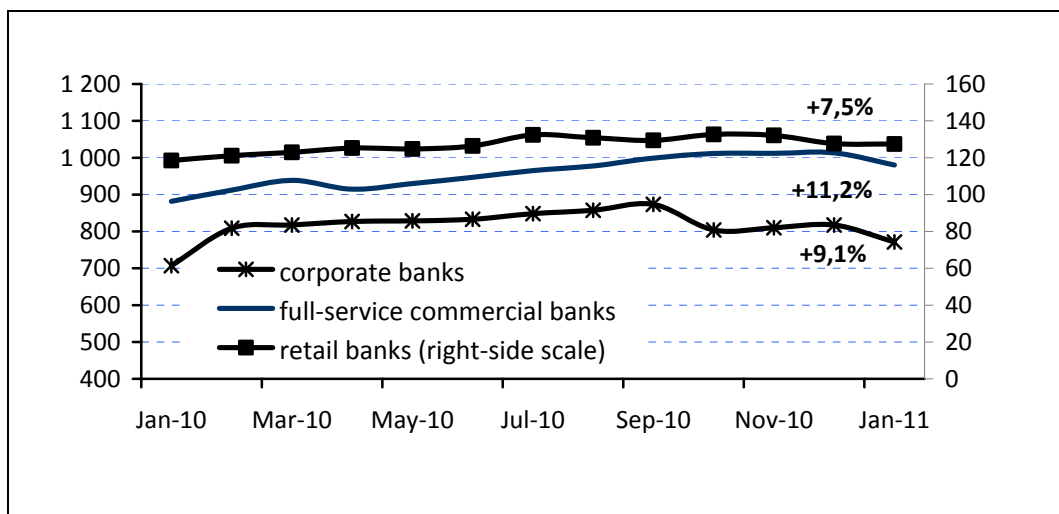
Fig. 62. Corporate and retail loans granted by the 500 largest Russian banks, by banking specialization, bln RUB

Dynamics of overdue accounts were heterogeneous as indicator of the quality of credit portfolio in terms of banking specialization in 2010. The quality of portfolio of loans to non-financial institutions improved visibly in the group of corporate banks in 2010, as evidenced by a smaller share, a decrease from 5.8 to 4.5%, of overdue accounts in the corporate credit portfolio as of January 1, 2011.

A share of overdue loans in the corporate portfolio of full-service commercial banks remained the same: 6.1% as of 2010 year-end against 6.2% as of the beginning of the previous year. The group of full-service commercial banks showed no improvement in the quality of credit portfolio servicing in the field of retail lending: a share of overdue accounts also increased from 5.3 to 5.5%.

In retail banks, a share of overdue accounts decreased from 10 to 9.2% in 2010, thus maintaining the highest level in the banking system.

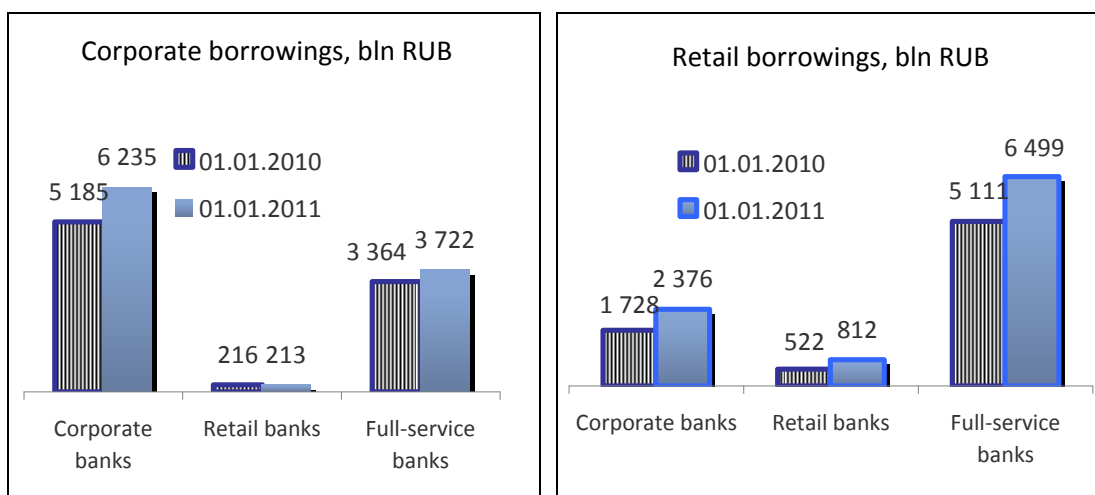
The structure of residues of provisions for impairment losses on loans corresponded to a large extent to the foregoing data on a share of overdue accounts in the credit portfolio of the groups of banks. For example, the group of full-service commercial banks showed the highest growth, 11.2%, in such provisions in 2010. It should be noted that the December decrease, nearly RUB 20 bln, in the provisions of Sberbank – one of the principal players in the group of full-service commercial banks – slightly improved the final dynamics of provisions in this group. The group of corporate banks showed a 9.1% growth in provisions in 2010, while retail banks, which had the highest provisions-to-overdue-accounts ratio, increased residues of provisions by 7.5%, thereby showing the lowest result in terms of banking specialization among the groups of banks (*Fig. 63*).



Data Source: the Central Bank of Russia, official financial statements published by banks (f-101).

Fig. 63. Dynamics of provisions for impairment losses on loans at the 500 largest Russian banks, by banking specialization, bln RUB

Full-service commercial banks were found to be leading borrowers in terms of growth in deposits in 2010, mostly through a steady growth of deposits at Sberbank of Russia OJSC. It is the replenishment of the deposits which were opened at high recession-driven interest rates for a period of more than one year that became the key growth factor in retail borrowings. In 2010, volumes of deposits at full-service commercial banks totaled RUB 1,388 bln (+ 27% against 2009). Corporate banks increased their corporate borrowings portfolio by 20% (+ RUB 1,050 bln). The largest banks, namely VTB Bank and Gazprombank, were responsible for “the lion’s share of” growth, and growth in assets on current corporate accounts had an average effect of nearly 40% on total growth in borrowings from non-financial institutions accounted (Fig. 64) in 2010.



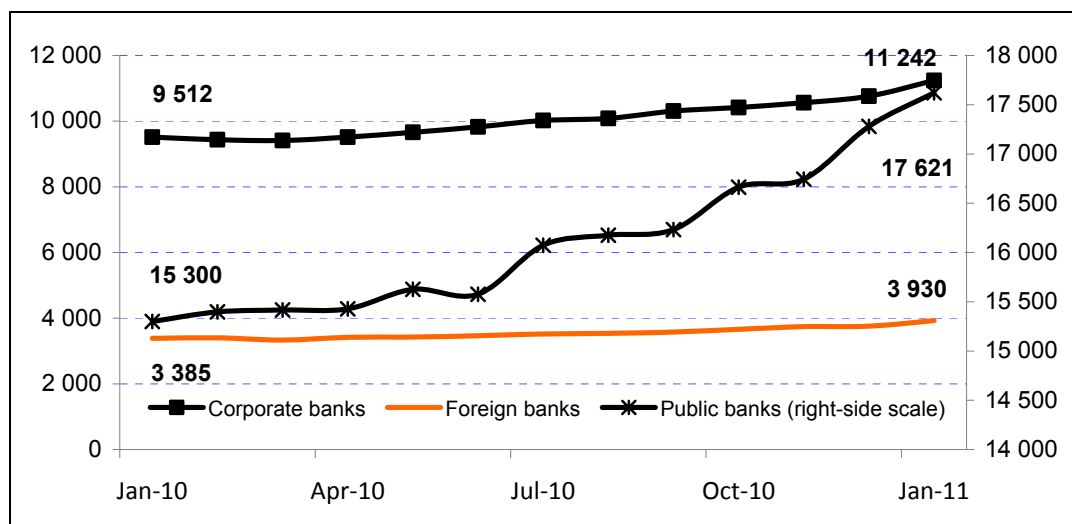
Data Source: the Central Bank of Russia, official financial statements published by banks (f-101).

Fig. 64. Corporate and retail borrowings by the 500 the largest Russian banks, by banking specialization, bln RUB

A combination of a much less intensive growth in costs incurred on creation of the provisions and a steady growth in volumes of loans in the corporate and retail banking sectors increased considerably financial performance of the banks in 2010. As of 2010 year-end, the group of full-service commercial banks, which earned a total of RUB 299 bln, was ranked number one in terms of accumulated profit. Corporate banks, which managed to earn a total of RUB 207 bln in 2010, were ranked number two in terms of annual financial performance. The group of retail banks earned a total of RUB 53 bln in the preceding year.

By type of ownership

The maximum interest which the owner holds in the charter capital or equity of a bank as of July 1, 2010 was used as the factor for recognizing the bank as pertaining to a certain type of ownership (private, public or foreign). We aggregated the data on the banks on the basis of the information specified in forms 101 and 102 of mandatory reports posted on the website of the Central Bank of Russia.



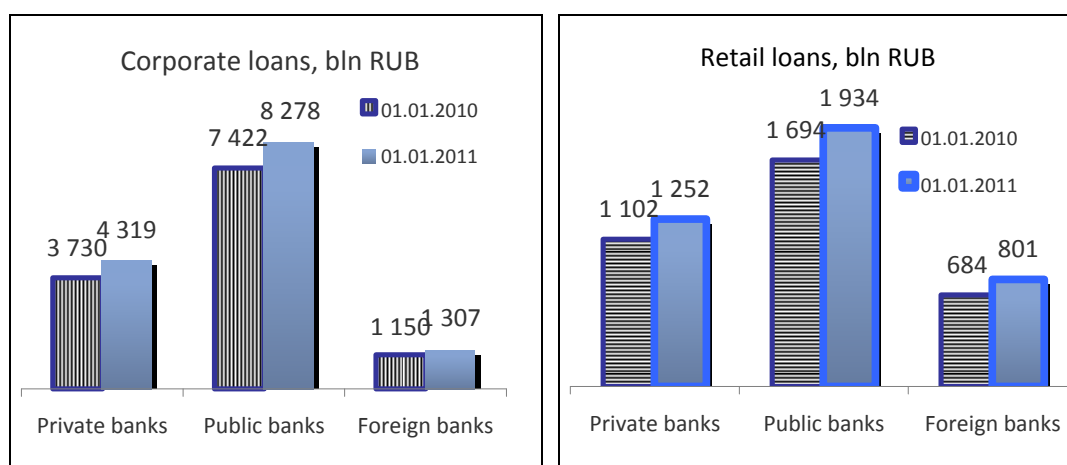
Data Source: the Central Bank of Russia, official financial statements published by banks (f-101).

Fig. 65. Assets of the 500 largest Russian banks, by type of owner, bln RUB

The following ratio by type of ownership was observed within the 500 largest Russian banks by January 1, 2011 (in terms of asset size): banks in which the state holds an interest (including Sberbank of Russia OJSC) accounted for 53.7% (against 54.3% in the preceding year), foreign banks for 12% (the same as of January 1, 2010), and private banks for 34.3% (against 33.7% in the preceding year). The foregoing statistics show that private banks were more active than public and foreign banks in 2010. However, state-held capital kept prevailing over private and foreign banks across the entire system, mostly because of Sberbank, VTB Bank, Gazprombank. Dynamics of assets at the 500 largest Russian banks in 2010 by type of ownership is shown in Fig. 65. As of 2010 year-end, private banks increased their assets most rapidly, with an annual growth rate of 18%. In 2010, Alfa Bank, the largest Russian private bank increased its assets by RUB 226 bln or 34%; TransCreditBank reported a 53% growth in its assets by a total of RUB 134 bln, the assets of NOMOS-BANK increased by RUB 92 bln.

Foreign banks were ranked number two in terms of intensive growth in assets (by 16%) in 2010, which was 1 p.p. above the overall growth in the assets across the entire banking system of the Russian Federation. UniCredit Bank (a 31% growth in assets, + 164 bln RUB), Citibank (+ 30%, + 59 bln RUB), ING Bank (Eurasia) (+ 42%, + 37 bln RUB), Nordea Bank (+ 22%, + 35 bln RUB) contributed most to the growth in the assets at foreign banks in Russia in 2010. A 21% growth in the assets of Sberbank (RUB 1,617 bln), 28% at VTB24, and 5% at VTB Bank should be highlighted among the backbone banks in which the state holds an interest.

Competition between banks for reliable corporate got stronger in the year that followed the post-recession year. It was the interest rates that became the key argument in this struggle. Specific features of the Russian banking system, which include high concentration of inexpensive resources at public banks, effected the growth structure in the field of corporate lending in 2010. Public banks kept leading in terms of growth in corporate loans in 2010: a growth of RUB 856 bln against RUB 589 bln at private banks and a mere RUB 157 bln at foreign banks. It is noteworthy that private Russian banks remained to be leaders in terms of growth rates of corporate loans through increase in the number of sales of credit products in the SME segment. In turn, foreign banks were most active in retail lending. According to the official reports published by banks, the portfolio of loans which private Russian banks granted to non-financial institutions in 2010 increased by 16% to reach RUB 4,319 bln. Banks in which foreign companies hold an interest, increased their retail credit portfolio by 17%, from RUB 684 bln to RUB 801 bln (Fig. 66).



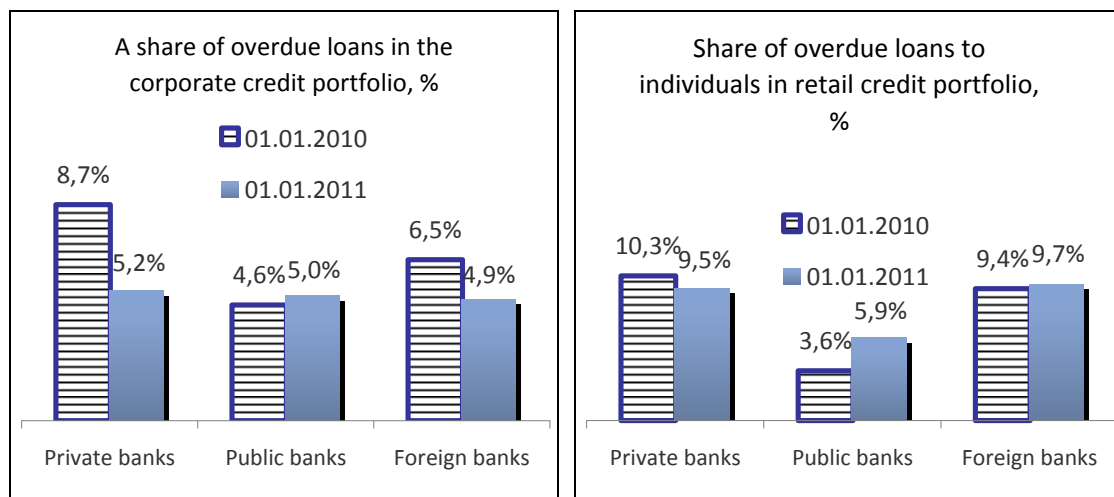
Data Source: the Central Bank of Russia, official financial statements published by banks (f-101).

Fig. 66. Corporate and retail credit portfolios at the 500 the largest Russian banks, by type of owner, bln RUB

The interbank loans market became one of the top-priority investment goals among foreign banks in 2010. For example, in the group of foreign banks, 37% of the biggest growth in the assets at UniCredit Bank was gained through transactions related to lending to financial institutions. In the same year, WestLB Vostok Bank's portfolio of loans to other banks increased by RUB 30,5 bln, while Citibank added RUB 10 bln to its interbank credit portfolio.

In 2010, private Russian banks were found to be most effective in terms of improved quality of credit portfolio. A share of overdue accounts reduced in both corporate and retail credit

portfolios of private banks in the same year. The most relevant quantum jump was reported in the corporate portfolio of the banks in this group. A share of overdue accounts in this group decreased from the historical maximum reported late in 2009, from 8.7 to 5.2%. We are reminded that it was the private banks that happened to face most of the issue of large-scale, negative revaluation of companies' loan collaterals and had to launch a large-scale loan restructuring campaign. Even now private banks maintain the maximum level of provisions to cover overdue accounts in the banking system of Russia. For reference, the value of the foregoing coverage ratio for private banks as of January 1, 2011 was 195%, whereas for public banks it was equal to 169%, and a 167% for foreign banks. A share of overdue loans in the retail portfolio at private banks decreased by 0.8 p.p in 2010. As of 2010 year-end, foreign banks reduced a share of overdue accounts in the corporate portfolio by 1.6 p.p. At the two largest foreign banks specializing in corporate lending – UniCredit Bank and Raiffeisen Bank – a share of overdue accounts decreased from 5 to 3% and from 7.5 to 5.5%, respectively. On the other hand, public banks reported growth in a share of overdue accounts in both corporate and retail portfolios in 2010. Sberbank and VTB, the two largest state-owned banks, had a substantial share overdue loans in the loans to non-financial institutions. In year-end, a share of overdue accounts was 5.8 and 7.8%, respectively (*Fig. 67*).



Data Source: the Central Bank of Russia, official financial statements published by banks (f-101).

Fig. 67. A share of overdue accounts in the corporate and retail credit portfolios at the 500 largest Russian banks, by type of owner, %

In general, dynamics and intensity of growth in provisions for impairment losses on loans corresponded to a trend towards changes in a share of overdue accounts. Year-end provisions increased much faster in the group of public banks, by 17%, against 4.3% in the group of foreign banks, and a mere 2.4% in the group of private banks. It should be noted, that in December 2010 the provisions at Sberbank of Russia decreased considerably by nearly RUB 20 bln in, which slightly improved annual dynamics of provisions in the public banking sector.

Following is a breakdown of the groups of banks by type of ownership as of 2010 year-end: public banks accounted for 63% (RUB 353 bln, of which RUB 225 bln was earned by Sberbank) of the total profit of the 500 largest banks, private Russian banks accounted for 20% and foreign banks for 17% of the total profit.

Hence the following basic trends emerged in terms of type of ownership in 2010:

- 1) *public banks* were least aggressive in increasing their credit portfolios while kept accounting for the biggest share of overdue accounts in the banking system. Most of the profit accumulated in the banking sector was concentrated in this sector owing to large volumes and relatively inexpensive liabilities in this sector ;
- 2) *private banks* intensively developed corporate lending and managed to improve considerably the quality of assets as of 2010 year-end. High level of allocation of loans in this group could allow additional profit to be generated from decrease in provisions under ongoing trend towards improvement of borrowers' solvency ;
- 3) *foreign banks* still accounted for a smaller share in terms of assets. Return of foreign capital to the Russian Federation under a favorable macroeconomic scenario in 2011–2012 could encourage inflow of inexpensive liabilities from parent companies located abroad and, as a consequence, further increase in foreign banks' market share. The level of overdue accounts under retail loans in this group remained beyond the market average. The end of excessive liquidity period in the banking system could provide extra benefits to foreign banks actively crediting in interbank loan market. The created provisions for impairment losses on loans are unlikely to undergo an additional, substantial reduction at foreign banks, because the provision coverage ratio was the lowest in this group of banks against public and private banks.

3.10. The Market of Municipal and Sub-Federal Borrowings

3.10.1. The dynamics of market development

In 2010, the consolidated regional budget and budgets of territorial public extra-budgetary funds had a deficit in the amount of RUR 99.3 billion (0.22% of the GDP). As compared to the year 2009, the amount of the deficit of the consolidated regional budget decreased by 75% of the GDP. In 2009, the deficit of those budgets amounted to RUR 329.3 billion (0.84% of the GDP).

In 2010, constituent entities of the Russian Federation had a budget deficit of RUR 88.1 billion, while urban districts, a budget deficit of RUR 15.1 billion, intracity municipal entities of Moscow and St. Petersburg, a budget deficit of RUR 0.1 billion and municipal districts, a budget deficit of RUR 1.2 billion; at the same time the budgets of urban and rural settlements were drawn with a surplus of RUR 4.5 billion.

Table 10

The ratio of surplus (deficit) of territorial budgets to budget expenditures (%)

Year	Consolidated regional budget*	Regional budgets
2010	-1.4	-1.6
2009	-5.3	-5.3
2008	-0.7	-0.7
2007	0.8	0.6
2006	3.7	4.4
2005	1.6	2.3
2004	1.1	1.6
2003	-2.6	-2.3
2002	-2.7	-3.0

* with public extra-budgetary funds taken into account.

The source: calculated on the basis of the data of the Ministry of Finance of the Russian Federation.

In 2009, constituent entities of the Russian Federation had a budget deficit of RUR 276.9 billion, while urban districts, a budget deficit of RUR 39.7 billion, intracity municipal entities of Moscow and St. Petersburg, a budget deficit of RUR 0.07 billion and municipal districts, a budget deficit of RUR 18.9 billion; at the same time the budgets of urban and rural settlements were drawn with a surplus of RUR 6.2 billion.

Table 11

**The ratio of surplus (deficit) of territorial budgets to budget expenditures
in the 2007–2010 period (%)**

Year	Budgets of intracity municipal entities of Moscow and St. Petersburg	Budgets of urban dis- tricts	Budgets of municipal districts	Budgets of urban and rural settlements
2010	-1.12	-1.16	-0.11	1.72
2009	-0.63	-3.32	-1.88	2.63
2008	-1.47	1.09	-0.26	2.72
2007	5.34	1.23	-0.04	2.34

The source: calculated on the basis of the data of the Ministry of Finance of the Russian Federation

As of January 1, 2011, sixty-three constituent entities of the Russian Federation (against 61 regions in 2009) had a deficit of the consolidated budget (including that of territorial public extra-budgetary funds). The aggregate deficit volume amounted to RUR 202.5 billion or 5.2% of the revenue side of the budgets of those constituent entities (in 2009 it amounted to RUR 377.9 billion or 7.8%).

The median level of the budget deficit amounted to 3.9% of the revenues of the respective budget. The highest ratio of the budget deficit to the revenue side of the budget was registered in the Chukotsky Autonomous Region (25.3%), the Republic of Mordovia (23.3%), the Sakhalin Region (16.1%), the Republic of Udmurtia (14.7%), the Novgorod Region (14.6%) and the Vologda Region (14.2%). (*Table 14*).

In 2010, in twenty constituent entities of the Russian Federation (as against twenty-two ones in 2009) there was a surplus budget. The aggregate surplus volume in the above regions amounted to RUR 128.9 billion or 3.5% of the value of the revenue side of the budgets of those constituent entities (in 2009 it amounted to RUR 4.6 billion or 3.9% of the revenue side of the budgets of those constituent entities). The median value of the budget surplus amounted to 3.7% of the revenue side of the budget.

The highest ratio of the surplus to the level of revenues of the consolidated budget was registered in the Yamal Nenetsk Autonomous Region (10.2%), the Irkutsk Region (6.4%) and the Moscow Region (5.8%). Over a half (51.1%) of the aggregate surplus of the consolidated regional balance was ensured by the following three constituent entities of the Russian Federation: Moscow (20.7% or RUR 21.4 billion), the Moscow Region (19.5% or RUR 20.2 billion) and the Yamal Nenetsk Autonomous Region (10.2% or RUR 11.2 billion).

3.10.2. Changes in the Structure of the Accumulated Debt

In 2010, the value of the accumulated debt of the consolidated regional budget as regards borrowings increased by RUR 225 664.0 million or 0.51% of the GDP (*Table 12*). The external debt of regional consolidated budgets decreased by RUR 1.6 million, while the domestic one rose by RUR 225 665.6 million.

Table 12

Net borrowings of regional and local budgets (% of the GDP)

Year	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Borrowings of sub-federal authorities and local authorities, including :	0.33	0.15	-0.29	-0.04	0.47	0.37	0.26	0.09	0.21	0.17	0.29	0.74	0.51
reimbursable loans from budgets of other levels	-0.09	-0.11	-0.03	0.04	0.12	-0.1	-0.02	-0.03	-0.04	-0.01	0.03	0.33	0.37
Sub-federal (municipal) bonds	-0.01	-0.05	-0.27	-0.07	0.16	0.31	0.29	0.09	0.14	0.08	0.17	0.24	0.07
Other borrowings	0.43	0.31	0.01	-0.02	0.19	0.6	...	0.03	0.11	0.10	0.09	0.17	0.07

The source: calculated on the basis of the data of the Ministry of Finance of the Russian Federation.

The structure of borrowings

In 2010, the total volume of borrowings of the regional consolidated budget amounted to RUR 708 700.1 million, including RUR 782.2 million of the external debt. As in 2009, the Republic of Baskortostan was the only region which took external loans.

The aggregate volume of domestic borrowings of regions and municipal governments amounted to RUR 707 917.9 million. On the domestic market, the largest borrowers (which accounted for 49.0% of all the borrowings) were the Moscow Region (RUR 121.9 billion), Moscow (RUR 88.2 billion), the Nizhny Novgorod Region (RUR 46.9 billion), the Omsk Region (RUR 34.4 billion), the Republic of Tatarstan (RUR 29.2 billion) and the Saratov Region (RUR 26.8 billion). As compared to 2009, the volume of the domestic borrowings in nominal terms increased by RUR 74 250.6 million, that is, a 2.6% increase in real terms.

In the total volume of the domestic borrowings of the consolidated regional budget, issue of securities accounted for 15.7%, while loans from budgets of a higher level, for 24.0% and other borrowings (loans from commercial banks and international credit institutions), for 60.3%.

Relative growth in borrowings from credit institutions with a drop in the share of securities issue from 28.5% in 2009 to 18.1% was the most significant change in the structure of borrowings of regional budgets. (Table 13).

Table 13

Structure of domestic borrowings of sub-national budgets (%)

	2010			2009			2008		
	Regional consolidated budget	Regional budgets	Municipal budgets	Regional consolidated budget	Regional budgets	Municipal budgets	Regional consolidated budget	Regional budgets	Municipal budgets
Issue of securities	15.7	18.1	4.3	24.9	28.5	4.4	43.7	51.9	1.9
Loans from budget	24.0	29.0	...	26.9	31.5	0.4	5.0	5.9	0.2
Other borrowings	60.3	53.0	95.7	48.2	40.0	95.3	51.4	42.6	97.8

The source: calculated on the basis of the data of the Ministry of Finance of the Russian Federation

The highest ratio of the net borrowings to the budget revenues was registered in the Republic of Mordovia (21.6%), the Vologda Region (14.3%), the Udmurt Republic (14.0%) and the Novgorod Region (13.7%) (*Table. 14*).

The largest net borrowers were Moscow (RUR 57.9 billion), the Republic of Tatarstan (RUR 20.4 billion) and Krasnodar Territory (RUR 18.3 billion).

The accumulated debt was reduced to a great extent by the Moscow Region and the Irkutsk Region, a decrease of RUR 13.1 billion and RUR 1.6 billion, respectively.

Table 14

**Execution of consolidated budgets of constituent entities
of the Russian Federation in 2010.**

	Budget revenues (thousand RUR.)	Deficit (+), Surplus (-) of the budget (thousand RUR)	Ratio of the deficit (surplus) to revenues, %	Ratio of borrowed funds to revenues, %	Ratio of net borrowings to revenues, %	Ratio of the expenses related to repayment of the debt to revenues, %	Ratio of net borrowings to the deficit (surplus) . %
1	2	3	4	5	6	7	8
The Central Federal District							
Belgorod Region	65 566 654 148.13	1 546 542 556.15	2.36	6.19	2.41	3.78	102.22
Bryansk Region	34 675 737 106.05	1 033 262 450.28	2.98	12.40	1.87	10.53	62.76
Vladimir Region	45 274 258 575.14	1 820 055 163.34	4.02	2.75	2.61	0.14	64.98
Voronezh Region	74 979 306 077.64	1 759 286 114.09	2.35	4.18	2.79	1.39	118.89
Ivanovo Region	30 860 666 218.59	1 605 217 141.91	5.20	12.77	5.50	7.27	105.74
Tver Region	48 908 692 548.20	4 174 321 256.94	8.53	16.50	4.00	12.50	46.88
Kaluga Region	40 327 003 832.70	2 065 374 109.22	5.12	16.08	10.16	5.92	198.46
Kostroma Region	21 936 949 766.21	2 280 207 919.18	10.39	29.08	10.75	18.33	103.40
Kursk Region	39 094 815 213.48	-1 553 167 024.19	-3.97	2.22	2.05	0.17	-51.58
Lipetsk Region	39 905 530 230.33	1 463 616 369.14	3.67	7.27	2.94	4.34	80.04
Moscow region	348 090 262 623.50	-20 179 038 812.07	-5.80	35.02	-3.75	38.77	64.69
Orel Region	24 048 982 091.11	316 209 227.31	1.31	4.48	2.26	2.22	171.75
Ryazan Region	39 373 544 597.75	2 140 839 564.03	5.44	43.70	7.91	35.79	145.42
Smolensk region	30 411 257 064.16	3 376 385 199.24	11.10	30.74	10.31	20.43	92.85
Tambov Region	33 781 066 358.39	1 037 262 111.07	3.07	7.19	1.95	5.24	63.46
Tula Region	51 627 916 764.12	3 412 590 136.28	6.61	24.04	5.58	18.46	84.35
Yaroslavl Region	53 606 108 974.56	4 536 257 456.89	8.46	24.21	4.93	19.29	58.22
Moscow	1 164 517 113 636.11	-21 419 664 867.72	-1.84	7.58	4.97	2.60	-270.45
Total	2 186 985 865 826.17	-10 584 443 928.91	-0.48	14.04	3.45	10.59	-712.67
The North –Western Federal District							
Republic of Karelia	33 674 528 779.01	543 518 438.17	1.61	28.82	7.78	21.04	481.90
Republic of Komi	52 336 510 862.93	-1 037 414 279.59	-1.98	9.82	-0.23	10.05	11.58
Archangelsk Region	64 667 507 726.30	328 660 682.50	0.51	17.96	6.19	11.77	1 217.94
Vologda Region	47 915 534 299.77	6 824 805 954.23	14.24	17.64	14.34	3.30	100.65
Kaliningrad Region	39 969 507 872.08	2 922 152 698.31	7.31	14.15	10.28	3.87	140.62
Leningrad Region	74 212 863 062.88	-2 135 240 069.22	-2.88	0.99	-0.26	1.24	8.95

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(continued) table 14

1	2	3	4	5	6	7	8
Murmansk Region	54 557 192 452.17	-2 395 396 611.28	-4.39	6.56	4.61	1.95	-105.04
Novgorod Region	24 348 917 509.07	3 545 736 448.03	14.56	20.97	13.70	7.27	94.06
Pskov Region	23 619 723 931.39	679 575 542.80	2.88	6.03	5.39	0.64	187.19
St. Petersburg	363 179 989 863.93	11 915 661 459.80	3.28	1.36	1.36	0.00	41.42
Nenetsk Autonomous Region	11 747 109 329.99	-310 862 790.00	-2.65	0.32	0.05	0.27	-1.93
Total	790 229 385 689.52	20 881 197 473.75	2.64	7.14	3.71	3.42	140.58
The Southern Federal District							
Republic of Kalmykia	9 684 290 135.96	138 973 374.04	1.44	14.54	-0.03	14.56	-1.82
Krasnodar Territory	176 330 759 388.06	13 748 019 998.95	7.80	12.03	10.38	1.65	133.13
Astrakhan Region	28 985 998 680.31	3 703 941 135.57	12.78	49.46	11.30	38.16	88.40
Volgograd Region	79 270 869 463.83	2 492 564 272.18	3.14	14.91	4.02	10.89	127.85
Rostov Region	129 111 754 297.58	2 377 148 088.81	1.84	2.45	2.44	0.00	132.78
Republic of Adygeia (Adygeia)	13 102 722 476.38	504 924 626.70	3.85	2.88	2.86	0.02	74.32
Total	436 486 394 442.12	22 965 571 496.25	5.26	11.98	6.48	5.50	123.19
The Privolzhsky Federal District							
Republic of Bashkortostan	125 675 303 475.47	2 767 545 399.40	2.20	5.53	3.27	2.26	148.46
Republic of Marii El	20 266 454 970.46	1 511 194 115.17	7.46	16.56	7.86	8.69	105.43
Republic of Moravia	32 112 996 393.40	7 467 395 991.26	23.25	23.71	21.57	2.14	92.75
Republic of Tatarstan (Tatarstan)	182 085 911 826.03	17 670 329 704.75	9.70	16.01	11.20	4.81	115.41
Udmurt Republic	45 912 486 846.57	6 754 296 824.87	14.71	21.29	13.98	7.32	95.00
Chuvash Republic	35 634 072 325.55	1 836 695 595.32	5.15	11.20	5.86	5.34	113.68
Nizhny Novgorod Region	115 736 572 781.59	9 042 084 105.90	7.81	40.55	7.39	33.16	94.62
Kirov Region	49 090 707 884.99	1 332 558 447.56	2.71	11.08	3.97	7.10	146.36
Samara Region	124 326 175 253.97	1 501 396 819.58	1.21	9.25	1.01	8.24	83.97
Orenburg Region	71 250 615 599.60	4 561 554 168.59	6.40	4.56	4.18	0.38	65.28
Penza Region	43 682 105 936.00	1 226 855 395.77	2.81	14.99	3.01	11.98	107.08
Perm Territory	100 268 098 762.62	8 545 033 942.99	8.52	0.58	0.55	0.03	6.45
Saratov Region	70 672 143 825.41	9 259 372 151.96	13.10	37.90	11.88	26.02	90.70
Ulyanov Region	38 962 252 704.98	1 860 434 091.99	4.77	4.73	2.71	2.02	56.84
Total	1 055 675 898 586.64	75 336 746 755.11	7.14	15.51	6.40	9.11	89.72
The Ural Federal District							
Kurgansk Region	31 975 214 990.55	102 275 378.75	0.32	2.01	1.89	0.11	592.10
Sverdlovsk Region	168 552 373 386.37	-5 377 091 247.79	-3.19	1.62	1.25	0.37	-39.32
Tyumen Region	147 543 784 720.04	-3 213 481 225.89	-2.18	0.22	0.21	0.00	-9.81
Chelyabinsk Region	114 998 659 299.37	876 537 772.63	0.76	1.29	0.58	0.71	76.14
Khanty_Mansiisk Autonomous Region	173 618 321 659.92	2 576 613 009.12	1.48	0.73	0.28	0.44	18.94
Yamal Nenetsk Autonomous Region	109 988 721 688.39	-11 220 191 039.30	-10.20	0.00	-0.14	0.14	1.34
Total	746 677 075 744.64	-16 255 337 352.48	-2.18	0.86	0.54	0.32	-24.86
The Siberian Federal District							
Republic of Buryatia	41 144 616 734.40	1 621 596 081.37	3.94	16.16	10.40	5.76	263.79
Republic of Tuva	15 827 539 562.24	237 880 541.73	1.50	1.52	1.24	0.28	82.36

(continued) table 14

1	2	3	4	5	6	7	8
Altai Territory	77 362 709 183.82	-4 989 059 841.31	-6.45	1.20	-0.02	1.23	0.36
Krasnoyarsk Territory	184 697 369 470.07	-9 787 388 123.69	-5.30	4.39	-1.22	5.61	23.05
Irkutsk Region	104 706 951 762.25	-6 721 990 150.30	-6.42	2.54	-1.54	4.08	24.00
Kemerovo Region	119 151 656 505.64	3 823 279 098.20	3.21	4.91	2.22	2.69	69.15
Novosibirsk Region	105 691 604 894.93	2 142 346 572.03	2.03	15.90	1.92	13.98	94.66
Omsk Region	62 307 401 477.62	1 076 680 871.75	1.73	55.15	0.58	54.57	33.46
Tomsk Region	45 008 301 064.94	-308 298 635.17	-0.68	10.26	0.51	9.76	-74.16
Republic of Altai	13 858 853 947.65	1 432 374 113.70	10.34	5.27	1.35	3.92	13.04
Republic of Khakasia	20 049 671 053.75	641 221 121.41	3.20	13.85	6.41	7.45	200.30
Zabaikalye Territory	47 579 572 337.54	252 736 415.57	0.53	5.92	2.98	2.94	561.34
Total	837 386 247 994.85	-10 578 621 934.71	-1.26	10.34	1.04	9.29	-82.59
The Far Eastern Federal District							
Republic of Saha (Yakutia)	108 254 934 041.65	-3 751 876 391.60	-3.47	3.43	1.26	2.16	-36.42
Primorsk Territory	100 039 138 492.55	8 968 112 885.81	8.96	2.34	0.97	1.36	10.85
Khabarovsk Territory	79 326 103 684.95	-3 682 681 101.75	-4.64	0.56	-1.14	1.69	24.51
Amur Region	47 627 008 616.44	364 355 768.00	0.77	10.34	6.07	4.27	793.22
Kamchatka Territory	45 808 643 868.40	-1 963 432 773.58	-4.29	2.81	-0.20	3.01	4.70
Magadan Region	21 743 356 709.77	-1 067 188 564.91	-4.91	5.69	0.00	5.69	0.07
Sakhalin Region	56 692 992 485.91	9 114 315 769.08	16.08	5.90	0.96	4.94	5.96
Jewish Autonomous Region	9 846 763 310.10	-289 985 272.01	-2.94	0.31	0.29	0.02	-9.76
Chukotka Autonomous Region	13 799 337 565.98	3 488 925 629.59	25.28	0.00	-0.21	0.21	-0.82
Total	483 138 278 775.75	11 180 545 948.63	2.31	3.58	0.99	2.59	42.73
The North Caucasian Federal District							
Republic of Dagestan	67 238 418 632.32	2 055 680 189.90	3.06	4.80	4.80	0.00	157.08
Republic of Kabardino-Balkaria	23 603 459 127.10	713 400 782.83	3.02	5.67	2.53	3.14	83.70
Republic of North Ossetia -- Alania	18 608 730 067.87	2 006 212 975.77	10.78	20.15	7.09	13.07	65.73
Ingush Republic	16 587 911 010.22	1 499 708 988.07	9.04	0.00	0.00	0.00	0.00
Stavropol Territory	78 554 605 557.52	1 860 369 936.76	2.37	10.43	0.25	10.69	10.71
Republic of Karachaevo-Cherkessia	14 232 629 140.00	1 043 593 237.15	7.33	7.86	7.86	0.00	107.14
Chechen Republic	67 184 090 766.74	844 632 637.50	1.26	2.05	2.05	0.00	162.91
Total	286 009 844 301.77	6 302 858 874.46	2.20	6.65	2.60	4.05	118.04
Total	6 822 588 991 361.46	99 248 517 332.10	1.45	10.39	3.31	7.08	227.37
Russian Federation							

The Source: calculated on the basis of the data of the Ministry of Finance of the Russian Federation.

The Domestic Bond Loans

In 2010, prospectuses for bond issue by 17 constituent entities of the Federation and six municipal entities were registered while in 2009 only 10 regions and 5 municipal entities issued bonds).

In 2010, registered with the Ministry of Finance of the Russian Federation were prospectuses of following constituent entities: the Republic of Karelia, the Republic of Khakassia, the

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Republic of Komi, the Republic of Sakha (Yakutia), the Udmurt Republic, Krasnoyarsk Territory, Krasnodarsk Territory, Moscow, St. Petersburg, the Volgograd Region, the Nizhny Novgorod Region, the Murmansk Region, the Ryazan Region, the Sverdlovsk Region, the Tver Region, the Tomsk Region, the Yaroslavl Region, the Volgograd Region, Kazan, Tomsk, Novosibirsk, Ufa and Krasnodar.

In 2010, the total volume of the bonds placed amounted to RUR 111.1 billion as compared to RUR 158.1 billion in 2009 (that is, a reduction of RUR 47.0 billion in nominal terms or by 30.7% in real terms). Within a year, the volumes of issue of sub-federal bonds and municipal bonds fell from 0.41% to 0.25% of the GDP (*Table. 15*).

Table 15

The volume of issue of sub-federal and municipal securities (% of the GDP)

Year	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Issue	0.63	0.77	0.47	0.31	0.19	0.17	0.27	0.46	0.47	0.37	0.28	0.26	0.43	0.41	0.25
Redemption	0.47	0.56	0.48	0.36	0.46	0.23	0.10	0.15	0.19	0.28	0.14	0.18	0.26	0.16	0.18
Net financing	0.16	0.22	-0.01	-0.05	-0.27	-0.07	0.16	0.31	0.29	0.09	0.14	0.08	0.17	0.24	0.07

The source: calculated on the data of the Ministry of Finance of the Russian Federation.

The largest securities issues were carried out by Moscow (RUR 71.8 billion or 64.6% of the volume of the aggregate issue of territories), Krasnodar Territory (RUR 5.1 billion or 4.6%), the Nizhny Novgorod Region (RUR 5.0 billion or 4.5%), the Yaroslavl Region and St. Petersburg (RUR 3.0 billion, each or 2.7%) and the Volgograd Region (RUR 2.6 billion or 2.3%).

Thus, the six largest issuers accounted for 80.4% of the total volume of issues of regional and municipal bonds offering. (*Table. 16*).

Table 16

Placement of sub-federal and municipal securities in 2010.

Constituent entity of the Federation	Volume of issue (thousand RUR)	Share of the issuer in the total volume of the issue (%)	Ratio of the volume of issue to domestic borrowings (%)
1	2	3	4
The Central Federal District			
Belgorod Region	221 000 000.0	0.2	5.4
Tver Region	3 000 000 000.0	2.7	37.2
Kaluga Region	956 000 000.0	0.9	14.7
Kostroma Region	927 375 310.7	0.8	14.5
Moscow Region	8 482 620.6	...	...
Ryazan Region	2 100 000 000.0	1.9	12.2
Yaroslavl Region	3 044 952 985.7	2.7	23.5
Moscow	71 798 101 881.7	64.6	81.4
The North-Western Federal District			
Republic of Karelia	2 000 000 000.0	1.8	20.6
Republic of Komi	2 077 950 000.0	1.9	40.4
St. Petersburg	3 000 000 000.0	2.7	60.6
The Southern Federal District			
Republic of Kalmykia	14 109 000.0	0.0	1.0
Krasnodar Territory	5 100 000 000.0	4.6	24.0
Volgograd Territory	2 599 886 000.0	2.3	22.0

(continued) table 16

1	2	3	4
The Privolzhsky Federal District			
Republic of Bashkortostan	749 857 500.0	0.7	12.2
Republic of Tatarstan (Tatarstan)	2 000 000 000.0	1.8	6.9
Udmurt Republic	2 000 000 000.0	1.8	20.5
Nizhny Novgorod District	5 000 000 000.0	4.5	10.7
The Siberian Federal District			
Tomsk Region	1 308 603 000.00	1.2	28.3
Republic of Khakasia	1 200 000 000.00	1.1	43.2
Tomsk Region	1 308 603 000.00	1.2	28.3
The Far Eastern Federal District			
Tomsk Region	1 308 603 000.00	1.2	28.3
Republic of Khakasia	1 200 000 000.00	1.1	43.2
Tomsk Region	1 308 603 000.00	1.2	28.3
Russian Federation – total:	158 114 034.3	100	25.0

The source: the IET calculations on the basis of the data of the Ministry of Finance of the Russian Federation.

By now, the highest level of securitization was registered primarily with the largest issuers: Moscow (89.9%), the Khanty-Mansiisk Autonomous Region (75.0%) and Krasnoyarsk Territory (67.6%).

In 2010, the aggregate volume of net borrowings on the regional securities market amounted to RUR 29.8 billion, that is, a reduction of RUR 68.1 billion or by 72.2% in real terms as compared to 2009. At the same time, the volume of the redeemed municipal bonds exceeded by RUR 2.5 billion that of the newly issued bonds (*Table. 17*).

Table 17

The volumes of net borrowings on the market of domestic sub-federal and municipal securities (thousand RUR)

	Consolidated regional budget	Regional budgets	Municipal budgets
1	2	3	4
2010			
Net borrowings	29 774 599.3	28 611 970.0	1 162 629.3
Borrowed funds	111 106 318.3	105 854 346.2	5 251 972.1
Repayment of the principal debt amount	81 331 719.0	77 242 376.2	-4 089 342.8
2009			
Net borrowings	95 457 576.8	97 916 509.1	-2 458 932.3
Borrowed funds	158 114 034.3	153 992 570.1	4 121 464.2
Repayment of the principal debt amount	62 656 457.5	56 076 061.0	6 580 396.5
2008			
Net borrowings	68 851 271.9	72 984 947.8	-4 133 675.9
Borrowed funds	178 565 731.4	177 324 359.3	1 241 372.1
Repayment of the principal debt amount	109 714 459.5	104 339 411.5	5 375 048.0
2007			
Net borrowings	25 867 011	23 691 970	2 175 041
Borrowed funds	84 159 197	79 889 761	4 269 436
Repayment of the principal debt amount	58 292 185	56 197 791	2 094 394
2006			
Net borrowings	36 489 742	35 161 627	1 328 115
Borrowed funds	73 288 653	66 524 832	6 763 820

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(continued) table 17

1	2	3	4
Repayment of the principal debt amount	36 798 911	31 363 205	5 435 706
2005			
Net borrowings	20 887 596	16 939 894	3 947 703
Borrowed funds	81 220 540	75 016 756	6 203 783
Repayment of the principal debt amount	60 332 944	58 076 863	2 256 081
2004			
Net borrowings	47 880 300	44 470 128	3 410 172
Borrowed funds	79 436 708	74 995 965	4 440 743
Repayment of the principal debt amount	31 556 408	30 525 837	1 030 571
2003			
Net borrowings	41 908 199	40 043 511	1 864 688
Borrowed funds	61 712 635	59 012 901	2 699 734
Repayment of the principal debt amount	19 804 436	18 969 390	835 046
2002			
Net borrowings	17 696 530	17 153 760	542 770
Borrowed funds	29 141 777	28 169 158	972 619
Repayment of the principal debt amount	11 445 247	11 015 398	429 849
2001			
Net borrowings	6 601 447	6 667 592	-66 145
Borrowed funds	15 123 785	14 226 931	896 854
Repayment of the principal debt amount	8 522 338	7 559 339	962 999
2000			
Net borrowings	-1 877 328	-2 286 175	408 847
Borrowed funds	13 042 220	10 090 208	2 952 012
Repayment of the principal debt amount	14 919 548	12 376 383	2 543 165

The source: calculated on the basis of the data of the Ministry of Finance of the Russian Federation.

Most regions which issued debt securities on a regular basis kept issuing them in 2010, as well. The Volgograd Region has been issuing bonds each year since 1999, while Krasnoyarsk Territory, since 2003 and the Republic of Karelia and the Nizhny Novgorod Region, since 2004. (Table 18).

Table 18

Registration of prospectuses for issuing of sub-federal and municipal securities in the 1999–2010 period

Issuer	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
1	2	3	4	5	6	7	8	9	10	11	12	13
Constituent entities of the Federation												
Volgograd Region	*	*	*	*	*	*	*	*	*	*	*	*
Krasnoyarsk Territory					*	*	*	*	*	*	*	*
Republic of Karelia						*	*	*	*	*	*	*
Nizhni Novgorod Region						*	*	*	*	*	*	*
Tver Region				*	*		*	*	*	*	*	*
Moscow	*	*	*	*	*	*	*	*	*	*	*	*
St. Petersburg	*	*	*	*	*	*	*	*	*	*	*	*
Tomsk Region		*	*	*	*	*	*	*	*	*	*	*
Republic of Saha (Yakutia)				*	*	*	*	*	*	*	*	*
Yaroslavl Region					*	*	*	*	*	*	*	*
Udmurt Republic							*		*	*	*	*
Republic of Komi		*	*	*	*	*	*	*		*	*	*
Krasnodar Territory						*			*			*

Section 3.
Financial Markets and Financial Institutes

(continued) table 18

1	2	3	4	5	6	7	8	9	10	11	12	13
Murmansk Region				*	*							*
Ryazan Region												*
Sverdlovsk Region												*
Republic of Khakassia												*
Chuvash Republic	*	*	*	*	*	*	*	*	*	*	*	
Irkutsk Region			*	*	*	*	*	*	*	*	*	
Samara Region					*		*	*	*	*	*	
Khanty-Mansiisk Autonomous Region				*	*						*	
Moscow Region				*	*	*	*	*	*	*		
Lipetsk Region						*	*	*	*	*		
Kaluga Region						*		*	*	*		
Penza region								*	*	*		
Ulyanov Region									*	*		
Belgorod Region				*	*		*	*		*		
Kurgan Region								*		*		
Stavropol Region			*							*		
Republic of Bashkortostan			*	*		*	*	*	*			
Voronezh Region						*	*	*	*			
Novosibirsk Region	*				*	*	*		*			
Kostroma Region				*	*		*		*			
Ivanovo Region									*			
Republic of Kalmykia									*			
Tula Region								*				
Khabarovsk Territory				*	*	*	*					
Republic of Kabardino-Balkaria		*					*					
Leningrad Region			*	*	*	*						
Yamalo-Nenetsk Autonomous Region					*	*						
Bryansk Region						*						
Republic of Mordovia				*								
Sakhalin Region				*								
Kursk Region				*								
Primorsk Territory		*										
Municipal entities												
Volgograd	*	*	*	*	*		*	*		*	*	*
Kazan							*	*	*		*	*
Tomsk					*	*		*	*	*		*
Novosibirsk					*	*	*	*				*
Ufa				*	*	*						*
Krasnodar					*	*	*		*	*	*	
Krasnoyarsk					*	*	*		*	*	*	
City of Elektrostal, Moscow region									*		*	
Smolensk											*	
Lipetsk								*	*	*		
Magadan								*	*	*		
Bratsk										*		
Novorossiisk										*		
Yekaterinburg		*	*	*	*	*	*	*	*			
Klin District of the Moscow Region							*	*	*			
Noginsk District of the Moscow Region						*		*	*			
Blagoveschensk								*	*			
Cheboksary	*						*		*			
City of Balashikha of the Moscow Region									*			

(continued) table 18

1	2	3	4	5	6	7	8	9	10	11	12	13
Odintsovo District of the Moscow Region							*	*				
Astrakhan								*				
Bryansk								*				
Voronezh								*				
City of Orekhovo-Zuevo of the Moscow Region								*				
Yaroslavl								*				
Yuzhno-Sakhalinsk					*	*	*					
Novocheboksarsk	*		*			*	*					
Angarsk								*				
Vurnar District of the Chuvash Republic								*				
City of Shumerlya of the Chuvash Republic								*				
Barnaul						*						
Perm						*						
Nizhni Novgorod				*								
Kostroma	*	*										
Archangelsk	*											
Dzerzhinski	*											

The source: The Ministry of Finance of the Russian Federation.

Credit rating

In 2010, Russia's sovereign rating assigned by Standard&Poor's, an international credit rating agency as regards foreign currency bonds remained unchanged at the "BBB" level with a credit rating forecast being "stable". At the same time, Fitch Ratings, a credit rating agency upgraded the forecast evaluation of Russia's "BBB" credit rating from the "stable" level to the "positive" one.

In the first six months of 2008, Russia was assigned by both the rating agencies the "BBB+" credit rating with a "positive" forecast.

In 2010, Standard&Poor's upgraded the credit rating of the Irkutsk Region, Surgut, the Tomsk Region, the Yamalo-Nenetsk Autonomous Region and the credit rating forecast of the Leningrad Region, Novosibirsk, the Republic of Saha (Yakutia), the Sverdlov Region, the Tver Region and the Khanty-Mansiisk Autonomous Region.

At the same time, the credit rating of the Novgorod Region was withdrawn (Table. 19).

Table 19

Standard&Poor's international credit rating in the 1st quarter of 2011.

Name of the issuer	In foreign currency / Forecast	In national currency / Forecast
1	2	3
Sovereign ratings		
Russian Federation	BBB/Stable/	BBB+/Stable/
Rating of regional and local authorities		
Bashkortostan	BB+/ Stable /	BB+/ Stable /
Bratsk	The rating withdrawn	
Volgograd Region	BB-/Negative/	BB-/ Negative /
Vologda Region	BB-/ Negative /	BB-/ Negative /
Urban District of Balashikha	The rating withdrawn	

(continued) table 19

1	2	3
Dzerzhinsk	B-/Stable/	B-/Stable/
Irkutsk Region	BB-/Positive/	BB-/Positive/
Kaluga Region	The rating withdrawn	
Klin Region	The rating withdrawn	
Krasnodar Territory	BB/Stable/	BB/Stable/
Krasnoyarsk Territory	BB+/Negative/	BB+/ Negative /
Leningrad Region	BB/Positive/	BB/Positive/
Lipetsk Region	BB/ Stable /	BB/ Stable /
Moscow	BBB/ Stable /	BBB/ Stable /
Moscow Region	The rating suspended	
Nizhny Novgorod	BB-/Positive/	BB-/Positive/
Novgorod Region	The rating withdrawn	
Novosibirsk	BB-/ Positive /	BB-/ Positive /
Omsk	The rating withdrawn	
Samara Region	BB+/Negative/	BB+/ Negative /
St. Petersburg	BBB/ Stable /	BBB/ Stable /
Saha (Yakutia)	BB-/ Positive /	BB-/ Positive /
Sverdlov Region	BB/ Positive /	BB/ Positive /
Stavropol Territory	B+/ Stable /	B+/ Stable /
Surgut	BB/ Positive /	BB/ Positive /
Tatarstan	The rating withdrawn	
Tver Region	B+/ Stable /	B+/ Stable /
Tomsk Region	B+/ Positive /	B+/ Positive /
Ufa	BB-/ Stable /	BB-/ Stable /
Khanty-Mansiisk Autonomous Region	BBB-/ Positive /	BBB-/ Positive /
Chelyabinsk Region	BB+/ Stable /	BB+/ Stable /
Yamalo-Nenetsk Autonomous Region	BBB-/ Stable /	BBB-/ Stable /

The source: The Standard&Poor's.

Section 4. The Real Sector of the Economy

4.1. The Macrostructure of Production

4.1.1. Main Trends and Factors of Economic Development in 2010

The macroeconomic situation throughout the year 2010 was characterized by an unstable dynamics of its main indices. Growth over the year's first half, which was sustained by the favorable conditions on the world raw materials market, in the second half-year gave way to a slower rate of economic development due to the effect of certain structural features of the domestic market.

While in the first half-year 2010 the reestablished positive dynamics of investments in fixed assets and an increasing retail turnover resulted in an acceleration of the rate of GDP growth, in Q III the dominant factor that was influencing the value of that index was the slow-down of the rate of industrial production growth and the declining volumes of agricultural production. In the first half-year 2010 the value of production index in agriculture amounted to 102.9 %, followed in Q III by a drop by 18.6 % on the same period of 2009. As a result, in Q III 2010 the rate of GDP growth declined to 2.7 % against 5.2 % in Q II and 3.1 % in Q I of the same period of the previous year. Besides, in Q III the situation was further complicated by the diminished effect of the external factors on the dynamics of economic growth.

In Q IV 2010, the impact of the factors created by an expanding investment and consumer demand proved to be sufficiently strong to compensate for the diminished volumes of agricultural output, and so the growth rate of GDP, according to preliminary estimates, rose to nearly 5.2 % on the same period of the previous year. As a result, GDP growth in 2010 amounted to 104 % as compared to the previous year's level.

The structural peculiarities of the rehabilitative growth in 2010 were determined by an accelerated growth of investments in fixed assets (106.1 % against the 2009 level) and retail turnover (104.4 %). The industrial production growth index in 2010 amounted to 108.2 % of its previous year's level, including that for the processing industries – to 111.8 %, for the extracting industries – to 103.6%, and the production and distribution of electric energy, gas and water – to 104.1 % The agricultural production volume amounted to 88.1 % of its 2009 level. The dynamics of GDP was positively influenced by a rapid revival of exports. As demonstrated by the results of 2010, the physical volumes of exports (as estimated by the methodology based on the system of national accounts (SNA)) rose by 11.1 % on 2009, and so became 5.9 % higher than the level registered in the crisis year (*Table 1*).

The slowdown in the rate of economic growth throughout the year 2008 and the economic decline in 2009 resulted from the simultaneous shrinkage of external and domestic demand. A comparative analysis of the conditions and factors that determined Russia's exit from crisis in 1998 and 2008 has shown that in both cases the determining factor was a favorable change in the external economic situation. From Q II 2009 onwards, alongside the gradual revival on the world raw materials markets and the adaptation of financial and credit institutions to the crisis situation, the rate of economic decline was also gradually becoming less pronounced. The situation in Q IV 2009 and Q I 2010 was determined by a robust growth in exports, and from Q II 2010 – also by the reestablished positive development of the domestic market. When analyzing the influence of the changes and structure of foreign trade turnover throughout the crisis year 2009, one should take into consideration the fact that the decline in the

physical volume of exports was rather mild in face of the plummeting volumes of imports. As a result, in 2009 – for the first time after the 1998 crisis – the rate of growth of net exports became positive, and thus produced a positive influence on the macroeconomic indices. In 2010, however, this trend disappeared. The shrinkage in the volume of exports in absolute terms was registered since Q II 2010, and the effects of the foreign trade component in the second half-year became markedly weaker (*Fig. 1*).

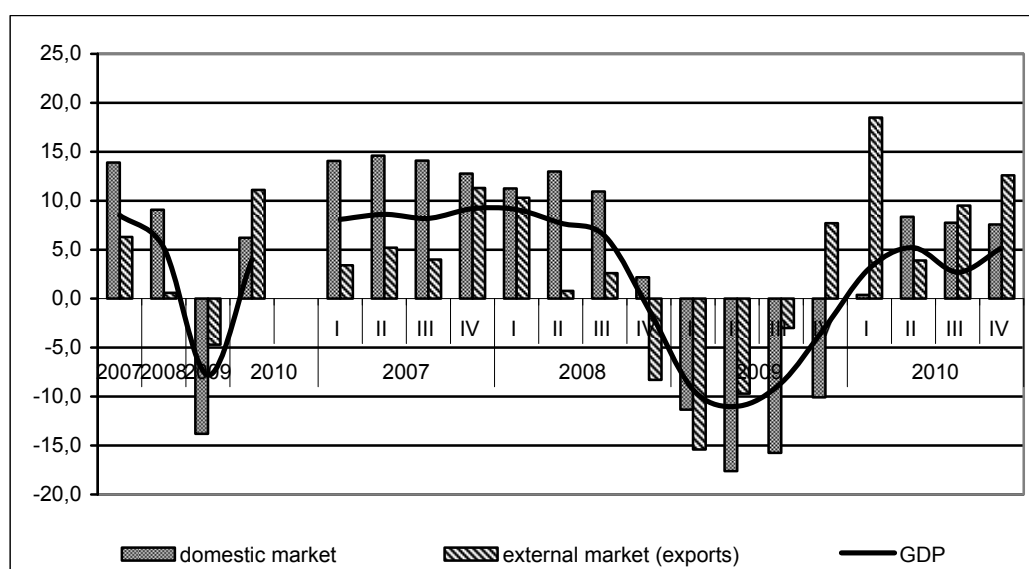
Table 1

**Main Macroeconomic Indices for
2009 – 2010, As % of a Previous Year's Level**

	2009					2010				
	Per annum	Q				Per annum	Q			
		I	II	III	IV		I	II	III	IV
Gross domestic product	92.1	90.7	89.0	91.4	97.1	104.0	103.1	105.2	102.7	105.0*
Investments in fixed assets	83.8	82.7	77.2	81.8	90.6	106.1	95.9	105.3	107.2	112.8*
Housing put in operation	93.5	102.5	99.7	98.8	86.4	97.0	91.7	107.5	85.9	100.5
Production volume in construction	84.0	80.7	80.7	82.8	89.3	99.4	91.9	99.9	102.2	105.6
Industrial production volume	90.7	84.5	86.4	90.4	101.8	108.2	109.5	110.9	106.4	106.5
Extraction of mineral resources	99.4	94.9	97.3	99.9	105.4	103.6	106.7	104.8	101.3	102.0
Processing industries	84.8	76.1	79.3	85.0	100.0	111.8	112.1	116.3	109.5	109.9
Production of electric energy, gas and water	96.1	94.9	94.5	94.0	101.4	104.1	107.7	102.6	103.9	101.6
Agricultural product	101.2	102.3	100.8	99.0	105.2	88.1	103.6	102.3	81.4	91.8
Cargo turnover in transport	89.8	82.8	82.2	93.1	102.0	106.9	111.6	113.0	101.7	102.4
Cargo turnover in transport	95.1	100.4	94.9	91.4	94.5	104.4	101.7	105.3	105.9	104.1
Commercial services to the population	95.8	99.1	95.3	93.6	95.6	101.4	99.9	101.6	101.5	101.5
Foreign trade turnover	64.9	56.2	55.4	59.9	91.0	130.9	144.1	139.0	125.9	119.9*
Real disposable money incomes	102.3	100.7	103.4	96.6	108.2	104.3	107.4	103.2	104.4	102.4
Real wages	96.5	99.2	96.1	94.8	99.3	104.2	103.1	106.1	105.1	102.4
Total number of unemployed	131.7	134.8	152.1	132.2	112.3	89.1	96.3	86.7	87.2	85.3
Number of unemployed, officially registered	148.9	126.5	157.4	163.0	152.3	90.0	114.2	91.1	81.0	91.2

* Preliminary estimates.

Source: Rosstat.



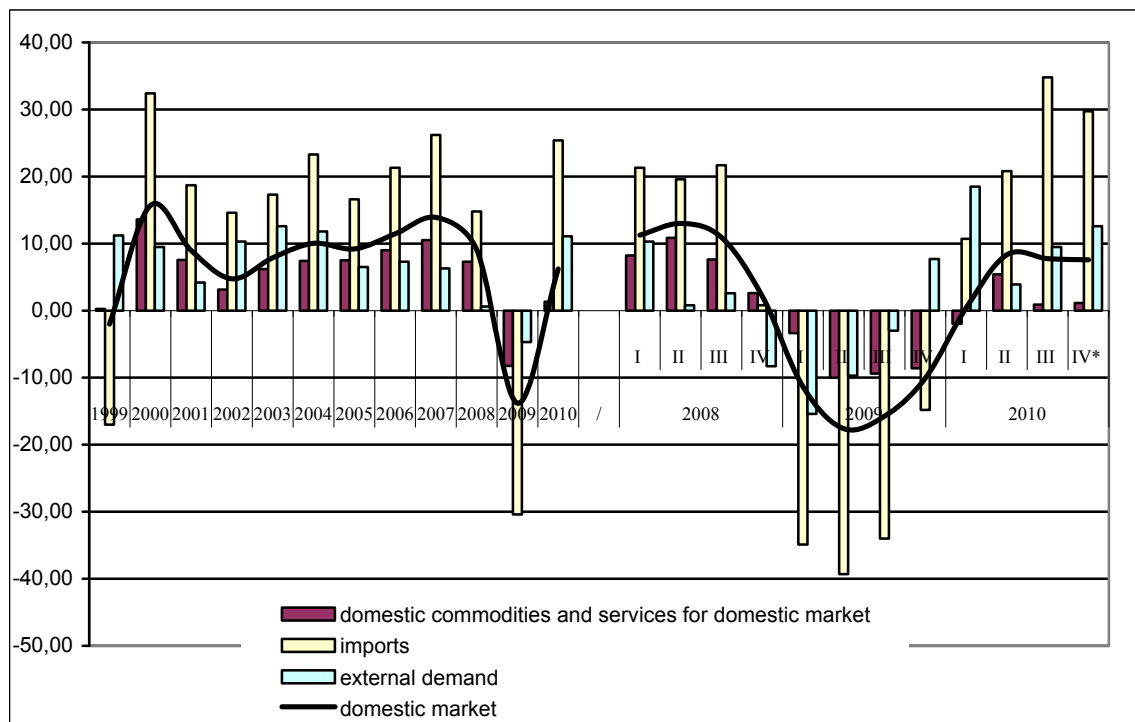
Source: Rosstat.

Fig. 1. GDP Changes, by Domestic and External Demand Components in 2008 – 2010, As % of the Same Quarter of a Previous Year

The specific combination of the rates of domestic and external demand had a decisive effect on the peculiarities of the post-crisis revival observed in 2010.

The initial conditions for the exit from the crisis were marked by a 9.8 % drop, in 2009, of the physical volumes of output displayed by the main types of economic activity on the previous year, and a drop in the volume of imports by 30.4 %. The plummeting volume of imports had a major impact on the dynamics and structure of the domestic market, because since 2005 the Russian economy had been characterized by an upward trend displayed by the share of imports in trade turnover and investment expenditures. The high share of imported commodities was determining an adequate balance of demand and supply also on the investment market. Although the dynamic growth of imports was conducive to the emergence of a competitive environment, the high share of imports in retail turnover and in the volume of investments in machinery, equipment and means of transportations was increasing the dependence of the domestic market's balance of commodity resources on the changes in the foreign economic situation. The simultaneous large-scale decline in the volumes of domestic production and imports in the crisis years 2008 – 2009 was determining the specificity of the structural changes that occurred on the domestic market. Early on in the crisis, the cumulative effects of the shrinking demand, declining incomes of enterprises and the population alike, and the drop in the ruble's exchange rate resulted in a strengthened position of Russian producers on the domestic market. However, in contrast to the period of 1999 – 2000, no leap in the level of domestic production occurred this time, because while in 1999 – 2000 the positive changes in domestic production resulted from an active involvement of idle competitive capacities and an accelerating rate of investments in fixed assets, the main factor that determined the improved situation on the domestic market in the first half-year 2009 was the availability of accumulated finished products.

The macroeconomic situation started to change from the second half-year 2009, when the rate of economic decline began to slow down in response to the gradual rebound of the foreign market and the revival production in the extracting sector of industry. In Q I 2010 the trend toward stabilization on the domestic market strengthened due to the reestablished positive dynamics of domestic production and imports. However, alongside a very slow revival of domestic production of commodities and services for the domestic market, since early 2010 an expansion of imports has been registered. While growth on the domestic market amounts to 6.2 %, and that of imports – to 25.4 %, the growth of domestic production of commodities and services for domestic consumption is estimated to be at the level of 1.3 %, and that for the foreign market – at the level of 11.1 %. The end of the 1998 crisis was characterized by stabilization, in 1999, of domestic production for the domestic market in face of a remaining downward trend displayed by the level of imports. In the period of 2000 – 2007, the rate of domestic production of commodities and services was persistently increasing, while at the same time, in terms of average per annum growth rate (which amounted to 107.3 %), it was lagging behind both imports (119.7 %) and exports (108.4 %) (*Fig. 2*).



* preliminary estimates.

Source: Rosstat.

Fig. 2. Changes in the Growth Rate of Domestic Demand in 1999 – 2010, by Component, As % of the Same Period of a Previous Year

As the influence of imports on the domestic market became stronger in 2009 – 2010, it caused some negative shifts in the overall supply structure where the share of imports in investment commodities was rapidly shrinking against the backdrop of a reorientation toward the other two types of commodities intended to satisfy consumer and intermediate demand (Table 2).

Table 2

Shares of Consumer, Intermediate and Investment Commodities in the Russian Federation’s Total Imports (Based on Balance of Payments), as % of Result

	Type of commodity		
	Consumer	Investment	Intermediate
2008			
Q I	45.0	22.6	32.4
Q II	41.3	23.9	34.8
Q III	43.6	24.2	32.2
Q IV	37.8	24.4	37.8
Per annum	41.8	23.8	34.4
2009			
Q I	46.8	18.6	34.9
Q II	44.0	18.1	38.4
Q III	42.9	20.6	36.5
Q IV	43.9	19.5	36.6
Per annum	44.3	19.7	36.0
2010			
Q I	43.5	16.8	39.7
Q II	39.5	18.7	41.8
Q III	42.1	19.8	38.1

Source: Rosstat.

The emergence of this trend was followed by an increasing share of imports in the retail commodity resources. The opposite trend observed in 2009, when the share of imports in retail commodities was shrinking, had disappeared. Thus, the share of imports throughout 2010 was systematically increasing, having achieved by Q III the level of 47 % (*Table 3*).

Table 3

Structure of Retail Commodity Resources in 2009 - 2010, %

	Retail commodity resources	Including	
		Domestic production	Domestic production
2009			
Q I	100	55	45
Q II	100	60	40
Q III	100	59	41
Q IV	100	61	39
Year	100	59	41
2010			
Q I	100	56	44
Q II	100	58	42
Q III	100	53	47

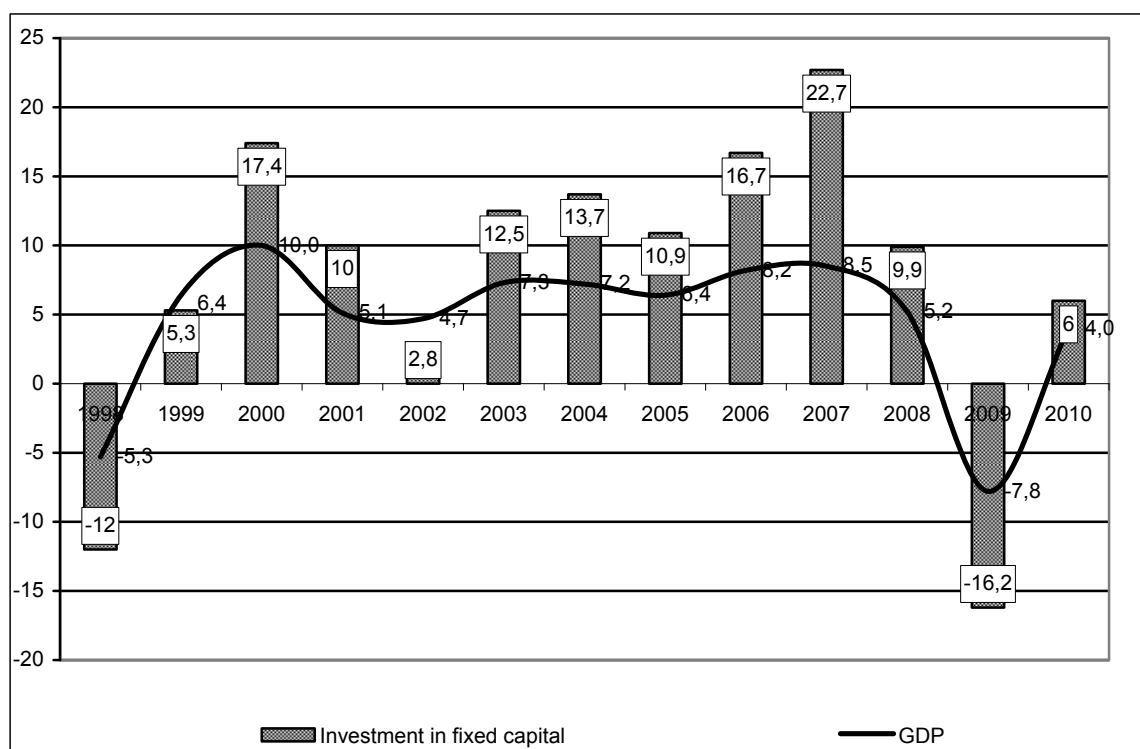
Source: Rosstat.

An analysis of the dynamics of economic development broken down by component of external and domestic demand can serve as an illustration of its very high dependence on foreign trade. Lack of any significant structural changes, the development by inertia of both exports-oriented and end-demand production (based on extensive use of basic factors), and a high share of imports in the resources available on the domestic market were determining the low competitive capacity of the Russian economy in conditions of the post-crisis rehabilitative growth in 2010.

4.1.2. Main Characteristics of the Use of GDP

The year 2009 saw a reversal of the formerly upward trend in the growth of investments (which could be observed throughout the entire period of 2000 – 2008), and so, for the first time since the 1998 crisis, a decline in the rate of investments in fixed assets was recorded that was much more rapid than the changes observed in the dynamics of GDP. Over the year 2010, the rate of investments in fixed assets was initially, in Q I, determined by the effect of the previous year's factors. From Q II 2010 onwards, the value of this index became positive, while the rate of quarterly growth began to accelerate. By the end of 2010, the rate of growth displayed by investments in fixed assets amounted to 106.0 %, which is by 2 p.p. higher than the rate of GDP growth. However, when estimating the significance of that index, one should take into consideration the low base provided by its level recorded in 2009, when the decline of investments in fixed assets amounted to 16.2 % and was much more pronounced than in the crisis year 1998. As a result, in 2009 the index of investments in fixed assets amounted to 88.8 %, and that of GDP – to 95.9 % of the 2008 level (*Fig. 3*).

Against the backdrop of a global crisis and the dwindling incomes of the national economy, from late 2008 onwards there occurred a change in the gross national savings to end consumption ratio. As demonstrated by the results of the year 2009, the share of gross savings in GDP fell to 24.3 %, which is comparable to the value of that index recorded in the crisis year 1998. In 2010, the share of savings in GDP increased to 28.0 %, while remaining well below the average level recorded in the period of 2004 – 2008 (33.4 %).



Source: Rosstat.

Fig. 3. Changes in Dynamics of GDP and Investment in Fixed Assets in 1998 – 2010, As % of the Previous Year

In face of the then existing situation on the market for capital and savings resources, the share of investments in fixed assets in GDP in 2009 dropped 19.4 % by comparison with the last decade’s historic high of its average value of 20.7 % (recorded in 2007 – 2008). However, in 2010 the share in GDP of investments in fixed assets climbed to 20.5 % due to the strengthening trend towards savings’ transformation (*Table 4*).

Table 4

Shares in GDP of Gross Savings, Total Accumulation and Investments in Fixed Assets in 1998 – 2010, as % of Result

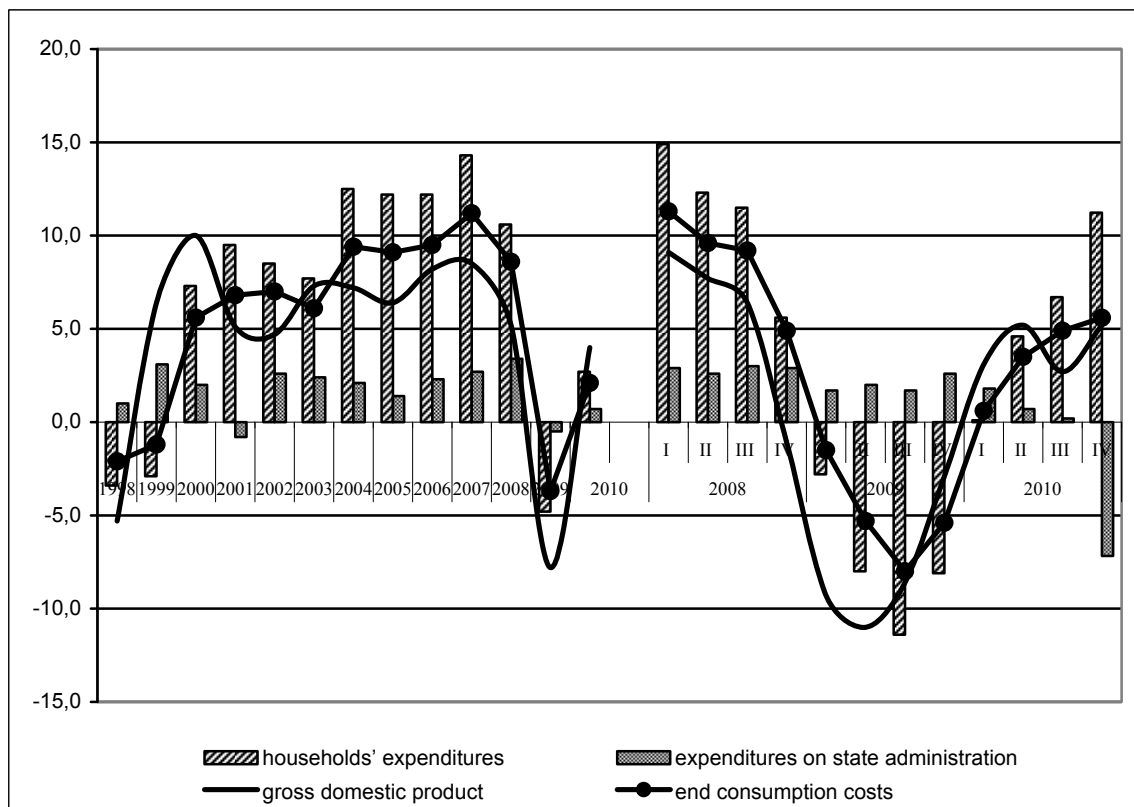
	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Gross savings	23.8	31.9	38.7	34.2	30.8	31.4	32.6	33.2	33.8	33.9	33.3	24.3	28.0
Total accumulation	15.0	14.8	18.7	21.9	20.1	20.9	20.9	20.1	21.2	24.2	25.5	18.9	21.8
Including:													
total accumulation of fixed assets	16.2	14.4	16.9	18.9	17.9	18.4	18.4	17.8	18.5	21.0	22.3	22.0	21.0
Investments in fixed assets	15.5	13.9	15.9	16.8	16.3	16.6	16.8	16.7	17.6	20.2	21.3	19.4	20.5

Source: Rosstat.

The dynamic growth of end consumption sustained by increasing real incomes of the population was one of the main factors that determined the upward development of the Russian economy over the period of 2000 – 2008. While households’ end consumption over that pe-

riod increased 1.91 times, the population's real incomes rose 2.23 times, real wages – 2.85 times, and the real size of allocated pensions – 2.22 times.

The 2009 crisis had a painful effect on the population's living standards and resulted in a deeper downfall relative to the previous period than that during the 1998 crisis. While the rate of growth of the population's real incomes in 2009 was at the level of 1.9 %, that of end consumption dropped on 2008 by 5.4 %, including end consumption by households – by 8.9 %. It should be noted that the changes occurring in the index of households' consumption was significantly influenced by the decline of real wages by 3.5 % by comparison with the 2008 level, while the growth rate of wages in nominal terms displayed its historic low since 1998 – 7.8 %.



Source: Rosstat.

Fig. 4. Changes in End Consumption Costs in GDP by Component in 1998–2010 and by Quarter in 2008–2010, as % of Relevant Period

In 2010, the main indices describing the population's living standards acquired positive values, but one should bear in mind when estimating those values the effect of the low baseline provided by the previous year's level. Judging by the results of the year 2010, the cost of end consumption relative to the previous year's level rose by 2.1 %, including that by households – by 2.7 %, but the corresponding values actually amounted to only 98.7 % and 97.8 % of the 2008 index. The growth of real incomes of the population in 2010 amounted to 4.1 % as compared to the previous year's rate and to 6.4 % as compared to 2008 (over the period of 2004–2008 the average per annum growth rate was 13.4 %). The specific features of the formation of the population's incomes were determined by the accelerating growth of social

benefits allocated within the framework of the government programs aimed at sustaining the population's living standards. Within the structure of the population's incomes the share of social benefits rose from 13.2 % in 2008 to 14.9 % in 2009 and to 18.0 % in 2010. The average size of allocated pensions over the period of 2009 – 2010 increased 1.78 times (in real terms – 1.5 times). Changes in the size of wages took a milder character. The growth of real wages in 2010 by 4.2 %, however, made it possible to neutralize the negative trends of the previous year and to achieve the 2008 level.

In 2010, retail turnover rose by 4.4 %, including that of foodstuffs – by 5.1 %, and that of nonfood commodities – by 3.8 %.

The consumer price index in 2010 amounted to 108.8 %, thus remaining at the previous year's level. At the same time, the prices of foodstuffs rose to 112.9 % against 106.1 % in 2009, and those of nonfood commodities – to 105.0 % against 109.7 % (*Fig. 4*).

4.1.3. Changes in the Structure of GDP, by Source of Income

A dynamic growth of the population's incomes represents one of the typical features of economic growth in the Russian economy. The activity on the domestic market is sustained by growth of real wages and is associated with redistribution of incomes from companies to the population. The share of wages in GDP rose to 52.8 % in 2009 and to 50.2 % in 2010 against its mean index of 46.1 % recorded over the period of 2002 – 2008 (*Table 5*).

Table 5

**Structure of GDP Formation, by Source of Income
in 2008 – 2009, as % of Result, in Current Prices**

	2008		2009				2010				
	Per annum	Per annum	Q				Per annum	Q			
			I	II	III	IV		I	II	III	IV
Gross domestic product	100	100	100	100	100	100	100	100	100	100	100
Including:											
Wages of hired labor, including hidden remuneration and mixed incomes	46.7	52.8	56.9	53.3	47.9	50.1	50.2	52.1	50.1	48.1	50.8
Net taxes on production and imports	19.2	16.7	14.3	15.6	17.4	17.8	18.1	17.5	18.4	17.0	19.1
Gross profit in the economy and gross mixed incomes	34.1	30.5	28.8	31.1	34.7	32.1	31.7	30.4	31.5	34.9	30.1

Source: Rosstat.

Within the structure of employed population the share of persons who were not working under employment contracts constituted only 8 %; these are employers who employ labor force at their own enterprises on a permanent basis; and self-employed persons. This phenomenon determined the specificity of the formation of the structure of GDP incomes and the population's incomes. More than 66 % of the population's incomes in 2010 was formed by wages paid to the employed, while the share of incomes from entrepreneurial activity and property was shrinking.

A typical feature of Russia's national economy has become a high degree of differentiation of mean wages by type of economic activity. In industry, the degree of differentiation of wages is determined by an increasing gap between the levels of wages in the extracting and

processing industries. In 2010, the amount of wages charges in nominal terms in the sector of extraction of mineral resources was 1.8 times higher than the average level of wages across the entire economy, including in the sector of fuel extraction by 2.2 times. Wages in the processing industries amounted to 90 % of the economy's average and 45 % of the index recorded in the extracting industries. The mean value of the index of charged wages was exceeded 2.3 times in the sectors associated with the production of petroleum products and transportation of mineral fuel and energy resources, as well as in the financial sector. In the spheres of education and public health care wages dropped to 66 – 76 % of the economy's average. The specific forms of remuneration depending on types of economic activity had a significant influence on the structure of incomes and expenditures, on the population's consumer demand, on the type of employment and the distribution of labor resources across the economy.

The level and share of remuneration received by hired labor in the structure of GDP had a dominating effect on the social parameters, including the labor market. In the crisis conditions of 2009 the number of the employed in the economy dropped to 69.4 mln persons against 70.9 mln persons in 2008, resulting in a climb of the rate of total unemployment to 8.4 % against 6.4 %.

The year 2010 saw a continuation of the implementation of anti-crisis measures aimed at supporting the labor market. A total of 39.5 bn Rb was allocated from the federal budget to subsidies granted to the budgets of subjects of the Russian Federation so that they could lower the level of tension on their labor markets within the framework of regional programs. In 2010, as compared to 2009, the number of employed in the economy rose by 0.4 mln, thus amounting to 69.8 mln persons. The level of unemployment, as demonstrated by the results of the year 2010, dropped to 7.5 % against 8.4 % one year earlier, while the overall number of unemployed (as estimated by the ILO methodology) amounted to 5.6 mln against 6.3 mln in 2009. The number of unemployed who were officially registered with government employment agencies slid to 2.2 mln, while the level of registered unemployment became 2.5 % against 3.0 % in early 2010. The improvement of the general situation in the national economy was associated with a stable downward trend displayed by the number of those employed persons who worked part-time, were kept on leave or idle – their number decreased from 1.6 mln in January 2010 to 0.9 mln in November 2010.

The tension coefficient (the number of unemployed persons registered with government employment agencies per 100 vacancies) between January and November 2010 decreased from 310.6 to 177.3 (*Table 6*).

Table 6

Dynamics of the Main Labor Market Indicators in 2009 – 2010

	2009	Q				2010	Q			
		I	II	III	IV		I	II	III	IV
1	2	3	4	5	6	7	8	9	10	11
Number of employed in national economy, mln	69.4	68.2	69.4	70.4	69.5	69.8	68.0	70.0	71.1	70.1
Number of unemployed, mln	6.3	6.8	6.5	6.0	6.0	5.6	6.6	5.6	5.2	5.2
Level of unemployment, as % of economically active population	8.4	9.1	8.6	7.8	8.0	8.8	8.8	7.4	6.8	6.9
Number of unemployed, registered with government employment service, mln	2.1	2.0	2.2	2.1	2.1	2.2	2.2	2.0	1.7	1.5
Level of registered unemployment, as % of economically active population	2.8	2.6	2.8	2.7	2.7	2.5	3.0	2.7	2.2	2.1
Average monthly wages of organizations' employees, in nominal terms, Rb	18,785	17,441	18,419	18,673	20,626	21,090	19,485	20,809	21,031	23,045

Table 6 (continued)

1	2	3	4	5	6	7	8	9	10	11
as % of relevant period of previous year										
Number of employed in national economy	97.8	97.7	97.1	97.9	98.7	100.6	99.6	101.0	101.0	100.9
Number of unemployed	131.1	134.8	152.1	132.2	112.0	89.1	96.3	86.7	87.2	85.2
Number of unemployed, registered with government employment service, mln	148.0	126.5	157.4	163.0	153.2	90.0	114.2	91.1	81.0	74.9
Average monthly wages of organizations' employees, in nominal terms	108.5	112.8	108.0	105.7	108.1	111.3	110.5	112.4	111.6	110.7
Average monthly wages in real terms	97.2	99.2	96.1	94.8	99.0	104.2	103.1	106.1	105.1	102.4

Source: Rosstat.

It is noteworthy that, while in the period of 2000 – 2008 changes in the demand for labor were determined by a shift in employment towards the services sector, during the 2009 crisis the most critical situation was observed in trade, as well as in industry and construction. In recent years employment was on the decline in nearly all the branches of industry, with the most rapid rates of decline in the processing industries. If in 2008 the number of employed in the processing industries dropped on 2004 by 596 thousand, and in the extraction of mineral resources sector – by 44 thousand, in 2009 the drop on the previous year in the average per annum number of employed amounted to 806 thousand and 44 thousand respectively. The formation of that trend occurred against the backdrop of a declining growth rate of labor productivity (*Table 7*).

Table 7

**Changes in Labor Productivity in the National Economy
of the Russian Federation, as % of Previous Year**

	2003	2004	2005	2006	2007	2008	2009
On the whole, across national economy	107.0	106.5	105.5	107.5	107.5	104.8	95.8
Including:							
Agriculture, hunting and forestry	105.6	102.9	101.8	104.3	105.0	110.7	105.0
Fishery and fish-breeding	102.1	104.3	96.5	101.6	103.2	95.5	109.2
Extraction of mineral resources	109.2	107.3	106.3	103.3	103.1	101.0	107.5
Processing industries	108.8	109.8	106.0	108.5	108.4	102.6	96.1
Production and distribution of electric energy, gas and water	103.7	100.7	103.7	101.9	97.5	102.1	96.3
Construction	105.3	106.8	105.9	115.8	112.8	109.1	91.4
Wholesale and retail trade	109.8	110.5	105.1	110.8	104.8	108.1	92.1
Hotels and restaurants	100.3	103.1	108.5	109.2	108.0	109.2	87.1
Transport and communications	107.5	108.7	102.1	110.7	107.5	106.5	100.1
Operations with immovable property, lease and related services	102.5	101.3	112.4	106.2	117.1	107.9	96.7
For reference: real wages	110.9	110.6	112.6	113.3	117.2	111.5	96.5

Source: Rosstat.

The low effect of the use of production factors was one of the main causes of the decline in the Russian economy's competitive capacity. A negative influence on the qualitative indices of economic development was exerted by the considerable gap between the rate of labor productivity and the level of remuneration in favor of the latter, which was visible across the entire economy even in crisis conditions. However, opportunities for any further growth in the level of remuneration became rather severely restricted as a result of a changed competitive environment on the commodity markets due to the strengthening of the ruble and a similarly increasing pressure of imports.

A comparison between changes in the indices of the population's employment rate, remuneration level and GDP has demonstrated that an accelerated growth of wages against a slower growth of labor productivity increased the load on the economy and was reflected in the results of financial activity.

Positive changes in the economy improved the financial status of businesses. As shown by operative data, in January – September 2010 they achieved a positive aggregate financial result in the amount of 4,305.5 bn Rb, which is by 51.7 % higher than the same index for the previous year. However, despite the presence of some positive trends, the pre-crisis rate of return indices have not yet been achieved for the entire national economy. The rate of return on sold commodities, products and work, as seen by the results of January – September 2010, was 11.6 %. Production decline and other manifestations of the crisis had different implications depending on the type of activity, and so development in 2010 was uneven and had certain specificities. The most profitable type of activity in January – September 2010 remained the extraction of mineral resources.

The favorable situation on the world market for energy carriers make it possible for the companies operating in that sector to receive, in January – September 2010, an aggregate positive financial result in the amount of 959.4 bn Rb, which is by 45 % higher than the same index for the previous year. The financial situation of the businesses operating in the processing industries also improved: as seen by the outcome of the period of January – September 2010, their aggregate financial result was 1,134.6 bn Rb, which is by 59.7 % higher than the previous year's level.

Due to instability of the business activity in the construction sector, the aggregate financial result for January – September amounted to 49.7 bn Rb, or only 80.7 % of the value of the same index for 2009.

Last year's anomalous climatic situation had a negative effect on agricultural output and, consequently, on the financial results achieved by the organizations operating in that sector. The aggregate financial result for the period of January – September in agriculture amounted to 54.9 bn Rb, which is by 12.5 % below the value of the same index for 2009. At the same time, the losses incurred by agricultural organizations rose by 84 % on January – September 2009 (*Table 8*).

According to our decomposition¹ of quarterly indices (*Table 9, Fig. 5*), in 2009 – 2010 the rate of GDP growth increased on the average by 29 % due to changes in labor input, but the contribution of that component during the period under consideration was shrinking (from 41.8 % in Q I 2009 to 30.5 % in Q III 2010). A more substantial contribution to the rate of GDP growth was made by changes in the volume of capital input in the process of production, which on the average accounted for 54 % of growth.

By comparison with the previous years the first two quarters of 2009 were marked by certain shifts in the structure of GDP growth, namely a declining contribution of capital input with a simultaneously increasing contribution of labor input. These structural changes reflected the way in which the crisis phenomena in the economy were influencing the behavioral strategies of producers who, while adjusting to new economic conditions, tend to apply a more flexible instrument – labor input management. Beginning from the second half-year 2009, there occurred a revival of the previously existing structure of output growth (typical of

¹ For more details concerning our methodology, see *Faktory ekonomicheskogo rosta. Nauchnye trudy N 70*. [Factors of Economic Growth. Scientific Works No 70.] M. IET, 2003. www.iet.ru

the pre-crisis period), which is characterized by a considerably larger contribution of capital input than that of labor input.

Table 8

**Rate of Return on Commodities, Products, Work, Services and Assets Sold
by Organizations, by Type of Economic Activity, in January – September
2008 – 2010, as %**

	Return on sold commodities, products, work, services			Return on assets			For reference		
							January – September 2010 to January – September 2009		September 2010 to December 2009
	2008	2009	2010	2008	2009	2010	rate of financial result	physical volume index	price indices
Total	15.8	11.2	11.6	6.8	3.8	5.1	152.6	104.8	
Including:	15.0	11.4	12.2	4.5	2.9	2.5	90.7	89.3	108.3
agriculture, hunting and forestry									
fishery and fish-breeding	10.7	25.9	25.0	4.8	13.0	12.5	121.5	90.0	
extraction of mineral resources	36.2	31.3	32.8	14.6	8.5	10.4	145.0	104.2	101.8
processing industries	20.6	12.3	14.4	12.1	3.9	6.0	159.7	112.6	110.5
production and distribution of electric energy, gas and water	3.6	7.3	6.9	0.6	2.9	3.6	140.7	105.1	113.6
construction	5.6	5.0	4.1	2.6	1.5	1.2	80.9	99.2	107.3
wholesale and retail trade; repair of motor vehicles, motorcycles, household appliances and personal items	11.3	7.0	8.3	7.0	3.6	5.7	169.9	104.4	106.2
transport and communications	16.4	15.8	15.0	5.0	3.9	3.7	115.8		145.0

Source: Rosstat.

The main factor determining the dynamics in rate of output growth in 2009 was TFP (total factor productivity), whose changes can on the average account for 73 % of the rate growth; in 2010 the contribution of that component in the majority of periods was negative.

The negative changes in labor input resulting from the financial crisis first appeared in late 2008 and then persisted in the dynamics of economic indices in 2009 – the year that saw the shrinkage of both the number of employed and their working time. In 2010, the rate of growth demonstrated by labor input was positive (0.8 % in Q I; 1.4 % in Q II; and 0.8 % in Q III), but nevertheless it was far behind the rate of decline observed over the previous year, so that the newly achieved level of labor reserves and the intensity of their use was lower than the corresponding indices recorded in 2007 – 2008.

The structure of labor input in the period under consideration was uneven, which reflected the economic instability on the labor market. In Q I 2009 the shrinkage of labor input was largely determined by the shorter working hours, the contribution of that component to the rate of GDP growth was nearly twice as high as the rate of output growth, which in its turn was determined by the declining number of employed. In Q II the slowdown in the rate of shrinkage of working hours was accompanied by a more rapid downslide in the number of employed, so in that period the contribution of both these components of labor input was practically the same. From Q III onwards the rate of decline demonstrated by labor reserves and the intensity of their use became slower, but this process was more rapid with regard to the latter component. As a result, in the second half-year 2009 the most significant component of labor input that determined its contribution to the rate of GDP growth was the dynamics of labor reserves. In the first two quarters of 2010, manipulating the length of working hours once again became the main instrument of adapting the labor market to changes in the market

situation: in Q I the shift of the rate of labor input growth towards positive values occurred exclusively due to longer working hours against the backdrop of the continuing shrinkage of the number of employed; in Q II, although the number of employed also began to increase, the intensity of the use of labor reserves remained the dominant factor that was determining the amount of input labor. In Q III, labor reserves were increasing at a somewhat higher rate than the intensity of their use.

Table 9

**Structure of the Rate of GDP Growth
(as Compared to the Same Period of Previous Year)¹**

	Q I 2009	Q II 2009	Q III 2009	Q IV 2009	Q I 2010	Q II 2010	III quarter 2010
Growth rate							
GDP	-9.3	-11.0	-8.6	-2.9	3.1	5.2	2.7
I. Factor inputs	-4.9	-4.2	-4.2	1.0	5.0	5.0	5.7
I.1. Labor	-3.9	-3.0	-1.9	-0.8	0.8	1.4	0.8
Employment	-1.3	-1.5	-1.0	-0.7	-0.2	0.5	0.4
Working hours	-2.6	-1.5	-0.9	-0.1	1.0	0.9	0.4
I.2. Capital	-1.0	-1.2	-2.3	1.7	4.2	3.7	4.9
Fixed assets	1.4	1.5	1.6	1.5	1.5	1.5	1.7
Use of production capacities *	-2.4	-2.7	-3.9	0.2	2.7	2.2	3.2
II. TFP	-4.4	-6.8	-4.4	-3.9	-1.8	0.2	-3.0
as % of rate GDP growth rate							
GDP	100.0	100.0	100.0	100.0	100.0	100.0	100.0
I. Factor inputs	52.6	38.3	49.0	-32.7	158.6	97.1	211.6
I.1. Labor	41.8	27.7	22.5	26.2	24.7	26.6	30.5
Employment	14.3	14.0	11.7	22.5	-6.5	9.3	16.0
Working hours	27.5	13.7	10.8	3.7	31.2	17.4	14.5
I.2. Capital	10.8	10.7	26.5	-59.0	133.9	70.4	181.0
Fixed assets	-15.4	-13.7	-18.8	-51.6	46.4	29.0	61.4
Use of production capacities	26.1	24.3	45.3	-7.3	87.6	41.5	119.6
II. TFP	47.4	61.7	51.0	132.7	-58.6	2.9	-111.6

* The estimates of the changes of the use of production capacities across the national economy are based on the data on the volume of the actually consumed electric energy.

Similarly to the situation with regard to labor cost, the manifestation of the crisis phenomena in the economy was the presence, in the overall dynamics of the capital input index, of a period during which the value of that index was on the decline. However, the duration of the period itself was shorter: instead of late 2008, it began in Q I 2009, while the shift of the capital input growth rate towards positive values was observed as early as Q IV of the same year.

In the first half-year 2009, the contribution of capital input to the rate of GDP growth amounted to almost one-third of that of labor input; in Q III, the contributions of these two components became equal. In Q IV 2009, capital inputs remained the sole factor that had a negative impact on the rate of GDP growth, i.e., it was the only index whose value was demonstrating growth in face of shrinking output. In 2010, capital inputs were growing at an accelerated rate as compared to GDP, which explains the dominant role of that component in the structure of output growth.

¹ The deviation from the previously published results occurred due to changes in the data published by *Rosstat*.

In 2009 – 2010, the main factor determining the character and direction of the changes displayed by capital inputs in the first three quarters of 2009 was the volatile intensity of the use of industrial production capacities. The rate of growth in the intensity of the use of capital inputs demonstrated a decline in January – September 2009, which then gave way to an upward trend from Q IV onwards. The mean quarterly growth rate over that period was 0.9 p.p. (in accordance with linear trend – by 1.2 p.p.¹).

The rate of growth of capital reserves remained positive throughout the entire period under consideration, although when broken up by quarter it demonstrated a slight decline – from 3.3 % in Q I 2009 to 3.0 % in Q III 2010. In accordance with our estimation methodology,² changes in capital reserves are determined by the changing volume of investments in fixed assets, whose the rate of growth remained negative until Q II 2010. At the same time, in spite of the growth of investments observed in Q II and III 2010, their volume in real terms remained not only below the 2008 level, but also below that of 2007. Thus, the declining amount of funds allocated to renewal and restoration of fixed assets, with due regard for the significant degree of their depreciation, resulted in a quarterly decline of the growth rate of capital reserves by 0.05 p.p.

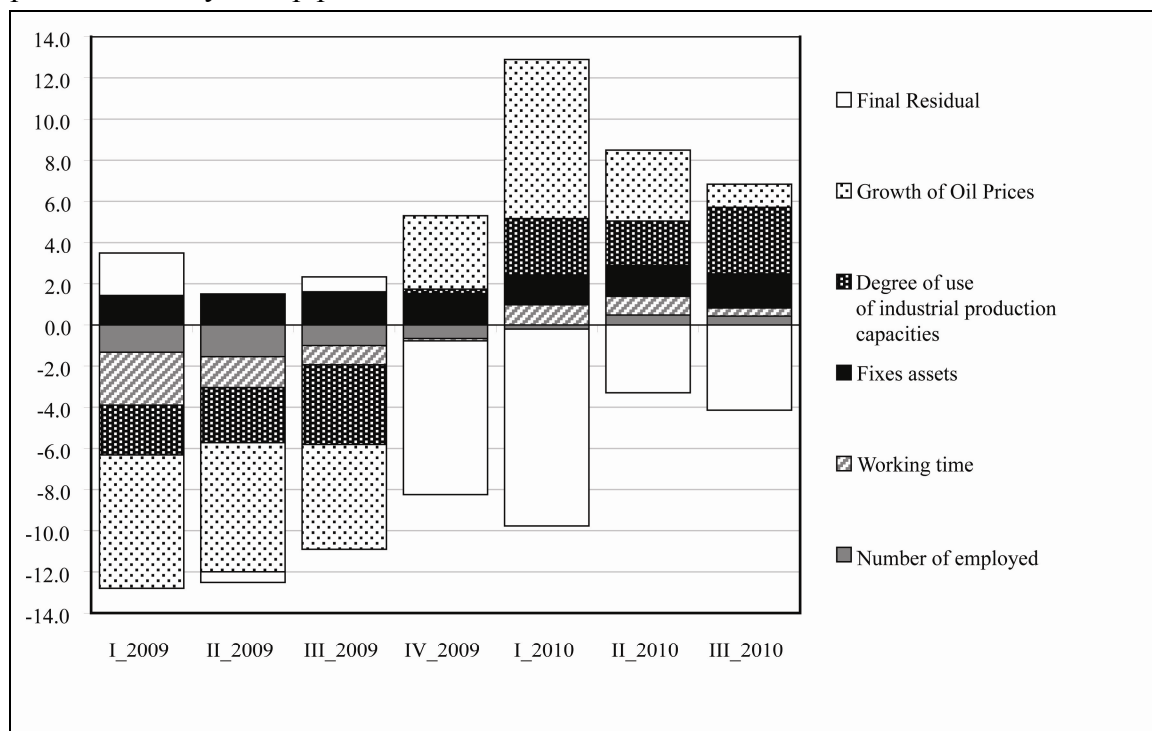


Fig. 5. By Factor Decomposition of GDP Growth (as Compared with the Same Period of Previous Year), with Estimates of the Effect of Oil Prices

¹ Growth rate changes are estimated by linear trends in order to lower the dependence of the resulting estimates on the specific choice of the first and last quarters of the period under consideration.

² In absence of quarterly statistics, the growth estimates of fixed assets are plotted on the assumption of constancy of the coefficient of their withdrawal and a constant share of investments earmarked for their renewal. It should be noted that the estimate obtained in this manner may be biased because it will not take into consideration the time lag between the moment when investments are received and the moment of their actual implementation.

The contribution of unexplained residual (total factor productivity) during the period under consideration is rather controversial. In 2009, that component was the dominating factor, which determined on the average 73 % of the rate of GDP decline. In Q I and III 2010, the rate of TFP growth remained negative, thus being responsible for its negative (and sufficiently significant) contribution to the rate of output growth; in Q II the contribution of TFP was positive but no more than 3 %. In this connection, similarly to all the other components considered earlier, the dynamics of total factor productivity demonstrates a downward trend with regard to the rate of its decline, with a quarterly average of 0.2 p.p. (or 0.7 p.p. in accordance with a linear trend). However, in contrast to the input of the main factors, this slowdown in the rate of its decline is insufficient for achieving a positive TFP dynamics.

It should be noted that the meaning of TFP after a decomposition of the growth of value indices (as represented by GDP) becomes somewhat different from the traditional understanding of technology-related productivity. The estimation by TFP describes not only the changes in the intensive (and primarily ‘technological’) components that are conducive to an increased production performance, but also the exogenous shocks, the influence of other indices that are excluded from the estimation of the input of the main factors, and the shifts determined by the uneven character of output prices and capital input¹, among which a significant role (especially in the short term) is played by the changes related to the dynamics of world oil prices.

In accordance with our results,² changes in oil prices (with the exception of Q IV 2009) largely determined the rate of growth of both TFP and GDP. On the average in the period under consideration, changes in the price factor determined approximately 60 % of the rate of output growth, whereas only about 42 % was determined by technology-related productivity (final residual). Besides, after the prices on the world raw materials markets were taken as a separate factor, the changes in the rate of the technology-related component’s growth became different from TFP dynamics: the rate of final residual’s growth was positive or close to zero only in January – September 2009, and then from Q IV the technology-related component demonstrated a stable decline. On the whole, during that period the dynamics of final residual was characterized by a slower rate of growth, on the average 1.1 p.p. per quarter (or 1.8 p.p. in accordance with linear trend).

Thus, the changes in the rate of GDP growth that were observed in 2009 – 2010 were accompanied by a certain transformation in the structure of its determining factors. It was characterized by a declining contribution of capital input, with a simultaneously increasing contribution of labor input, while in 2009 the role of total factor productivity remained predominant, and then in 2010 capital input once again began to play a dominant role against the backdrop of negative contribution of TFP. In this connection, changes in the growth rates of both labor input and capital input are determined in the main by fluctuations in the degree of their use (the length of working hours and the intensity of the use of production capacities).

¹ A price-based estimate of productivity coincides with a ‘physical’ one if the economy is in conditions of a long-term equilibrium and perfect competition. In other words, this coincidence takes place when all possible exogenous shocks are taken into account in the current equilibrium of the system.

² The singling out of the conjecture component within TFP and the conduct of the further decomposition of the growth rate of output are based on the presence of a statistically significant interrelation between the growth rate of GDP and the growth rate of world oil prices, which is estimated with a regression analysis of annual data for the 1999-2009 period. The resulting ‘final remainder’ purged of the influence of price fluctuations on world raw materials markets is a more correct characteristic of technological productivity, i.e., the intensive component of growth in output.

The rates of growth displayed by nearly all the extensive components (with the exception of fixed assets) were changing in a similar way: a negative rate of growth in 2009 followed by a shift towards positive values in late 2009 – early 2010.

On the average, in 2009 – 2010 the contribution of productivity factors to GDP growth amounted to approximately 18 % without oil prices (– 42 %), after the estimates of the contribution of price fluctuations on international raw materials markets were excluded. In this connection, it should be noted that in Q IV 2009 – 2010 the estimates of technology-related productivity were demonstrating a negative rate of growth.

4.1.4. The Dynamics and Structure of Production, by Type of Economic Activity

During the 2008 crisis, a decline in the rate of production was first recorded in the export-oriented industries, and then it spread into the processing industries whose development had been demonstrating a high rate of growth for a number of years. In Q IV 2008, for the first time after the 1998 crisis, a negative rate of development was observed in industry. The crisis in industry was marked by a rapid production decline in the processing industries. Until mid-2009 the situation was determined by the influence of inertia and the factors that had emerged during the acute phase of the financial crisis in 2008. The deepest slump in production with regard to the main types of economic activity was recorded in the first half-year 2009, when it amounted to only 13.9 % of the level recorded in the same period of the previous year. The drop in industrial production in the first half-year 2009 amounted to 14.5 %, including 22.3 % in the processing industries. Investments in fixed assets in that period dropped by 10.5 %, and those in the consumer market shrank by 2.5 %. The unemployment indices at that time reached their historic high – 8.8 % of the total number of employed.

From the second half-year 2009, in response to a revival of the external demand coupled with the anti-crisis measures, the situation began to improve, and so the year's results on the whole demonstrated that industrial production dropped by 9 % of the previous year's level, including by 0.6 % in the extracting industries and by 15.2 % in the processing industries. However, the situation was complicated by the persisting downward trends on the consumer and investment markets. As seen by the results of the year 2009, retail turnover dropped by 4.5 %, and investments in fixed assets – by 16.2 %.

With the rebound in demand on the international and domestic markets for energy carriers, the growing rate of extraction of mineral resources in Q IV 2009 once again triggered development in the processing industries. Growth of industrial production in the first half-year 2010 amounted to 110.2 %, including by 105.8 % in the extracting industries and by 114.3 % in the processing industries.

In Q III 2010 there occurred a slowdown in the rate of economic growth as a result of a drop by 18.6 % on the same period of the previous year in the volume of agricultural production, as well as a slower growth of exports. The industrial production index in Q III 2010 amounted to 106.3 %. However, in Q IV, alongside a sufficiently high growth rates displayed by investments and the consumer market, the rate of growth in industry was recorded at the level of 6.5 %, including 9.9 % in the processing industries (*Fig. 6*).

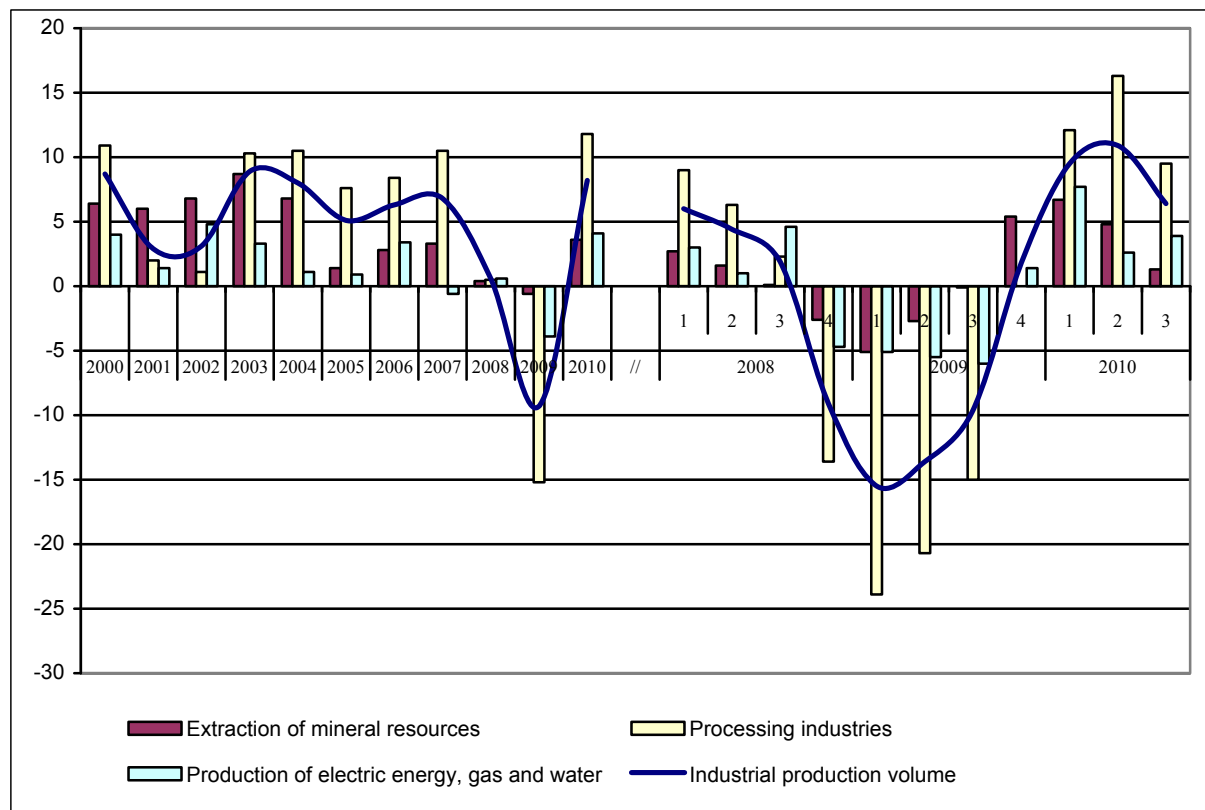


Fig. 6. Changes in the Rate of Production Growth in Industry, by Type of Economic Activity, in 2000 – 2010, as % of the Same Period of a Previous Year

The rate of development in the processing industries differs rather significantly depending on the type of economic activity, with the strongest influence on the specificity of rehabilitative growth being exerted by the ratio between the rates of production of capital and consumer commodities. While the rates of production of foodstuffs, leather products and footwear, coke and petroleum products, chemicals, and rubber and plastic products in 2010 rose above their pre-crisis level, the production of machinery and equipment, means of transportation and metallurgical products were below their 2008 indices (*Table 10*).

In view of the sufficiently strong fluctuations of the rate of growth between different types of activity across the processing industries, the plummeting rate of output in machine-building became a dominant factor that negatively influenced the level of business activity in related industries (construction materials and other types of intermediate commodities). The slump in the machine-building complex from Q IV 2008 onwards entered an acute phase, and the rate of production there throughout the year 2009 was far below the average level production in the processing industries.

In 2010, the rate of development in machine-building shifted towards positive values. Thus, in particular, the measures undertaken by the government in order to support the motor-car industry, including those designed to promote demand, resulted in a revival of domestic production growth.

Table 10

**Production Indices, by Type of Activity, in the Processing Industries
in 2008 – 2010, as % of the Same Period of a Previous Year**

	2008	2009	Q I	Q II	Q III	Q IV	2010	Q I	Q II	Q III	Q IV
Processing industries	100.5		76.1	79.3	85.0	100	111.8	112.1	116.3	112.6	109.9
Production of foodstuffs, including beverages and tobacco	101.9	99.4	97.5	97.5	97.8	103.9	105.4	103.8	106.4	105.4	105.9
Production of textiles and garments	94.6	83.8	79.1	78.0	82.6	95.9	112.1	110.2	115.6	111.4	111.3
Production of leather, leather products and footwear	99.7	99.9	85.8	97.3	104.5	112.3	118.7	126.3	120.0	111.4	118.4
Timber processing and timber products	99.9	79.3	71.7	74.7	79.8	92.4	111.4	111.1	112.6	111.4	110.5
Pulp and paper production, publishing and printing	100.3	85.7	78.1	82.9	86.3	96.5	105.9	106.7	109.3	106.7	97.8
Production of coke and petroleum products	102.8	99.4	95.8	99.8	100.2	101.6	105.0	104.7	105.3	103.5	106.4
Chemical production	95.4	93.1	77.9	86.4	91.9	123.1	114.6	123.8	115.7	112.5	108.1
Production of rubber and plastic products	122.8	87.4	72.7	84.7	89.3	101.4	121.5	122.8	119.2	121.9	122.4
Production of other non-metal mineral products	72.5	72.5	63.5	66.6	75.0	85.1	110.7	104.9	114.2	109.1	113.2
Metallurgy production and production of finished metal products	97.8	85.3	70.0	75.2	86.3	114.4	112.4	118.8	119.6	107.3	104.8
Production of machinery and equipment	99.5	68.5	56.5	62.5	70.7	87.8	112.2	109.1	130.5	101.4	110.5
Production of electrical, electronic and optical equipment	92.6	67.8	56.8	61.3	69.9	82.4	122.8	130.4	127.5	117.3	119.3
Production of means of transportation and transport equipment	100.4	62.8	61.0	59.2	56.7	74.3	132.2	113.3	141.2	138.1	135.9
Other industries	98.3	79.3	67.3	70.7	82.7	98.5	117.7	130.7	135.4	117.1	111.4

Source: Rosstat.

Over recent years, imports have continued to significantly influence the rate and character of development in the machine-building sector. This phenomenon occurred due to the fact that the very low competitive capacity of many types of machines and equipment by comparison with their imported foreign counterparts in terms of the price/quality criterion, as well as lack of proper capacities for the production of state-of-the-art technologies imposed considerable restrictions on the market available for the domestic machine-building products. The influence of imports varies significantly between different sectors of the economy and commodities markets. Growth of imports on the market for investment-linked machine-building products was one of the main factors that promoted investment projects, modernization of production the implementation of technological innovations. At the same time, imports competition became more acute, in particular in sectors like machine-tool manufacture, agricultural machine-building, production of construction machines and the motor car industry. These industries were characterized by low levels of investment activity, high rates of depreciation of fixed assets, backward technologies; one of the promising areas of development there was the transfer of foreign companies manufacturing facilities into Russia's territory (assembly plants). An accelerated output growth demonstrated by companies with the participation of foreign capital was altering the competitive environment and promoted the tradi-

tional types of production. However, it were those types of production that proved to be the most vulnerable ones in crisis conditions, because for many years no relevant steps had been taken in order to promote the production of parts by domestic enterprises. Given the well-developed network of inter-branch links in machine-building in general and in the motor-car industry in particular, the plummeting output there had a very painful effect on related industries and the infrastructure, as well as the employment level.

The 2008 crisis hit hard the Russian motor industry: domestic producers were forced to temporarily halt their conveyer belts and to cut their personnel. The dramatic drop in demand negatively influenced production development (among other things, because of the unattractive terms of consumer credits, declining incomes of the population, and overproduction which resulted in increased stock reserves, as well as difficulties experienced by domestic companies when trying to attract credits for replenishing their current capital). The foreign producers operating in the territory of Russia suffered from the instability of the currency exchange rate, because the bulk of spare parts (80 – 100 %) was being imported from the far abroad. Thus, the once very promising Russian market for motor vehicles quite soon began to resemble the stagnating European market, the only difference being that the number of passenger cars per capita in the Russian Federation had never reached the indices typical of West Europe. As a result of the crisis, in 2009 the production level in the Russian motor industry dropped by 60 %, including a drop in the production of domestic brands by 36.7 % as compared to the pre-crisis year 2008, in the production of foreign brands by 47.2 %, and in the import of new cars by 39.7 %.

The roles of raised import duties and the ruble's depreciation were roughly equal, in that the expenditures of Russian sellers rose by nearly 50 % (ruble-denominated). As a result, import of second-hand cars became unprofitable, because their price was higher than that of the foreign-brand cars manufactured in Russia. In this connection, while total sales of imported cars dropped by more than 3.7 times, the sales of new cars dropped 2.5 times, and those of second-hand cars – more than 25 times. The leader in the decline of motor car sales became the passenger car segment as a result of increased import duties.

The program of anti-crisis measures adopted by the Government of the Russian Federation for 2009, including the measures designed to regulate customs tariffs, made it possible for Russian car manufacturers to overcome the consequences of the economic crisis and to avoid bankruptcies and production stoppages through increasing their market share and thus compensating them for their losses resulting from the general drop in sales on the market. Besides, it created additional incentives for the founding of strategic alliances between biggest Russian and foreign producers.

In order to promote investments and the general financial rehabilitation of enterprises, government guarantees were granted to motor car manufacturers. The Open-end Joint-stock Company *Avtovaz* received financial support. Besides, companies' debts were restructured and the interest rates on credits attracted for the purposes of technological upgrading were subsidized.

In 2010, in addition to the previous decisions, the following measures were planned:

- continuation of the program for granting preferential credits to individuals willing to purchase motor cars of the Russian make;
- prolongation of the mechanism for government purchases of motor cars from Russian producers recognized as 'sole suppliers';
- launching of the program that envisages the purchase by individuals, with a discount of 50,000 Rb, of new Russian motor cars in return for old cars submitted by them for dis-

posal; the funding allocated for the program amounts to 11.05 bn Rb; it is planned to utilize up to 200,000 cars in this manner;

- the decision concerning the continuation of subsidizing Russian motor car manufacturers in order to compensate them in part for the payment of interest on credits attracted for the purposes of technological upgrading.

The government anti-crisis measures stabilized the situation, and so motor car output growth in 2010 was 1.7 times higher than the same index for 2009, including a twofold growth of output of passenger cars, a 1.65 times increase in the output of freight motor vehicles and a 1.26 increase in that of buses. Experts predict that the pre-crisis level of the motor vehicle market will be once again achieved by 2013 – 2014.

Nearly all the newly introduced measures had a positive effect on production and the situation on Russia's motor vehicle markets, and also moderated the negative processes on the labor market. While recognizing the significance and efficiency of the short-term anti-crisis measures, it should be emphasized that the stability of development on the motor vehicle market will depend on adequate solutions to the existing fundamental problems and on the implementation of an equally adequate strategy for developing the motor car industry.

The current situation in the Russian motor industry is rather controversial. The rapid growth of the domestic market in the period prior to 2008 sustained by the increasing incomes of the population and expanding consumer crediting as well as by the strengthening of the national currency was accompanied by structural changes in demand, when the share of domestic producers on the motor car market was shrinking alongside a simultaneous intensification of competition inside certain price segments between the foreign-brand cars assembled in Russian territory and imported new motor cars.

The government policy aimed at attracting foreign investments into the motor industry benefited end consumers, but were still insufficient for ensuring a comprehensive development and restructuring of the motor industry.

A significant impact on the dynamics of production was produced by the government program 'The Experiment Designed to Promote the Acquisition of New Means of Automobile Transport in Return to Those Taken Out of Service and Submitted for Utilization'. The age structure of the existing motor car fleet is quite disadvantageous. The mean age of a motor car in Russia is 12 years, and vehicles aged less than 5 years constitute only 26 % of the car fleet, whereas in Europe and the USA the mean age of a motor car is 8.5 years. The per annum rate of withdrawal of old vehicles from the motor car fleet in Russia is 3 – 4 % against 6 – 7 % in developed countries. It should be admitted that utilization of vehicles – given the current changes in the situation on the domestic market, the rate of production and imports – will have only a short-term effect that will soon disappear if such measures are not sustained by a comprehensive strategy of long-term development of the motor car industry. It appears that the age structure of the motor car fleet can be changed more efficiently by measures aimed at promoting purchases of new vehicles, namely establishing a tax on motor cars depending on their ecological class; subsidizing those consumers who buy vehicles of a higher ecological class; increasing the cost of insurance for second-hand vehicles; introducing tougher requirements for mandatory technical checks, etc. A comparison of the domestic motor car industry with foreign practices can serve as an illustration of Russia's significant lag in terms of production volume and investments in companies' fixed assets, research and development, and labor productivity. The funding earmarked by Russian motor car producers to research and development does not exceed 1 % of their annual proceeds, whereas for the leading foreign

manufacturers these expenditures amount to 4 – 5 % or more of their annual turnover. This results in the development cycle of new car models in Russia being much longer than in the case of the world production leaders, and so the rate of renewal is much lower in the case of the former.

The loss of a significant market share has resulted not only from the low level of the domestic motor car technologies, but also from insufficient investments in the development of new platforms and models, from the limited number of models and options offered to the consumers. Russian companies have invested in the development of their industry a share of their proceeds that is 4 – 5 times less than that of their foreign competitors, which is the result of the inefficiency of the financial mechanisms available to them, including those designed to attract credits.

The insufficient competitive capacity of the domestic motor industry's products is the outcome of low investments in fixed assets. This phenomenon can be explained, on the one hand, by the high cost and short terms of the available investment credits, which cannot be taken full advantage of because of the low rate of return on production (traditionally between 6 and 8 %) and companies' solvency levels; and on the other, by insufficient motivation for the government to make investments in the motor car industry.

In order to achieve the long-term development goals for the motor car industry, substantial capital investments will be necessary in the following key areas:

- creation of new production capacities for manufacturing motor cars, their parts and engines, in order to satisfy the growing demand by domestic products;
- modernization and technological upgrading of the existing production capacities in order to bring them up to a competitive level in terms of efficiency, productivity and product quality;
- research and development aimed at creating new platforms and models, the components and equipment needed for the production of those models, as well as purchase of licenses and adaptation of global platforms within the framework of collaboration with international partners;
- financing of current capital needed for sustaining the forecasted growth of sales on the Russian market.

* * *

Our analysis of the main macroeconomic trends has led to the following conclusion. Although in 2010 the Russian economy actually came out of the acute phase of the crisis, the unstable dynamics of the main macroeconomic indices, the slow exit from the crisis of the investment, financial and crediting sectors of the economy, and the complicated situation on the labor market are still imposing a system of restrictions to development in the short-term period.

The national economy continues to be dominated by the same factors that determined the speed and depth of its decline during the crisis and the insufficiently rapid elimination of the acute crisis phenomena: its dependence on changes in the world prices for Russia's exported raw materials; low domestic demand and a lax attitude of domestic producers towards making interventions on the most promising markets for consumer, investment and intermediate commodities; and a weak financial system.

The creation of necessary economic conditions for the economy's transition from the anti-crisis mode to rehabilitative growth implies implementing a system of measures aimed at modernization of production capacities, enhancement of innovation activities, and improvement of the quality of human capital.

4.2. Russian Industrial Enterprises in 2010

The section was prepared based on the materials of the surveys among managers of industrial enterprises, conducted by IEP in compliance with the European harmonized methodology monthly, from September 1992 and cover the entire territory of the Russian Federation. The panel is about 1100 companies, which employ more than 15 per cent of the total employment in the industry. The panel is biased towards large enterprises in each of the sub-industries. Feedback on questionnaires is 65-70 per cent.

Industrial surveys (IS) among business leaders is a quick way to gather information about the assessment of the situation in their enterprises and the expected (planned) changes in the key performance indicators of the enterprise. IS is a relatively new tool of economic analysis. The first survey was conducted by IFO Institute (Munich, Germany) in 1949. Soon afterwards such polls have been held in Great Britain, France and Italy. Since 1962, the EU is making efforts to harmonize (make comparable) the surveys in the countries of the continent.

There is a rather small number of questions in the IS questionnaire (no more than 15-20). The questions are of qualitative, rather than quantitative nature. Simple design of questions and answers allows the respondents to fill out the forms quickly and without involvement of other employees or any documentation. It is essential that the respondent in each enterprise should be the Manager of the top level, who has a complete Fig. of the situation at the enterprise and directly involved in the company management. In 2008 28 per cent of responses to the IS questionnaires were received from the Directors of enterprises, 37 per cent - from the Deputy Directors, 22 per cent - from the leaders of economic departments.

In analyzing the results of industrial surveys a specific derivative index is applied, known as balance. Balance is calculated as the difference between the percentage of respondents given the answer about their business standing as "increasing" (or "above regular" indicators) and the percentage of respondents whose assessment was as a "declining" (or "below regular"). The resulting difference allows to sort the answers to each question by one number with the sign "+" or "-".

Balance is interpreted as the first derivative or the process rate. If the balance of answers to the question about the expected price change is with the sign "+", it means that the average prices in the near future will continue to grow (for example, there dominating the companies, reported on an expected increase in their prices). The increase of the balance within a month from +10 to +17 per cent means that average prices in the industry will grow more intensely as the increased prevalence of companies, predicting growth. A negative balance means a decrease in average prices (more companies are going to lower their prices). Changing the balance from -5 per cent to -12 per cent is interpreted as plans of the intensity of prices lowering.

4.2.1. First Quarter: an Attempt to Recover from Crisis

In early 2010, Russian industry continued its recovery from the crisis. The dynamics of sales and estimates of the demand allowed businesses to maintain output growth and demand forecasts, backed up by the portfolio of orders, showed the formation of the most popular hopes for recovery from the crisis.

In January 2010, the demand for industrial production for the first time during the current crisis has ceased to decline: the share of reports on falling sales reached the level equal to the reported growth. However, the improvement of the dynamics of demand in comparison with quarter IV of 2009 was negligible and noticeable only to those that was close to zero. Here-

with, the original data quite adequately reflected the nation-wide ten-day vacations, having demonstrated the decrease, which is not cleaned from seasonal factors balance by 8 points versus January level, recorded in 2002-2008. Thus, the January (2010) dynamics of the demand proved to be quite comparable to the pre-crisis level.

This thesis is confirmed by the indicators of satisfaction of the total demand. The share of normal ratings has increased immediately by 10 points and reached 42 per cent for the industry in general, which was the maximum peak over the months preceding the crisis (see *Fig. 7* at the end of this section). January 2010 was not such a disaster for the Russian industry, as one might expect is projected November - December 2009.

In January 2010, industrial production, as estimated by businesses, continued (after cleaning from seasonal factors) its growth with the same intensity. Thus, the surveys recorded the output growth over the past five months. The initial data (before treatment on the season) showed, of course, in January the decline in production, but it was the same as happened in January 2002-2008 and two point five times less than in January 2009. In other words, the dynamics of output began to come back to normal after the level of demand.

Production plans of enterprises at the beginning of the year have been improved as compared with the plans, registered in December, by 52 points at a time. Such a sharp rise in optimism has not been mentioned even once in the original surveys over 1992-2010. Clearance from seasonal factors significantly adjusted growth of this indicator (up to 10 points), but the result was still decent (it gave way to Crisis maximum only by 1 percentage point).

The growth of optimism in the plans of production output had quite certain grounds in the industry. According to the companies, the new year of 2010 started with the active portfolio extension. The orders scope for the quarter increased from 4.9 to 6.5 months and therefore, reached the pre-crisis level (January 2006 – 6.7; in 2007 – 6.7; in 2008 - 7 months).

Pricing policies of enterprises in early 2010 was influenced by the growth in demand for manufactured products and the traditional New Year upsurge in prices and tariffs. However, both factors at this time, though not as strong as at the best of times, pushed up the actual price dynamics and price plans of the manufacturers, although a modest crisis result of January 2009 was, of course, surpassed. In January 2010 a moderate decline of prices in November - December gave way to a more intensive growth. The January growth rate of the wholesale prices reached the maximum of the previous crisis months and had all the chances to continue - pricing plans for businesses, too, have reached the crisis peak in January.

HR plans of enterprises suffered in January 2010 the most significant changes. Within the month the balance of intentions has changed from sharply negative (reduction of employees) (-25 points) to expressly positive (recruitment) (+7) and has become another crisis maximum peak (see *Fig. 8*). Thus, the Russian industry for the first time during the current crisis has declared of the desire to abandon the dismissals and start to hire employees.

Reduction in the number of employees and the positive dynamics of the main industry performance indicators have helped the companies to recover the situation with the payroll. In early 2010, the normal level of salaries of workers and engineering manpower went to the Russian industry 49 per cent of enterprises (see *Fig. 9*). Before the crisis, this figure exceeded, as a rule, 50 per cent and reached 60 per cent, while the share of enterprises with low wages (below normal level) was then about 40 per cent. In January 2010, the latter indicator dropped from the crisis peak of 59 per cent (in the II quarter of 2009) to 47 per cent.

In February the industries have again demonstrated the dynamics of sales and production, similar to the pre-crisis level. The growth of demand rate (based on initial data) in February

has improved significantly for the first time during the current crisis and ceased to be negative, i.e., the share of enterprises whose sales have increased, becoming equal to the shares of the enterprises, decreasing the sales. But the removal of seasonality has reduced the optimism of the data cleared from seasonal factors - in the industry there were only minimal for the current crisis reduced demand for products, which, incidentally, also looked very good as compared with what happened a year earlier.

In February, the share of normal estimates of demand fell by 9 points and rolled off to the level of September - October 2009. This figure indicated the sharp swings since November 2009, which indicates the disorientation of producers, who do not seem to understand what is happening with the economy and what sales volumes should be considered adequate to the current economic situation.

Production growth rates in the Russian industry (after seasonal clearing) got stabilized at a moderate increase in output. A baseline data, as well as data on demand, have demonstrated quite traditional for 2003-2008 February upsurge. It seems that the dynamics of output in the Russian industry was returning to the pre-crisis trend. Production plans of enterprises in February, too, traditionally (like in pre-crisis period) have improved since the January jump-up in optimism. As a result of the initial data for January - February 2010, the balance of the planned changes in production rose by 68 points: from -25 in December to 43 in February (in 2008 the growth in the same period totaled to 48 points in 2007 - to 43 points and in 2006 - by 51 points). Clearance of the seasonal factors has the New Year growth before stabilization at the level of 21 points, which was the crisis maximum peak.

Idle capacities for the planned increase in production by industrial enterprises was sufficient enough. In late 2009 - early 2010, the excessive capacity (in view of the anticipated changes in demand) were available in 30 per cent of enterprises (see *Fig. 10*). Thus, it is not just idle capacity, it's power capacity whose use is impossible even with quite optimistic forecasts of demand. The minimum level of security with such "square" was the capacity registered in early 2008 - up to the peak of the very strong heating of the Russian industry made - and 11 per cent.

Another indicator of the possibility of rapid recovery of growth is the mentioning of the lack of equipment by enterprises as an obstacle to growth in production output - from the beginning of 2009 - averaged 10 per cent and was three times lower than the historical maximum (32 per cent), registered in mid-2007 (see *Fig. 11*).

The growth of prices at the beginning of the year in the industry remained at the highest in the previous 18-month level. Businesses for the third time during the current crisis have turned to price upsurging. The first attempt in March 2009 resulted in the balance of price changes by 2 points, the second one (in September 2009) - by 7 points, in February 2010 for the second consecutive month the price growth was kept at 11 points. The pricing plans reflected the intention of businesses to continue, or at least to keep such price growth rate in coming months.

In February 2010, the industries have recorded the most moderate rates of staff dismissal since the beginning of the crisis assessments. Balance within the month has grown by 23 points and almost reached the zero level (no layoffs in general in the industry). In February, recruitment of workers is resumed in the food, light and building industries. The balance for plans of changes in employment for the first time during the current crisis has entered the positive zone - the companies confirmed their intention to move from a reduction of workers to their employment.

Availability of credits in the industry has reached 64 per cent (see *Fig. 12*) in February 2010. Average minimum lending rate has decreased to 16.4 per cent per annum in rubles. Banks continued to reduce the thresholds to access to their monetary resources. In the first place – to the ferrous metallurgy entities (normal access was provided to 98 per cent of the enterprises, the average minimum rate of 14.4 per cent per annum), to chemistry and petrochemistry enterprises (79 and 14.1 per cent), to food businesses (66 and 14.7 per cent) and machine-building (61 and 13.7 per cent) sectors.

The share of bad credits in the industry has declined in early 2010 to 23 per cent (the share of businesses with loans and not able to serve them). Crisis maximum of this index (49 per cent) was registered in April 2009

The first quarter of 2010 was the best since the crisis began, but clearly worse in terms of dynamics. Recovery from the crisis has slowed down. In March, the dynamics of demand has shown only a stabilization of about zero, the fall in demand has decreased, while there was no growth yet. As a result, two thirds of businesses were dissatisfied with sales of their products and only one-third considered them normal. The most comfortable feeling in the first quarter of 2010 was observed among the businesses of food industry (64 per cent of satisfaction), chemistry and petroleum chemistry (55 per cent) and non-ferrous metallurgy (54 per cent). Demand forecasts for the I quarter 2010 have stabilized, remaining the best since the crisis beginning and comparable with the level of the first post-default years. Despite the lack of sales, the businesses had not allowed the increase in surplus stocks of finished goods at their warehouses. Balance of estimated reserves in general in the industry did not change and remained at the crisis level (less the upsurge in November 2009) and at the level of reasonable redundancy, typical for the pre-crisis years.

The intensity of output growth by the end of the first quarter of 2010 has reached the rate of growth of +34 balance points, which was normal for the pre-crisis years. Purification from seasonal factors has decreased the growth rate to +11 balance points, which was the best during crisis and was already comparable to the pre-crisis value of this indicator. Plans of output, as well as demand forecasts, have demonstrated the record in stability (before and after purification from seasonal factors) in the first quarter of 2010. Growth of output in the second quarter should have dominated in all sectors.

The growth of wholesale prices in Russian industry in the first quarter of 2010 remained the highest in the current crisis in terms of intensity. In March all sectors increased the prices, except for the construction industry, which has turned from the policy of reducing prices to the stability thereof. The most intensive growth took place in March in chemical and petrochemical industries (+35 b.p.). However, in the second quarter industry was planning to slow down the prices growth: the New Year inflation upsurge was over. The balance of anticipated changes in prices within March has decreased by 6 points and returned to the level of November 2009. After that, the industry started "price attack" for four months, whereas the previous two ones lasted for two months each.

In March 2010 the industry for the first time during the current crisis has turned from layoffs to hiring employees. Such plans have appeared in January, survived in February, and finally were realized (see *Fig. 8*). Layoffs continued only in metallurgy and timber industry, while in the other industries the number of personnel was growing, particularly intensively in food and light industries. Positive trend in employment growth gained in intensity during all the I quarter.

4.2.2. Second Quarter: a Pause

At the beginning of the II quarter the Russian industry demonstrated an adaptation to the stagnation of I quarter 2010. Growth rate in demand for industrial products got stabilized in both, according to the initial data and purified from seasonal factors. But the dynamics of demand within January - April was the best since mid-2008, when the global financial crisis has only started in Russia. However, demand forecasts, which jumped up in January, started to decline.

The assessments of finished products stocks have also stabilized since December 2009 - excessive stocks the industry has established the traditional for the pre-crisis months (see *Fig. 13*). The majority and stable part of the enterprises (60-64 per cent) believed their stocks were normal since September 2009. In the I quarter of 2010 the physical volume of stocks of finished products continued to reduce. However, the rate of decline gradually reduced, but the plans for the II quarter reflected the intention of businesses to increase the intensity of the stocks reduction.

In April, the change of the output rate has not undergone fundamental changes. Manufacturing continued its growth with a modest (by pre-crisis standards) intensity, which according to the businesses estimates, has not changed since September 2009, when the producers did not recon on special demand growth. In April, output plans have undergone the strongest negative adjustments in January 2009. A small but steady growth in production in April resulted in industrial capacity utilization to 66 per cent (see *Fig. 14*). With such intensity the equipment was used prior to the crisis in 2005. Herewith, the crisis minimum indicator was recorded in January 2009 and amounted to 53 per cent.

Estimates of excessive capacity have confirmed the positive dynamics of their utilization. In the II quarter of 2010 the share of companies with excessive capacity has decreased to 24 per cent, which also corresponds to the level of 2005. In January 2009 43 per cent of responses "more than enough" have been obtained. Absolute pre-crisis minimum (January and April 2008) of this indicator was 11 per cent.

The businesses continued to regard the insufficient demand for their production as the main obstacle to the growth of output. In the II quarter of 2010, it was mentioned by 53 per cent of manufacturers (the crisis maximum of the I Quarter 2009 was 67 per cent). In the second place was the lack of funds, which was mentioned in the list of barriers by 45 per cent of the companies. Decrease of this hindering effect during the crisis quarters was only 5 points - that is, there were no significant changes here. The third place was taken by the main problem of the Russian industry, i.e., the lack of staff! It was mentioned by 26 per cent of enterprises, the crisis minimum a year earlier amounted to 14 per cent. In the fourth place there were non-payments of customers and competing imports. Mentioning of non-payment has reduced during the crisis from 41 to 22 per cent, mentioning of imports has increased from 13 to 21 per cent. Vagueness of the current economic situation made it difficult to take decisions only to 20 per cent of the directors of industrial enterprises. A year ago, this factor was considered a hindrance by 45 per cent of IEP (among which 90 per cent were enterprise directors, their deputies and heads of economic units). Thus, the management of enterprises was clearly better informed of the situation.

In April 2010, Russian industries continued to increase the number of their employees. Growth rate remained unchanged as compared with March level, when for the first time during the crisis recruitment exceeded the dismissal level. Staffing plans of the enterprises in April have not changed – for the fourth month in the industries intentions to increase the staff

were dominating. As a result, by the II quarter of 2010, industries got rid of the excess of employees in view of anticipated changes in demand: the share of "more than enough" estimates caught up with the share "insufficient" estimates; the balance was zero (see *Figure 15*). The crisis maximum of this balance has been registered in the I quarter of 2009 and made 26 points, the absolute minimum during the pre-crisis period (-20 points) was recorded in the I quarter 2008. At the level of individual industries a shortage of employees was noted: the answers "insufficient" became dominant in the light industry and construction industry.

Easy access to credits for the industries continued to grow: in April, the normal access to borrowed funds already had 61 per cent of the enterprises. However, within four months in 2010 this indicator increased only by 7 points, whereas in the IV quarter of 2009 it has grown by 14 percentage points. Lending recovery for the Russian industries has definitely slowed down. Average minimum interest rate on ruble loans offered by the banks was decreased in April for the industry in general to 15.7 per cent per annum.

The ability of businesses to serve the existing loans continued to increase. In April 2010, already 78 per cent of the holders of loans thought so, while in February there were 72 per cent of them. Crisis minimum of this indicator (50 per cent) occurred in April 2009. Minimum financial solvency in terms of credit in the II quarter of 2010 were: mechanical engineering (recognized by 24 per cent of businesses with loans), construction industry (also 24 per cent) and LESPROM (22 per cent). The highest self-esteem of solvency has been registered in the metallurgy: only 2 per cent of the industry have acknowledged their failure to service loans.

In May, the weak positive trend in demand for industrial production remained. The rate of sales growth has improved (after cleaning from seasonal factors) for further 2 points and has become more positive - sales began to grow more steadily. Since the beginning of the year, the indicator upgraded by 10 points – insufficient to overcome the crisis, but it is important that the growth is sustained, as in the IV quarter of 2009 the rate of changes in demand has stabilized at a negative level (i.e., the sales level was still declining). In May, the demand estimates were still positive (sales growth continued), but clearly less than at the beginning of the year.

In May 2010, the satisfaction in demand has increased to 58 per cent for the first time during this crisis having exceeded the share of responses "below normal" and has reached the pre-crisis level (September 2008). The gap from the crisis bottom (19 per cent, April 2009) has already reached 39 points. The highest satisfaction with sales volumes was registered in August 2007 and amounted to 72 per cent. Formally the difference between that absolute maximum made 14 points. The sharp increase in sales satisfaction in the previous months (23 points in March - May) at the background of a very slight change in their growth rate (by 6 points over the same three months) demonstrates, that the industries in the II quarter finally came to terms with the sluggish recovery from crisis and had little hope for restoration of former high growth in demand and output.

However, the normal level of demand for businesses before the crisis and that in 2010 are not the same, which is demonstrated by production capacity utilization. On average in 2007, the demand was considered normal if 77 per cent of capacities were utilized, and in the II quarter of 2010 that level reached 72 per cent. In 2001 production capacity utilization with normal volumes of sales was 62 per cent.

The growth rate of output in May has increased (after cleaning of seasonal factors) to 15 points and as a result has reached the maximum of the previous crisis months and the level of

the average indicator of the first half of 2008. In I quarter of 2010 the growth was 10 points, in the IV quarter 2009 - 9 points. Planned output growth have also reached the crisis maximum. In May 2010 they caught up with the plans of August 2008

In May, prices of enterprises continued to increase. The rate of their change since the beginning of the year were within the range of 9 + 13 points, which definitely indicated the confidence of producers in their market power (see *Fig. 16*). Within the twelve months out of twenty months preceding the crisis, companies have been forced to reduce prices.

At the end of the II quarter low demand for industrial products has become a matter of concern to enterprises, forcing them to amend prices and HR policies, but has not prevented the growth of output and control over stocks of finished products.

In June, the growth in demand for industrial products was sustained, but the rate of its growth has remained very low, little different from zero. Therefore, in the middle of the year there was only a pause in falling sales. The total growth of demand for industrial products has not yet begun. The situation of "neither growth nor decline" was recorded in October 2009 surveys, when the difference in changes of demand for the first time during the current crisis was close to zero. As a result, for the third consecutive quarter there was no substantial progress in the dynamics of sales in the industries.

This uncertainty provoked nervousness in the enterprises assessment of the current sales. Before July 2009 the share of "normal" assessments for about 8 months remained at the bottom of the crisis (satisfaction was at the stable level of 23 per cent), and then went up to the next level of 35 per cent. Then the uncertainty in the industries became to vary: the satisfaction jumped from 33 to 54 per cent at near-zero growth in demand (see *Fig. 7*). Producers seemed to be trying to figure out, what is happening in the economy and what volumes of demand are adequate to the situation. As the result, in the II quarter of 2010 the enterprises of ferrous metallurgy (74 per cent were satisfied with the sales), chemical and petrochemical enterprises (71 per cent), and food industry (64 per cent) were able better to adapt to the industrial demand dynamics.

Dynamics of stocks of finished goods assessments in the first half of 2010 had a steady positive trend, demonstrating a good management of supplies in this crisis. Only within six months (from November 2008 to April 2009) industries had the highest excessive reserves at their warehouses. In May 2009 the balance of assessments has returned to the level of 2004-2005, and from December 2009, it was declining gradually to the indicators of 2006-2007. The problem of stocks of finished goods, so acute in the Russian industries in the 90 years of the twentieth century, was the most easily solvable in this crisis.

According to the surveys, output growth in June reached the next crisis record and was closer to the values of this index began in 2008 (see *Fig. 17*). Therefore, the industries in September 2009 have demonstrated quite good and stable production growth in the time of crisis. Output plans in the first half of 2010 maintained high and relatively steady optimism.

In June the companies had again decided to use price leverage to promote sales of their products and suspended the growth of wholesale prices, which was in effect from the beginning of the year. Monthly rate of price growth has declined from the crisis peak to almost zero (see *Fig. 16*). There was no such a significant pricing adjustment since December 2008. And the price plans of enterprises since March stabilized at the level of actual growth rate of January - May, indicating that the June adjustment was unplanned and demonstrating the desire to restore the growth of prices in the coming months.

In June, industries have continued recruitment, which began in March. The growth rate of employment within all those months was low, but stable. Businesses were accurate in labor market policies, selecting, apparently, the most skilled workers. Nevertheless, their forecasts for the next six months fell down to a minimum. According to the estimates, in 2010 the companies were more focused in planning its staffing policies on the forecasts of demand, rather than on the output plans. In 2009 the situation was reverse. In 2005-2007 hiring of employees was also dependant on the demand.

The ability of businesses to pay the loans was in the middle of 2010 81 per cent (among those who had credits), but remained virtually unchanged for two months. The worst indicator (monitoring began, unfortunately, only in March 2009) was recorded in April 2009. Afterwards only 50 per cent of the companies, who took loans, recognized their ability to pay its debts. Other 50 per cent critically assessed their ability as insufficient. This distribution of ratings in responses to such a delicate and painful issue demonstrates, in our opinion, the reliable answers of enterprises. The highest inability of businesses to service their loans was recorded in April - June 2010 in construction materials industry. It was noted by 26 per cent of businesses with loans. In second place was mechanical engineering - 22 per cent, in the third place - LESPROM (18 per cent). Only steel mills were confident in their credit ability for 100 per cent.

4.2.3. Third quarter: there is no more optimism

The lack of positive trends in the sales dynamics has misled the businesses, started to affect the forecasts and to restrain output growth at the beginning of the second half of the year.

The intensity of demand growth in July did not experienced significant changes and remained almost at the zero level: there was neither particular growth, nor significant reduction of sales in the industry. Similar dynamics of sales was recorded in the surveys in February 2010. The similar Fig. was observed at the baseline data (before cleaning from seasonal factors), although in this case the absolute levels were somewhat higher. But the conclusion was the same: no changes in the dynamics of demand for industrial products were observed in the first half of the year.

This situation has forced the companies to change their estimates of demand again. As a result, in July they were improved by 13 points (in June, deteriorating by 17 points was noted), and got increased again - the share of answers "below normal" again proved to be in the minority. This indicator was highly volatile from the beginning of 2010, which indicated the absence of estimates of the current situation. Confusion in the state industrial statistics resulted in further aggravating of the situation. The lack of positive trends in demand has brought pressure on optimistic forecasts of businesses. In July, the expected changes in demand were the most pessimistic since the beginning of 2010.

In July, the surplus stocks of finished goods were expired in the industries in general – i.e., the share of responses "below normal" caught up with the share of replies "above normal". A similar situation was quite rare for post-default period: companies still prefer to have a small surplus of finished goods inventory to meet unexpected orders. In mid-2010 the share of replies "above normal" has fallen to historic minimum, while the share of responses "normal" has reached the historic maximum (see *Fig. 18*). This was the result of intense reduction of volumes (not to be confused with estimates!) of stocks in the II quarter. In the III quarter the

industries planned, despite the forecasts of Ministry of Economic Development, to continue to reduce their stocks, and most intensively in 2010.

Low demand has begun to hinder the growth of production in the Russian industry. In the III quarter it was mentioned as an obstacle to growth in output, which increased by 9 points and reached 61 per cent. In the second place remained a lack of operating assets, but the prevalence of this interference was reduced to 30 per cent, which was an absolute (!) minimum within total monitored period since 1993. The Fig. is complemented with 5 per cent share of responses on the lack of credits, which was recorded in the surveys of two consecutive quarters. In the third place there was the lack of personnel (a quarter of enterprises suffered from this factor over the past two quarters) indicated not so much about the current issues of industry, but demonstrated the high readiness of enterprises to respond on increased demand and that the businesses remember the staffing problems of pre-crisis years.

After five months of stable and relatively high (in terms of crisis indicators) increase of selling prices, in June - July the businesses attempted to activate demand for their products due to more moderate increase in prices. If in January - May 2010 prices were rising at the rate of 11 balance points, in June - July that rate fell down to 4 b.p. However, such an adjustment of price policy was not scheduled. This is reflected in the price plans of enterprises, who have maintained a high anticipated rate of price growth up to July.

HR policy of enterprises in the middle of 2010 was influenced by two opposing trends. On the one hand, the lack of growth in demand forced the companies to be cautious in hiring employees. On the other hand, the lack of growth in demand from month to month increases the probability of its recovery in the next month. The latter increased the industries readiness for the post-crisis breakthrough and urged them to accumulate resources for it (even more so - reserves), and in the first place - the most deficient ones. And in the pre-crisis years it was the personnel. As a result, at the beginning of the III quarter the businesses returned to the same (as in March - May) rates of increase of the number of employees (see *Fig. 8*).

Assessments of the current number of employees have confirmed the preparation of the businesses to increase production. In the III quarter due to anticipated changes in demand, the staff shortage in the industries has increased. For the first time the shortage (i.e., prevalence of "less than adequate" estimates) was recorded in the surveys of the II quarter of 2010. Meanwhile, there was no deficit in production capacity, typical for post-crisis output growth. The balance of capacity ratings was positive, i.e., responses of "more than enough" were dominating. In the III quarter capacity prevalence has even increased as compared with the II quarter of 2010, when hopes for an early exit from the crisis were stronger.

The struggle for deficient personnel forced the businesses to increase wages. In the III quarter of 2010, a normal (though, according to business leaders) salary level was achieved in 56 per cent of the plants (see *Fig. 9*). In the pre-crisis 2007, that indicator rose to 60 per cent, and during the crisis in 2009 it fell down to 37 per cent. In mid-2010 the estimates of the ratio of wages of employees has reached the pre-crisis level. It should be noted, that this is the estimated, rather than the absolute range of salaries.

In August, the Russian industries maintained the same rate of growth of output, prices, employment, but the deterioration in estimates of demand, sales, production planning and recruitment, prudent inventory management policy were demonstrating the growing uncertainty of enterprises.

Decreased demand growth in August did not surpass the zero level, which was sustained since February 2010, i.e., the businesses did not register demand growth for seven months

and got used to this situation. The latter urged businesses to make more realistic assessment of sales - in August 63 per cent of businesses estimated their sales volumes as normal (growth in comparison with July by 13 points). However, estimates of sales index remained the most volatile in 2010. Demand forecasts in August also demonstrated negative dynamics. Both, the original, and cleared from seasonal factors estimates indicated willingness of the industries to zero growth in demand in autumn 2010, whereas in the I quarter of the year the businesses expected sales growth at the rate of +10 ... +13 balance points. Therefore, the optimism of the beginning of the year gradually diminished. In August, for the second consecutive month, the businesses reported an absence of surplus stocks of finished products in the warehouses in the industries in general. The balance of assessments stopped in the negative zone, indicating that the growing prevalence estimates of "below standards" over assessments "above normal" and the uncertainty in demand growth.

Output growth in August, according to the businesses, survived and did not change as compared with previous months in 2010. However, in the autumn months the companies planned to move to a less intensive output growth. Estimated production growth decreased to the annual minimum, according to both, the initial and cleared from the seasonal factors indicators.

In August, the industries continued to hold their prices growth at one of the lowest level in 2010, and in general have not yet succumbed to inflationary fever of abnormally hot July - August. But the food industry, which to increase prices in May - July, in August has reported on the most intensive growth in 2010.

In August the industries returned to the former (+ 5points, as in March - May),rate of employees' recruitment. Therefore, the businesses continued the recruitment, even in the absence of growth in demand and with a deterioration of forecasts for output and sales. But in the next few months these positive processes were expected to stop. Plans to change employment rate in September - October have been reduced to the annual minimum and reached zero - the industries planned to stop recruitment.

Availability of credits after stabilization in May - July at 65 per cent in August has increased to 69 per cent - the banking system has again lowered the requirements to the borrowers from the industries (see *Fig. 12*). In August, it has involved mainly machine building plants, whose access to credits has increased from 64 to 71 per cent. The banks and food businesses were in the same position. But the metallurgy still remained at the first place (78 per cent). The light industry is treated by the banks in the worst manner. Average minimum interest rate for ruble credits offered by the banks in August has decreased to 13.5 per cent per annum, with a normal (for the businesses) availability of credits, it was 12.5 per cent.

The ability to service existing credits in the industries has stabilized at 80 per cent (of the number of businesses with loans) from April 2010. During this period 16-19 per cent of the enterprises recognized their failure to meet liabilities to the banks. Therefore, the prevalence of bad loans (of borrowers) in the industries in general has become stable. The greatest credit risks were registered in the construction industry (31 per cent of enterprises), in light (29 per cent) and wood processing (25 per cent) industries .

Final assessments of enterprises of their real (not reporting - for tax) financial and economic standing has stabilized in the II and III quarters of 2010 (see *Fig. 19*). The overwhelming majority (69 per cent) of producers estimated their position as satisfactory; herewith the share of such assessments did not change during four quarters and has become very close to the middle values of this index in the pre-crisis 2007, when it made 73 per cent. Therefore,

the industries have definitely overcome the crisis in financial terms. In the second place by prevalence were the businesses, estimating their financial and economic standing as "bad". They have stabilized too and averaged 21 per cent (10 per cent before the crisis). In the worst quarters of the crisis the share of these estimates increased to 36 per cent. The share of estimates "good" in the II and III quarters of 2010 has reached the crisis maximum of 9 per cent, but was too far from the average indices of 2007 (17 per cent).

In September, there were no significant positive changes in the dynamics of majority of indicators in the industries. Herewith the assessments of stocks of finished goods and recruitment policies have shown a growing uncertainty of the businesses in the future.

In September, there were no actual changes of demand for industrial products. Therefore, the stagnation of sales (growth rate does not exceed the range -3 ...+ 3 points) remained in the Russian industries since the beginning of the year. Prospects for growth in demand for products also improved in September as compared with August and also has not undergone significant changes against previous months of 2010. Businesses still have not seen tangible opportunities to increase sales of their products. Herewith, satisfaction with the current sales in September has decreased by 6 points, which was a modest change after the growth by 16 points within the previous two months (see *Fig. 7*). The industries, therefore, still remain in some hesitation about volumes of demand, which are adequate to the current economic situation.

The dynamics of assessment of stocks of finished products more and more clearly indicated, that the confidence of the businesses in the fast sales growth was getting less month by month in 2010. The share of responses "below normal" has reached in September 2010 the seven-years (!) maximum. Meanwhile, the share of responses "above normal" has reached the absolute (1992-2010 years!) minimum. As a result, the balance has decreased to 10 points after -2 and -3 points within the preceding months. It means, that the prevalence of estimates of "below normal" has become even greater in the industries. Such a low value of the balance of estimates for the reserves has not been observed in the Russian industries since 2000, when the businesses believed in the sustainability of the post-default growth and have moved from policy of minimized stocks to maintaining their abundance. In the III quarter there was observed a reverse trend in the situation development. However, there was no objective limitations for replenishment of the warehouses in the industries, some capacities were idle, there was no problem with staffing, credits became cheaper, sales volumes were low. However, the businesses need excessive stocks for quick execution of the new (unplanned) orders. Therefore, the reduction of warehouse stocks in 2010 was a deliberate policy of the Russian producers, who were losing confidence in the appearance of new customers and in soon transfer from stagnation to a noticeable increase in demand.

In general, until September the industries with extreme caution reacted to the inflationary boom, generated by the anomalous heat. The balance of the prices growth varied from +6 to +8 points (see *Fig. 16*). The reaction of food companies was, of course, the most expressed. While in June – July the share of reports on unchanged prices in the industries amounted to 92-95 per cent, in September it dropped to 62 per cent, whereas the share of reports on price growth has increased from 2 to 38 per cent. But plans to change the prices indicated the desire of the businesses to recover this inflationary impulse in future. In September, pricing intentions have not changed and remained within the indices of the preceding seven months. The exception was, of course, in the food industry, which had an intention to retain high actual rate of prices growth of September in October and November.

In August - September industries have nearly stopped the recruitment of personnel. The growth rate of the number of workers decreased to +3 points after + 8 points in July and +5 points in March - May. The businesses in spring and summer of 2010 began to create a reserve of skilled personnel in anticipation of a possible increase in demand, but the extended recovery from the crisis has forced them to suspend the process. Meanwhile, within recent months of the year, the industries planned to resume the dismissals.

The decreasing tendency of the businesses to improve productivity has become was one of the results of activation of recruiting policy in the II and III quarters of 2010. The index, calculated on the basis of changes in the plans for changes in the output staffing number, has declined to 25 per cent, whereas in the I quarter its value made 36 per cent. Those indicators can be interpreted as the share of industrial enterprises, which are ready to increase output faster than the number of employees.

In Autumn the banks continued to expand opportunities of industries crediting, but only at the expense of reducing the proposed interest rates on loans to enterprises. In September, this indicator decreased generally in the industries up to 13.2 per cent per annum in rubles against 13.7 per cent in August. The lowest rates were offered to large (over 1000 people. employees) businesses – 11.2 per cent; to small and medium businesses, in the best case, at the rate of 15.7 per cent per annum (see *Fig. 20*).

4.2.4. Fourth Quarter: What is Going on in the Russian Industry?

In October there were no significant changes in the dynamics of demand. The balance of that indicator has remained between -3 ...+ 3 points. Within nine consecutive months the sales growth rate differed little from zero - the stagnation of demand was sustained. Due to this circumstance, businesses have been forced to assess their scope of sales less critically. In August - September the satisfaction of demand in the Russian industries averaged 58 per cent, which became the crisis record. Demand forecasts in October remained at September's level - at the best level of the preceding nine months. The industries have maintained some hope for growth in demand, but the New Year holidays will reduce the optimism of these forecasts.

The stocks of finished products in the Russian industries continued to decline. In October the share of answers "below normal" increased to 22 per cent, resulting in the maximum level from May of 2001 (see *Fig. 18*). Then, in early 2001, the Russian industries have finally believed in the sustainability of post-default (and importantly - non-barter) growth in demand and have moved from policy of minimized stocks to their abundance. In the second half of 2010, the belief in the imminent restoration of the pre-crisis growth, by contrast, began to decline. It forced more and more companies to minimize their inventories of finished products against the regular levels. As a result of growth in the share of estimates "below normal" and reducing share of estimates "above normal", the balance (i.e., the difference) between them has declined in October to -12 points and has reached the 10-years minimum. Negative balances were recorded in all industrial sectors, indicating a widespread uncertainty of businesses in the early industrial growth.

Dynamics of production in October, according to the businesses' estimates, has not undergone fundamental changes as well. The balance remained between +11 ... +16 points, which was sustained over eight months. Production plans of enterprises remained at the level of the crisis maximum peak. The industry has not finally parted with the hope for significant industrial growth recovery.

Low demand remained the main obstacle to the output growth, but its mentioning has considerably reduced during both, after the crisis peak in January 2009 (69 per cent), and after the III quarter of 2010 (55 per cent). In late 2010 in only 43 per cent of businesses the demand prevented increase of the output. The lack of working capital has reached the historic minimum in hindering the effect of the Russian industries output in the III quarter of 2010, when, perhaps, a modest faith in output growth has matched with the provision of its own resources and the increasing availability of bank access. In the IV quarter the frequency of this factor mentioning has increased by 5 points.

The lack of staff has undergone the strongest changes during the current crisis. Before the crisis (in the III quarter of 2008) a half of the Russian industry suffered from the lack of staff. Afterwards, in the II and III quarters of 2009, the frequency of rate of that obstacle mentioning has increased up to 14 per cent, and to the IV quarter of 2010 it rose up to 32 per cent. Therefore, the businesses have faced the staff deficient already at the stage of stagnation. The combination of the lack of personnel with the dynamics of employment (termination of recruitment and the intention to reduce the personnel) indicates the structural problems in the labor market and the growing prudence in personnel policies of enterprises.

Defaults of payments, which were the main fear at the beginning of the crisis, have reduced their negative impact on the Russian industries. In late 2010, their impact has fallen to 17 per cent after 41 per cent at the peak of the crisis. The imports, on the contrary, have gradually, but still very slowly recovered the impact on domestic producers. At the peak of the current crisis the restraining influence of import fell down to 13 per cent after 31 per cent in the mid-2008 (absolute maximum of all period under review). Within seven crisis quarters of 2010 the imports have already managed to win back 10 points and in the IV quarter of 2010 had interfered with 23 per cent of the businesses. We would like to note, that the default and ruble devaluation in 1998 there was a decline of negative impact of imports on the Russian industries by 3 per cent (in the III quarter of 1999 there was an absolute minimum).

Pricing policies of the businesses have undergone significant changes in October. First, the industries have demonstrated the most significant growth in prices during the current crisis. After saving a relatively modest price growth in June - September at the rate of 8.4 points, the balance growth in October has reached 13 points. Secondly, the price forecasts of the businesses have also increased significantly in October after the seven months of gradual slowdown.

The lack of positive changes in the dynamics of demand and output has forced the businesses to stop recruitment. In October the rate the of employment growth in the industries has definitely lost its positive indicators, but have not yet turned negative: recruitment has apparently ceased, but substantial layoffs have not started yet. However, the plans of enterprises indicated a high probability of the sustained negative trends in the dynamics of employment. The balance of the expected changes in the number of employees as a result of the seven-month decline has become definitely negative, became negative and the worst in 2010 (see *Fig. 8*).

In November, the surveys have registered positive signals from Russia's industries, while maintaining a number of negative factors. The growth in demand and output continued, the forecasts of these indicators remained at the peak of the crisis. Changes in the estimates of stocks of finished products have demonstrated the readiness of the businesses to the larger increase in demand. Anyway, the acceleration of price growth rates and expectations of inten-

sive growth of costs (most likely due to increased insurance deductions) should have a negative impact on sales. The dynamics in the availability of credit has been reduced.

The source (not cleared from the seasonal factors) data on the dynamics in demand have again showed zero growth in November. This situation with the sales persisted in the industries since August. However, after clearance from seasonal and calendar factors, the growth rate of sales has acquired a positive value: the demand grew, with growth in October and November 2010 - the maximum for the current crisis. A similar situation was observed with the sales forecasts. On the eve of the New Year holidays, the businesses expected to reduce sales of their products, it becomes commonplace for producers and consumers. But the removal of seasonal factors has demonstrates the retention of the highest level of optimism in the forecasts of demand in the industries during the crisis. Positive dynamics of actual sales and forecasts have stabilized by estimates of satisfaction in the demand. After the August upsurge up to 62 per cent, the volatility in the share of normal estimates sales have gradually faded and were fixed at 58 per cent (see *Fig. 7*).

In November, the businesses have refused to minimize the stocks of finished goods and once again moved to the sustainability of a reasonable surplus. During the preceding five months the share of estimates "below normal" was slowly, but steadily growing up due to reduced share of responses "above normal". As a result, the balance of estimated reserves has become negative and has declined to the ten-year minimum. The industries was clearly losing the belief in fast recovery of the growth in demand and have minimized their accumulation of storage, prepared for quickly satisfaction of the orders for new buyers. Such a policy of inventory of finished goods control in the businesses was usual in the 90 years of the twentieth century. It has reached the highest peak after August of 1998, when the growing demand and a lack of faith in the stability of post-crisis recovery of the industries have brought the balance of reserves estimates to the record of -25 ...- 21 points in the second half of 1999.

In November, the balance of reserves estimates became zero after 11 points in October. Continuation of this trend in the next few months will mean that the industry has found faith in a speedy recovery. Although we cannot exclude that the growth of surplus stocks has been associated with the rejection of a moderate pricing policy and a transition (possibly forced) to a more intensive increase in the price.

Production capacity utilization rate indicates a growing intensity of the use of machinery and equipment in the industries. In the IV quarter of 2010, this index has increased to 68 per cent and reached the level of the end of 2005. However, since the II quarter of 2010 the load has increased by only 3 percentage points (see *Fig. 14*).

The assessment of overcapacity also did not change within this period. The excess of equipment remained in the industries at the level of 13 points. In this case, 71 per cent of businesses had a normal, according to them, provision with the capacity for a possible increase in demand for their products. The latter index has returned to the pre-crisis level.

In November the rate of price growth has increased by several points and has reached the peak of the crisis - selling prices of businesses did not grow up so intensively since August 2008. After a relatively moderate price growth in June – September; from October the industries demonstrated their record growth. As judged by the forecasts, the companies were willing to increase prices, most likely, at the expense their sales volumes. Indeed, the sales growth rates were still very low and did not give industries sufficient grounds for demonstration of their market power. Moreover, comparison of changes in demand and prices has demonstrated, that in November the outpacing increase in prices against demand growth was regis-

tered in the industries already at 29 per cent of the businesses, whereas within the preceding (except for the first, the most inflationary) months of 2010, this ratio of changes in demand versus prices was noted only at 18-22 per cent of the enterprises.

Since the traditional New Year's upsurge of prices and tariffs was to come only in January 2011, we have to assume, that the industry was preparing for growth rate of insurance contributions (former UST). According to a special survey of IEP, conducted in May 2010, increased selling prices would be the most common reaction of businesses on this tax innovation. 70 per cent of respondents planned to behave this way. And it seems, that in November the companies have already started preemptive increase in prices, reducing the effectiveness of counter-inflationary policy of the authorities. The second most common response to the growth of the insurance payments should be reduced profits of the businesses, the third one - reduced social deductions for personnel.

Intensification of the actual increase in prices and the intention to maintain it was supported by the forecasts on excessive growth. In November in the Russian industry there was recorded the highest increase of overhead excessive costs over the past seven years. The balance of this index has increased within the quarter by 26 points and has reached +50 (see (See *Fig. 21*)).

In November, the industry in general did not aggravate the situation in the Russian labor market at the expense of staff reduction. The rate of change of the index has not decreased, as it could be expected, according the October forecasts, to distinctly negative values. It remained in the zero zone, which showed the hold-on in employment, but did not mean the beginning of significant layoffs. The businesses seemed not to be able to define their staffing policies. Uncertainty was increased by the lack of positive dynamics in sales. If in the II quarter of 2010, industry got rid of (as a result of layoffs, and the growth of expectations for growth in demand) from the surplus labor resources, in the III quarter it clearly noted a lack of personnel, in the IV quarter this positive trend for the period of crisis has been broken. The lack of personnel has decreased by 7 points or almost disappeared. Plans to change the number of employees reached the annual minimum in November. Reductions were planned in all sectors, except for timber industry. The most intensive - in the construction industry and mechanical engineering.

By the end of the year, the situation in the Russian industry was influenced by contradictory trends. On the one hand, data on the dynamics of demand and output, cleared from seasonal factors, has shown the achievement of the next crisis records. The situation with employment has not deteriorated (as it was expected). On the other hand, reduction of staff was still in the plans. The growth of availability of credits has stopped.

Initial data on the dynamics of demand in December have not changed: the rate of the growth rate remained at the zero level. Therefore, in the industries in general, nearly within entire second half of the year the share of reported sales growth was equal to the reports on their shares decline. Anyway, in December, 2010, formal methods of clearing from seasonal factors have demonstrated an increase in demand growth. As a result, it has reached a crisis peak and the level of their pre-crisis indicators.

In December evident improvement of the demand dynamics has not affected the estimates of its volumes. Satisfaction of demand remained at the level of the preceding months (see *Fig. 7*). Therefore, it was not too bad, because within the II and III quarters the percentage of normal estimates of demand has been subjected to strong fluctuations, indicating the uncertainty of the businesses in which the volumes of sales could be considered adequate to current

economic conditions. At the end of the year the situation has become probably more understandable for the businesses.

Clear improvement of the dynamics of demand in December did not affect the estimates of its scope. Satisfaction of demand remained at the level of previous months (see *Fig. 7*). This, however, is not too bad, because in the II and III quarters the percentage of normal estimates of demand has been subject to strong fluctuations, indicating that the uncertainty of enterprises in which the sales take adequate current economic situation. At the end of the year the situation seems to be become more understandable for companies.

Despite the fact, that in the second half of the year the output growth, according to the initial responses of the businesses were demonstrating surprising stability, remaining since May in the range between +13 ...+ 20 points (while excluding October and November, there is a unique range between +18 ... +20), after cleaning from seasonal factors has revived such a monotonous *Fig.*. As a result, in December, the highest rates of output growth during the current crisis have been received .

Since the beginning of the latter quarter, the industry has fundamentally changed its pricing policy and switched to steady increase in sales prices. If in the III quarter the balance of price changes made 6 points, in the IV quarter of this index was released by an average of 17 points. The leader in intensity of prices growth within the preceding three months of the year was not the food industry, but the light and chemical industries.

In December the price plans of the businesses have also significantly changed. The industries, like in the pre-crisis time, planned a significant increase in their prices within the first months of the new year (see *Fig. 16*), even, perhaps, to the detriment of sales. But it seems, that the increase in the tax burden did not leave any other choice to the businesses. Such a sharp revision of the price plans has not been observed in the Russian industries since September, 1998.

By the end of the year, despite the clear intention of the preceding months to reduce staff, the industries have kept in general the number of employees at the same level – there was no significant recruitments or layoffs. In December, the level of pessimism in plans has decreased. If in November it has reached the year (2010) maximum of 5 points, (i.e., extensive dismissals were expected), in December balance of plans improved by 5 points, although it remained negative: the industries still expects to reduce staff. In the IV quarter of 2010 the estimates (not absolute indicators!) of salaries of workers and specialists have reached the pre-crisis level. 59 per cent of business leaders considered the level their employees' wages normal, and 36 per cent considered it below normal (see *Fig. 9*). A similar ratio was observed in 2007 and in early 2008. At the peak of crisis the assessments were reverse: only 37 per cent of the managers recognized salaries as normal, 59 per cent .of leaders considered it "below normal".

By the end of 2010, the growth of credit availability has stopped. The share of normal assessments of this indicator in the second half of the year has stabilized at 66 per cent. Therefore, the banks have stopped mitigating the credit conditions of the real sector in view of continuing uncertainty. Stabilization of the interest rate, offered by the banks in general for industries at the level of 13 per cent for ruble credits, confirms this conclusion. Herewith, for small and medium-sized businesses the rate has been frozen at 15.0-15.5 per cent, for large businesses it has been maintained at the level of 11-12 per cent per annum.

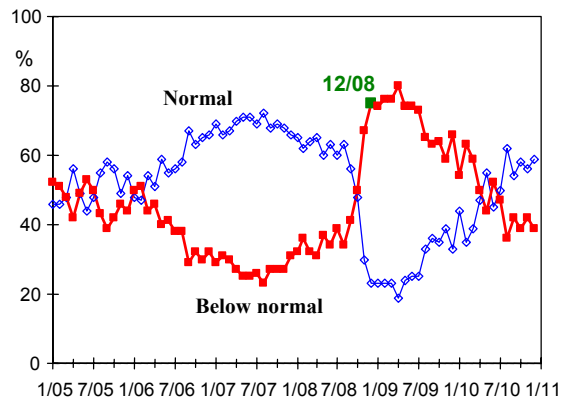


Fig. 7. Dynamics of the main estimates of effective demand

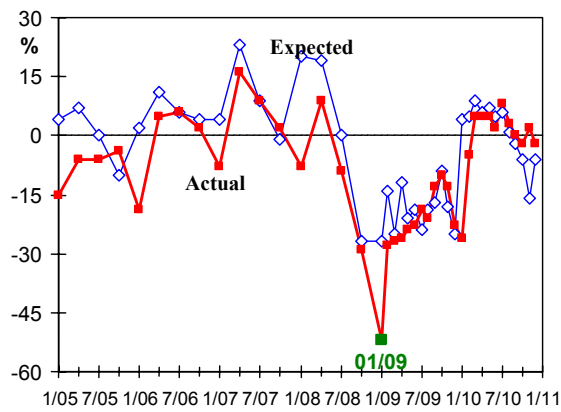


Fig. 8. Change in employment (balance = % growth - % decrease)

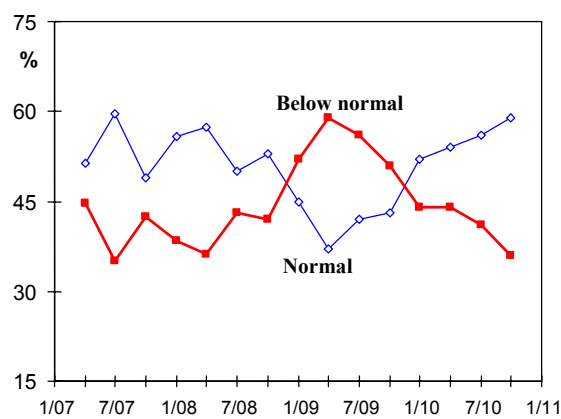


Fig. 9. Evaluation of salaries of workers and specialists by enterprise managers

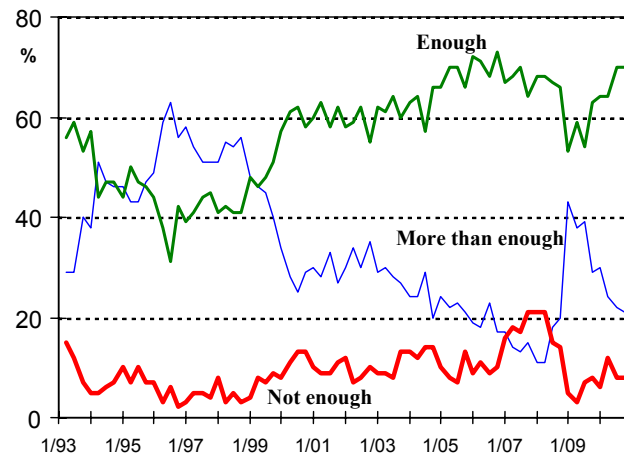


Fig. 10. Share of businesses with excessive, adequate and insufficient facilities

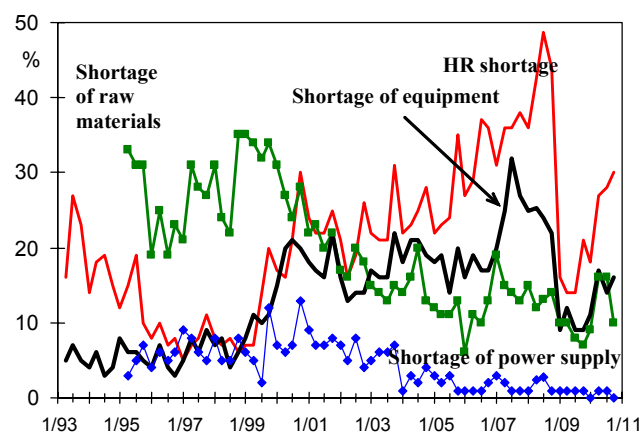


Fig. 11. Resource barriers in output growth

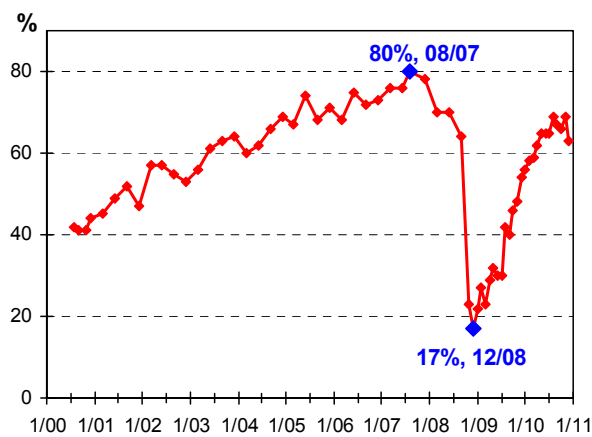


Fig. 12. The share of enterprises with normal access to credits

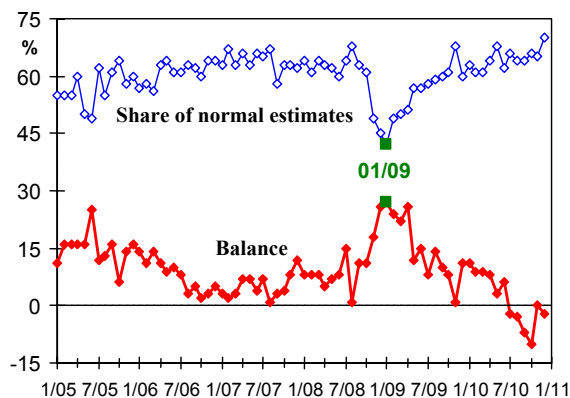


Fig. 13. Estimates of stocks of finished products balance (balance =% higher than normal -% below normal)

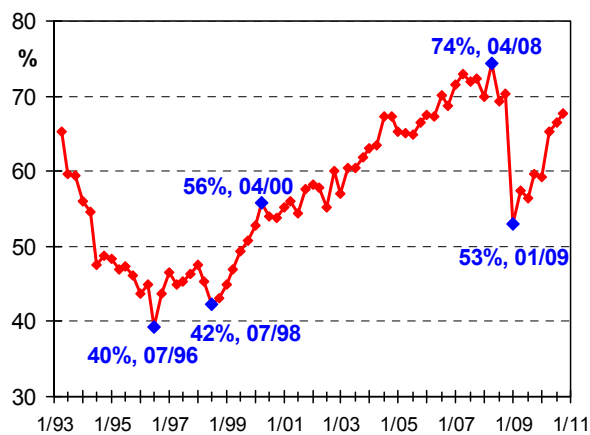


Fig. 14. Capacity utilization in industry,%

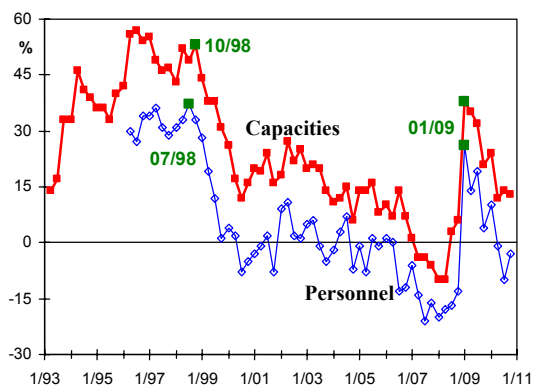


Fig. 15. Balances of capacities and staff (Balance = "more than enough" - "less than enough")

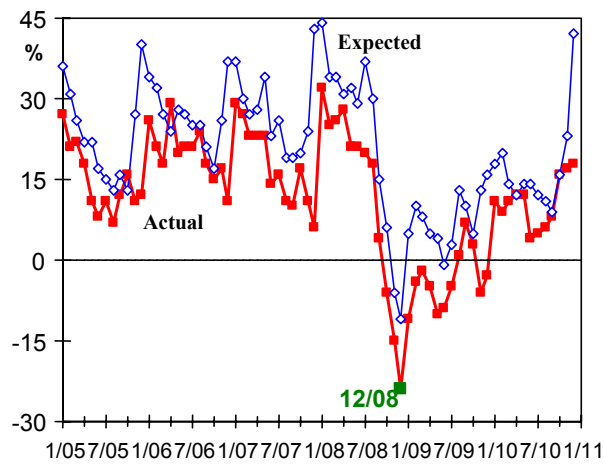


Fig. 16. Changes in selling prices (balance =% growth -% decrease)

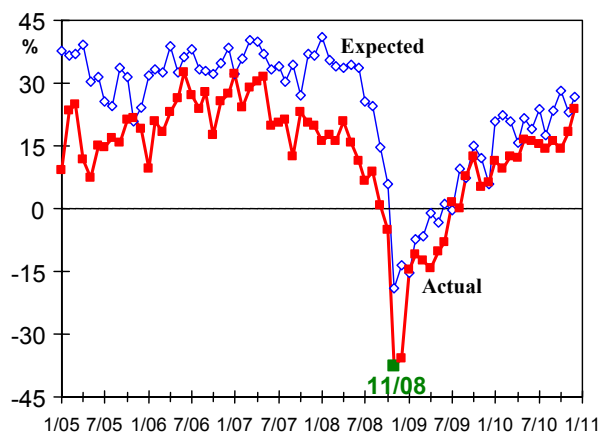


Fig. 17. Changes in production (balance =% growth -% decrease)

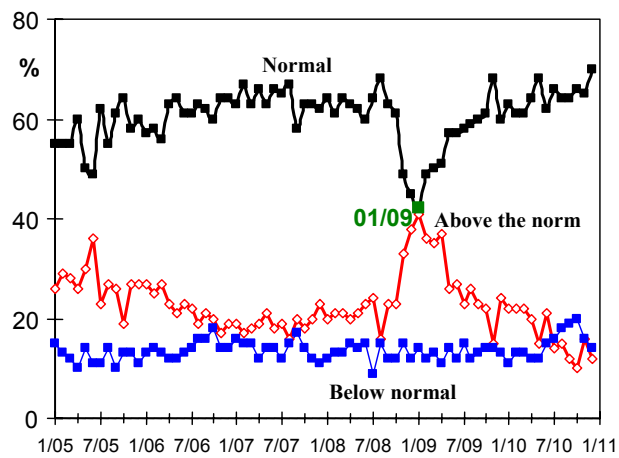


Fig. 18. Dynamics of assessments of finished goods stocks

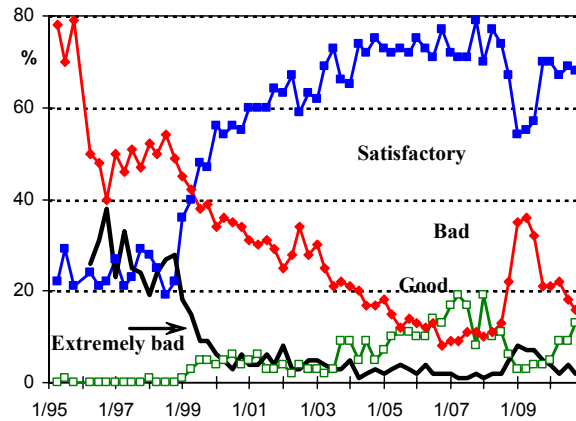


Fig. 19. Estimates of the economic situation of enterprises

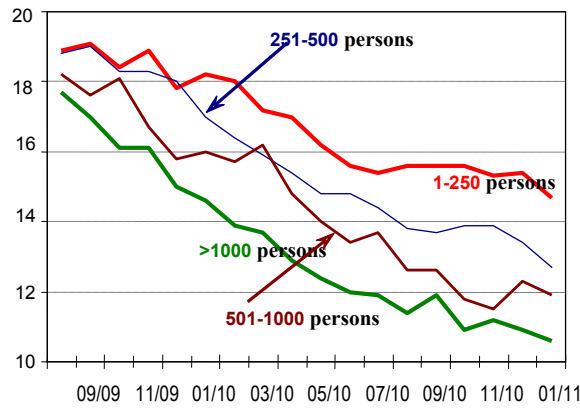


Fig. 20. The dynamics of the average minimum rate for ruble credits to businesses of different sizes, % per annum

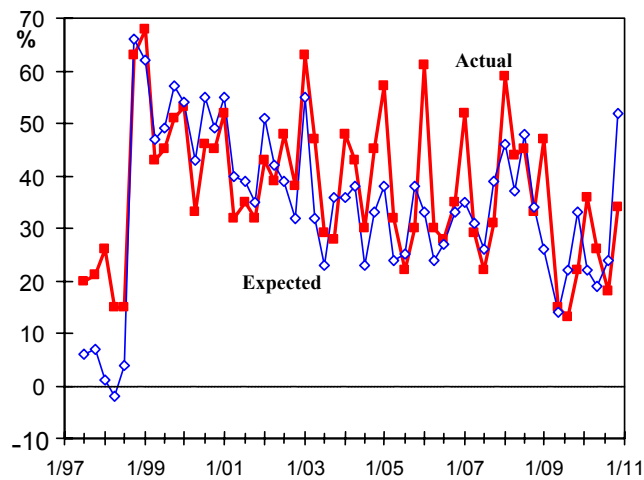
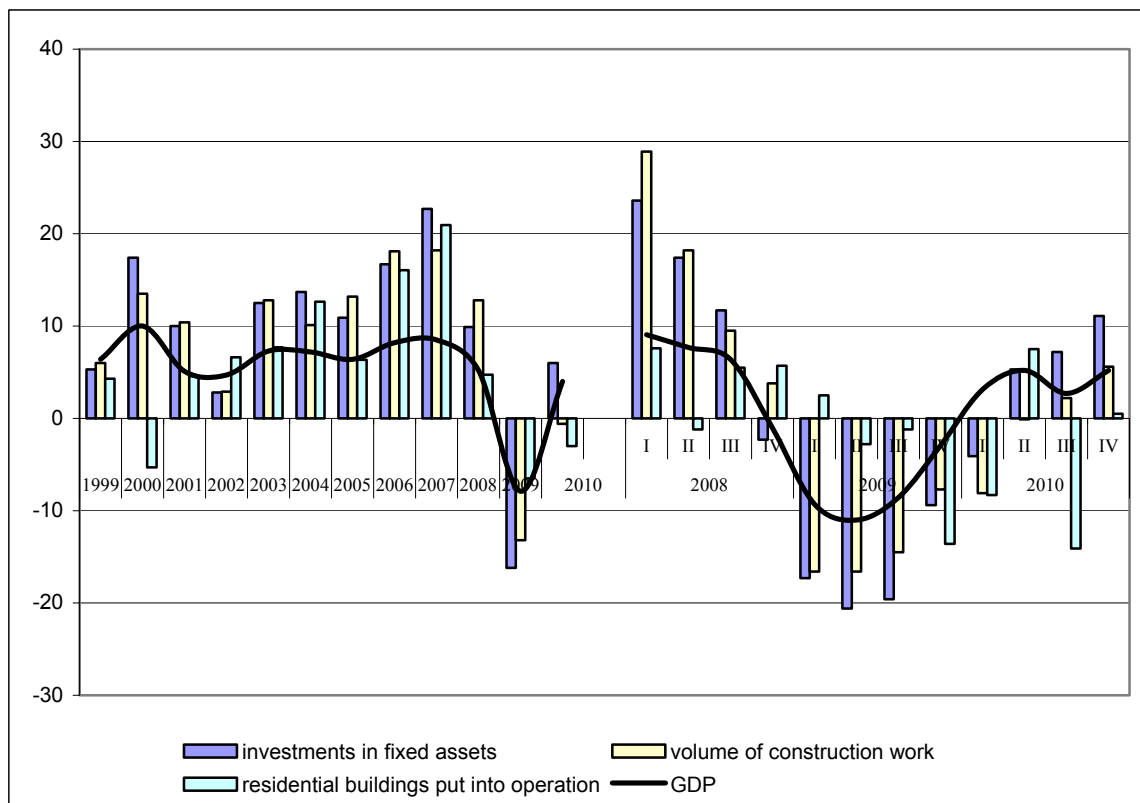


Fig. 21. Changes in the unit costs (balance = 0% of growth - % decrease)

4.3. Investments in the Real Sector of the Economy

4.3.1. Domestic internal investments in fixed assets

As the domestic economic situation improved in 2010, some gradual changes to the better were also occurring in the investment sector. The first half-year 2009 saw the peak of the investment crisis, and then from Q III onwards there emerged a trend towards a slowdown in the rate of decline in the investment sphere which was due, among other things, to the improving financial situation of businesses. In 2009 the volume of the investment activity had plummeted – while GDP dropped by 7.9 %, investments fell by 16.2 %; however, in Q II – IV 2010 the dynamics of investments became positive, and its rate outstripped that of GDP growth. On the whole, over the year 2010 the rate of growth of investments in fixed assets was 6.0 %, while GDP rose only 4.0 % on the previous year (*Fig. 22*). The dynamics of investments in fixed assets differed rather significantly between big and small-sized enterprises. The 2008 crisis in its initial phase resulted in some critically low investment activity indices displayed specifically by small-sized enterprises; in 2009, however, it was the investment activity in the small business segment that served as a factor that was playing down the scale of decline in the volume of investments across the entire economy. The government financial support granted to small and medium-sized businesses in 2010 was one of the established priorities. In 2010, the overall volume of budget allocations received by way of government support by small and medium-sized businesses amounted to 17.97 bn Rb. The main emphasis in the government program for supporting entrepreneurial activity was placed on the development of innovation-oriented small-sized enterprises and organizations, as well as those oriented towards modernization of their production facilities. Another direction of support provided to small and medium-sized businesses was the anti-crisis program of crediting through Vneshekonombank. Over the year 2010, investments in fixed assets in the small business segment rose by 8.0 % (in 2009 they dropped by 13.5 %), while their share in the total volume of investments across the national economy increased to 32.1 % against 27.2 % in the previous year. It should be noted that growth of investments in fixed assets made by big enterprises in 2010 amounted to 5.1 %. While in 2009 the volume of big enterprises' investment activity dropped by 17.5 % on the previous year, the volume of investments in fixed assets in 2010 amounted to 86.7 % of the 2008 index.



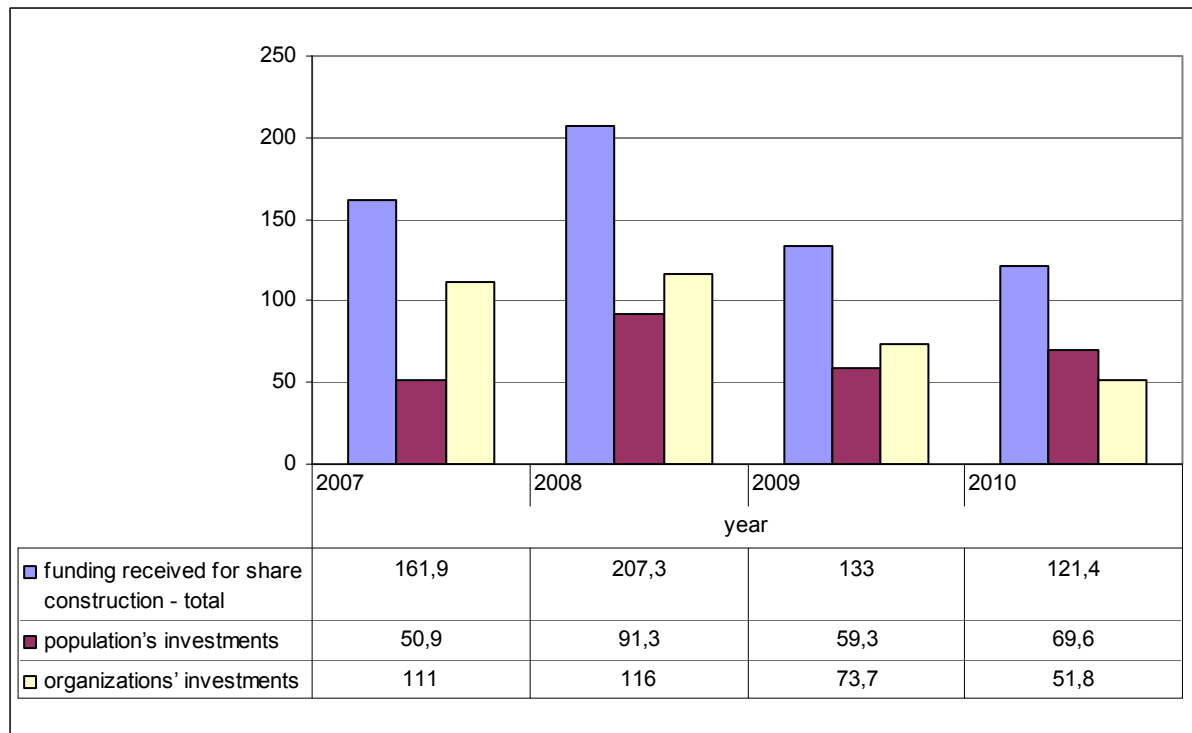
Source: Rosstat.

Fig. 22. GDP Growth Rate, Investments in Fixed Assets, Volume of Construction Work and Residential Buildings Put into Operation in 1999 – 2010, by Quarter, as % of Same Period of Previous Year

A typical feature of 2009 – 2010 was a decline in the total gross floor space of dwellings put in operation. The decline of that index began in Q II 2009, and amounted to 6.5 % by the year’s results. In 2010 it dropped on 2009 by 3.0 % and amounted to 58 mln square meters. The situation in 2010 was negatively influenced by the rapid decline in the number of new housing construction projects that had occurred in 2008 – 2009. Besides, the situation with regard to financing allocated to housing construction was also deteriorating. In 2009 the funding received to cover share construction dropped by 74.3 bn Rb, including the population’s investments – by 32.0 bn Rb on 2008.

In 2010, the share of investments in housing construction in the overall structure of investments in fixed assets across the economy shrank to 1.9 % against 2.6 % and 3.3 % in 2009 and 2008 respectively. While the volume of investments in housing construction in 2010 dwindled, that year, in contrast to 2009, saw an increase in both the volume and share of the population’s investments in the total amount of financial assets invested in share housing construction, while the investments made by organizations declined. In 2010, the population’s investments in share housing construction amounted to 69.6 bn Rb and thus by 10.3 bn exceeded the previous year’s index, while the volume of investments made by organizations dropped by 21.9 bn Rb. In this connection it is noteworthy that in 2010 the overall index of gross floor space of dwellings put into operation as a result of investments made by the population (which included both their own and borrowed funds) amounted to 25.3 mln square me-

ters, which is by 3.2 mln square meters below the previous year's level, while the same index with regard to investments made by organizations rose by 1.5 mln square meters.



Source: Rosstat.

*Fig. 23. Funding Received for Share Construction
in 2007 – 2010, bn Rb*

Given the existing dynamics of investments and volume of work in the construction sector, the expenditures on housing construction in 2010 amounted to 372.3 bn Rb alongside a persisting downward trend displayed by their share in the structure of investments in fixed assets. Simultaneously with a growing volume of industrial construction, the share of spending on the construction of buildings was also increasing, while the share of spending on the acquisition of machinery and equipment became stabilized (*Table 11*). It should be noted that, in face of an instable rate of domestic production of capital commodities, investments in the acquisition of imported machinery, equipment, and means of transportation (less those made by small-sized businesses and the indices of informal activity) amounted to 378.9 bn Rb in 2010, or to 18.0 % of the total volume of investments in machinery, equipment, and means of transportation (against 371.8 bn Rb, or 20.7 %, in 2009).

The trend towards a reduction, in absolute terms, in the volume of budget funding allocated to investments in fixed assets which was visible in 2008 - 2009, came to a halt in 2010, but the decline in the share of investments made by the Federation's subjects continued (*Table 12*). In 2010, budget funded investments in fixed assets amounted to 1,242.7 bn Rb, or by 1.9 bn more than in the previous year. In this connection, the volume of federal budget resources allocated to investments rose by 19.2 bn Rb on 2009 and thus amounted to 642.1 bn Rb which, in fact, compensated for the losses resulting from the cuts made by subjects of the Russian Federation in their own budget funding allocated to investments.

Table 11

**Structure of Investments in Fixed Assets, by Type of Fixed Assets,
in 2008 – 2010 (Less Small-sized Businesses and Informal Activity), % of Total**

	Bn Rb			% of total		
	2008	2009	2010	2008	2009	2010
Investments in fixed assets – total	6,272.1	5,769.8	6,413.7	100	100	100
including:						
in dwellings	467.2	343.5	372.3	7.5	6.6	5.8
in buildings (except dwellings) and structures	3,286.8	3,221.2	3,495.8	52.4	53.8	54.5
in machinery, equipment, means of transportation	2,071.3	1,798.2	2,109.6	33.0	32.2	32.9
other	446.8	406.9	436.0	7.1	7.4	6.8

Source: Rosstat.

Table 12

**Structure of Investments in Fixed Assets, by Source of Financing,
as % of Total (Less Small-sized Businesses and Informal Activity)**

	2008	2009	2010	Including		
				Q I	1st half-year	January - September
Investments in fixed assets – total	100	100	100	100	100	100
including by source of financing:						
<i>companies' own funds</i>	39.5	37.1	41.2	45.1	44.9	43.0
of these:						
profits	18.5	14.8	14.7	15.0	16.3	16.0
<i>attracted funds</i>	60.5	62.9	58.8	54.9	55.1	57.0
of these:						
banks' credits	11.8	10.3	8.7	9.5	9.2	9.1
including those provided by foreign banks	3.0	3.2	2.0	3.2	2.8	2.7
borrowed funds from other organizations	6.2	7.4	5.6	6.4	6.6	6.6
budget resources:	20.9	21.9	19.4	12.9	15.5	17.4
federal budget	8.0	11.5	10.0	5.5	7.6	8.5
budgets of subjects of Russian Federation	11.3	9.2	8.2	6.6	7.1	7.8
Other	21.2	23.0	24.8	25.9	23.4	23.6
Of these: funding received as share in construction	3.5	2.6	1.9	2.0	2.2	2.0
including population's funds	1.9	1.3	1.1	1.0	1.1	1.1
Share in total volume of investments in fixed assets received from abroad	4.3	4.3	3.8	5.8	5.3	4.8

Source: Rosstat.

The government's demand for the products and services of Russian enterprises was sustained through the implementation of the planned investment projects in the fields of transportation, telecommunications, etc. being materialized within the framework of the Federal Targeted Investment Program (FTIP), federal target programs (FTP), and the big infrastructure projects launched by the RF Investment Fund. It should be noted that expenditures within the framework of federal target programs were either preserved at the previously planned level or insignificantly reduced.

In accordance with the list of construction sites and objects to be used for federal government needs as of 1 January 2011 confirmed by Regulation of the RF Government, of 30 December 2009, No 2130-r and included in the Federal Targeted Investment Program for 2010, it was planned that government investments should be allotted to 2,039 construction sites and objects. It was planned that, in the year 2010, 1,036 objects would be put into operation. Only 254 of these objects were put into full-scale operation in January – December 2010, while 31

of them were put into partial operation. Besides these, 5 objects planned to be put into operation in later years were put into full-scale operation, and 25 such objects were put into partial operation.

With all the changes taken into account, the federal budget funding earmarked for the construction of objects and the implementation of the measures included in the FTIP amounted to 651.5 bn Rb, including 321.9 bn Rb to finance the investment-related costs of the FTIP (49.4 % of the total volume of the FTIP) and 231.9 bn Rb to finance the other expenses of the FTIP (35.6 %), and also 97.7 bn Rb to finance the special work included in the state defense order (15.0 %).

In comparison with 2009, the total growth of the sum of federal budget funding allocated for these purposes amounted to 50.2 bn Rb, including a 23.0 bn Rb increase in the financing of the investment-related costs of the FTIP and a 34.1 bn Rb increase in the financing of the other expenses included in the Program.

According to *Rosstat*, the budget means that were allocated in 2010 to the FTIP construction sites and objects (apart from the special work included in the state defense order) supervised by the RF Federal State Statistics Service amounted to 380.3 bn Rb, or to 71.3 % of the per annum limit (*Table 13*). In 2010, 1,341 objects were fully funded, and another 435 objects were 51.0 to 99.0 percent technically complete. The per annum limit of government capital investments in the transport, agro-industrial and special complexes was funded to a much higher extent (94.2 %, 77.9 %, and 79.1 %, respectively) than the limit of investments in construction sites and objects to be used for government needs. The social complex received 54.2 % of the budget funds earmarked for that item. In 2010, the customers purposefully spent 344.1 bn Rb in government capital investments or 62.9 % of the per annum limit of funds envisaged for their construction.

Table 13

Objects Included in the Federal Targeted Investment Program and the Volume of Government Capital Investments in January – October 2010 (Apart from the Construction Sites and Objects Included in the State Defense Order)

	Number of objects as of 2010		Put into operation in January–October 2010		Limit of government capital investments for 2010		Funded from federal budget in 2010	Use of investments from all sources of funding, 2010
	Total	Including those planned for putting in operation in 2010	into full-scale operation	into partial operation	Total	Including from federal budget		
	Units				Bn Rb			
Total	2,039	1,036	259	56	547.7	531.3	380.3	344.1
including:								
transport complex	415	230	59	16	201.1	195.7	184.3	160.2
agro-industrial complex	198	89	42	12	7.0	6.8	5.3	5.4
special complex	277	122	32	4	30.6	28.2	22.3	21.0
social complex	1,073	561	122	24	289.6	286.7	155.3	142.3
other objects	76	34	4	-	19.4	13.9	13.1	15.1

Source: Rosstat.

From a territorial point of view, the use of the established limit of the funds envisaged for financing the construction sites and objects included in the FTIP was above the Russian aver-

age in the North-Western, Urals, Siberian, Volga and Far Eastern Federal Districts. The use of budget investments was far below the national average in the Central Federal District.

Table 14

The Use of Funds at Construction Sites and Objects to be Used for Federal Government Needs, by Federal District, in 2010

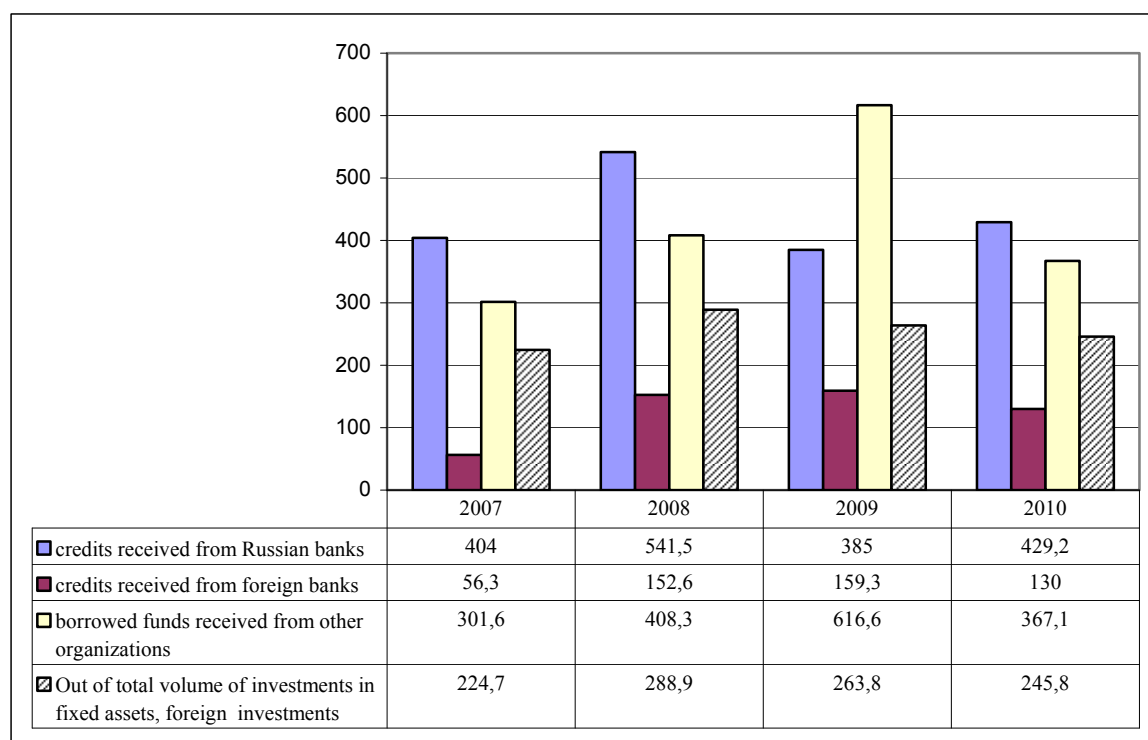
	Limit of allocations from all sources, bn Rb	Limit of government investments for year, bn Rb	Actually used funds from all sources of financing	
			bn Rb	As percentage of per annum limit
Russian Federation	547.5	531.3	344.2	62.9
Central Federal District	252.6	250.1	101.7	40.2
North-Western Federal District	64.2	63.9	64.9	101.2
Southern Federal District	72.0	70.8	44.1	61.2
North Caucasus Federal District	11.1	10.9	7.9	70.6
Volga Federal District	28.6	26.9	23.4	82.0
Urals Federal District	5.1	4.7	4.6	89.7
Siberian Federal District	21.7	21.0	20.5	94.4
Far Eastern Federal District	92.5	83.0	77.1	83.3

Source: Rosstat.

The slow recovery of both the domestic market and the incomes of the economy contributed to the preservation of the trend toward investment programs being financed with companies' own resources. In 2010, their own resources used for investment purposes amounted to 2,644.7 bn Rb against 2,092.0 bn Rb in the previous year, while their share increased from 37.1 % to 41.2 %. The structure of the attracted resources used for financing investments in fixed assets demonstrated an intensification of the trend toward curbing the participation of banking and borrowed capital. In 2010, out of a total of 2,769.0 bn Rb of attracted funds, banks' credits amounted to 559,2 bn Rb, or 14.8 % (against 18.4 % in 2008).

In 2009, the reduction in absolute terms of the volume of banks' credits granted for the purpose of making investments was determined entirely by the shrinking scale of activity of Russian banks. The increased amount of credits attracted from foreign banks and active borrowing of funds from other organizations were the factors that helped to prevent any further deepening of the crisis on the investment market. In 2010, the situation changed for the better: after the banking sector had adapted to the new realities and the business activity revived, growth of crediting granted by domestic banks fully compensated for the diminishing volume of credits provided by foreign banks (*Fig. 24*).

As a result, the share of investments in fixed assets received from abroad in the total volume of investments in fixed assets made in 2010 dropped to 3.8 % against 4.3 % in the previous year. A significant influence on the volume of investments was exerted by changes in the structure and dynamics of foreign investments. Although, as seen by the results of the year 2010 reported by *Rosstat*, the amount of foreign investments received by the Russian economy reached 114.7 bn USD, and thus rose by 40.1 % on 2009, the share of direct investments in the structure of received investments declined to 12.1 % against 19.4 % a year earlier. Direct foreign investments in 2009 dropped by 13.2 % on the previous year.



Source: Rosstat.

Fig. 24. Dynamics of Funding Attracted for Financing Investment in Fixed Assets in 2007 – 2010, in bn Rb

The situation was aggravated by an increase in net capital outflow. According to the preliminary estimated published by the RF CB, in 2010 net export of private capital amounted to 38.3 bn USD (*Table 15*).

Table 15

Net Capital Import/Export by the Private Sector, According to Balance of Payments Data, bn USD

	Net capital import/export by private sector, total	Including:	
		net capital import/export by banks	net capital import/export by non-financial enterprises & households
2007	82.4	45.8	36.6
2008	- 132.8	- 56.9	- 75.8
Q I	- 23.7	- 9.9	- 13.7
Q II	40.7	22.1	18.6
Q III	- 19.3	- 13.5	- 5.8
Q IV	- 130.5	- 55.6	- 74.9
2009	- 56.9	- 30.4	- 26.6
Q I	- 35.0	- 6.9	- 28.1
Q II	3.4	- 5.9	9.2
Q III	- 33.8	- 27.5	- 6.3
Q IV	8.5	10.0	- 1.4
2010 (estimate)	- 38.3	11.4	- 49.7
Q I	- 14.7	0.8	- 15.5
Q II	2.8	6.8	- 4.0
Q III	- 3.7	10.0	- 13.7
Q IV	- 22.7	- 6.2	- 16.5

Source: CB of Russia.

Given the general trend toward the weakening of investment activity, the role of institutional investors underwent certain changes in 2009 and 2010. As the share of investments in state property continued to decline, the share of investments in private property rose in 2010 by 3.0 pp and 7.7 pp on 2009 and 2008 respectively. Apparently, private domestic businesses focused on preserving their positions on the domestic and foreign markets, all the more so because the development of this trend was taking place against the background of a decline in both the volume and the share of investments made by enterprises under foreign or joint ownership (between Russian and foreign partners) in the total volume of investments (*Table 16*).

Table 16

Structure of Investments in Fixed Assets, by Type of Ownership, in 2008 - 2010, as a Percentage of the Total (Less Small-sized Businesses and Informal Activity and Investments Unobservable by Direct Statistical Methods)

	2008	2009	2010
Investments in fixed assets	100	100	100
Including by type of ownership:			
Russian	79.4	80.8	83.9
state	23.3	24.9	23.5
federal	13.3	15.4	15.2
subjects of Russian Federation	9.9	9.4	8.1
private	37.5	42.2	45.2
mixed Russian	12.8	8.8	9.9
ownership of state corporations		-	1.3
foreign	9.6	8.9	6.2
joint ownership between Russian and foreign partners	11.0	10.3	9.9

Source: Rosstat.

In 2010, the structural shifts in investments in fixed assets were determined by the increasing share of industry in the total volume of investments in fixed assets (less small-sized businesses) – to 45.1 % against 43.2 % in 2009 and 40.9 % in 2008. In this connection, one could observe a rather noticeable differentiation by type of economic activity in the growth rate of that index. In the extracting industries the volume of investments in fixed assets rose in 2010 by 8.9 %, in the processing industries – by 3.3 %, and in the sector of production and distribution of electric energy, gas и water – by 24.1 %. For the majority of types of economic activity, the levels of investments remained far below their pre-crisis indices (*Table 17*).

With regard to the processing industries, the noteworthy phenomena are the rise, on 2009, in the volumes of investments in the production of coke and petroleum products by 31.5 %, in the production of metal products by 35 %, and in the production of cellulose by 23.7 %. The specific feature of 2010 was an upsurge of the investment activity in the production of textiles and leather as a result of an altered customs regime for importing relevant equipment and raw materials.

A low investment demand for capital commodities and construction materials coupled with a low load on the existing production capacities resulted in a drop, on 2009, in investments in metallurgical production by 11.2 %. As a consequence, in 2010 the volume of investments in this sector amounted to 63.3 % of its pre-crisis level in 2008. A difficult situation also persists with regard to the production of construction materials, where investments dropped by 31.5 % over the period of 2008 – 2010.

The specific feature of the investment activity in 2010 was the reestablished positive growth rate of investments in the machine-building complex. The rise on 2009, as demonstrated by investments in the production of machinery and equipment, was 17.8 %; the same

index for the production of electrical, electronic and optical equipment amounted to 1.7 %, and that for the production of means of transportation – to 4.4 %. At the same time, our analysis of the dynamics and structure of investments points to a lower share of investments in machine-building – 2.4 % of the total volume of investments across the entire economy and 5.3 % of investments in industry. The revival of the investment activity in the machine-building complex occurs at a much slower rate than in the other sectors. As seen by the results of 2010, the volumes of investments in the machine-building complex with regard to some specific types of economic activity were at the level of 68 – 82 % of their 2008 indices.

One positive factor was the rise, by 8.1 % on 2008, of the volume of investments in the development of transport in 2009 – 2010. However, it should be noted that the dominant influence on the character of investments, by type of transport activity, was exerted by the increasing investments in the development of pipeline transport – by 1.67 times as compared to the 2008 level, while investments in the development of railway transport over the same period dropped by 8 %. The changes in the dynamics and structure of investments in transport require further careful observation, given the fact that in 2010, in terms of the national economy's openness to international trade, Russia ranked 48th on the availability and quality of transport infrastructure, 33rd on the quality of railway infrastructure, 82nd on the quality of aquatic ports, 87th on the quality of airports, and 111th (near the bottom of the list) on the quality of motor road infrastructure.

Table 17

The Volume and Dynamics of Investments in Fixed Assets in 2008 – 2010, by Type of Economic Activity (Less Small-sized Businesses and Informal Activity)

	2008	2009	2010	2008	2009	2010
	bn Rb			as % of previous year		
Total	6,272.1	5,769.8	6,413.7	105.6	82.5	105.1
of these:	243.0	192.6	190.9	95.7	75.2	88.9
agriculture, hunting and forestry						
extraction of mineral resources	1,040.9	967.8	1,109.8	103.9	88.3	108.9
including:	950	893.5	1021.5	104.8	89.1	108.7
extraction of fuel-and-energy mineral resources						
processing industries	1,034.0	881.9	993.7	107.8	78.2	103.3
Production and distribution of electric energy, gas and water	558.2	585.6	786.3	111.3	99.8	124.1
construction	91.7	162.7	194.1	91.7	66.1	117.3
wholesale and retail trade; repairs	168.7	138.4	158.4	95.6	75.7	108.9
transport and communications	1,628.0	1,624.6	1,696.1	112.4	99.1	109.0
including communications	257.4	180.6	207.3	95.1	66.6	108.6
financial activity	74.7	74.6	77.2	95.6	99.4	107.1
Operations with immovables, lease, services	733.8	558.2	658.3	100.9	70.8	92.8
of these: research and development	31.9	48.9	62.8	101.9	131.9	114.4
state administration and military security; mandatory social security	128.2	133.0	120.5	109.7	89.5	87.0
education	162.9	117.4	142.9	96.9	78.7	113.7
health care and social services	188.0	145.7	161.3	116.0	82.1	105.6
other communal, social and personal services	128.8	168.6	185.8	127.9	85.1	102.8

Source: Rosstat.

The problems associated with this country's exit from the investment crisis in 2010 had originated mostly from the extremely difficult basic conditions of the previous year. The changes occurring in the structure of investments in fixed assets in 2009 were determined by the rapid decline of the scale of business activity in the sectors of construction, operations with immovables, trade and communications. While there existed a general downward trend

in the volume of investments in industry, that process was influenced in particular by the drop in investments in the processing industries by 20.6 % on 2008. Besides, the situation was further complicated by the decline in the volume of investments in agriculture – by nearly 30 % on 2007 over the period of 2008 – 2009. The year 2010 saw a continuing downward trend in the volume of construction work. Growth of both investments and the volume of work in the construction sector occurred in Q IV 2010. On the whole, in 2010 the volume of investments in fixed assets remained 11 % below the pre-crisis level registered in 2008.

As demonstrated by a sample study (conducted by *Rosstat*) of the investment activity demonstrated by organizations operating in the sector of extraction of mineral resources, in the processing industries, and in the production and distribution of electric energy, gas and water, the main purpose of investing in fixed assets in 2010, just as in the previous years, was the replacement of deteriorated technologies and equipment. Investments aimed at performance improvement (automation and mechanization of the current production process, implementation of new production technologies, improved cost-effectiveness of production, and energy saving) were made by 32 – 46 % of all organizations; 32 % of organizations were aiming at increasing their production capacities without changing their product assortment; and 29 %, in addition, were aiming at expanding their product assortment.

The bulk of investments in fixed assets in 2010 was earmarked for purchases of new machinery and equipment. Among the organizations included in this study, the share of machinery and equipment aged under 10 years was 37 %; over 10 and up to 20 years – 40 %; over 20 and up to 30 years – 14 %. In the organizations operating in the spheres of production of means of transportation and equipment, chemical production, production of electrical, electronic and optical equipment, machinery, metallurgical products, cellulose, pulp, paper, and cardboard, the mean age of machinery and equipment was greater than that for the total number of organizations observed in this study.

The share of means of transportation aged under 10 years was 51 %, of those aged over 10 and up to 20 years – 33%. This index was above the mean value displayed by the organizations operating in the production of means of transportation and equipment, and in metallurgical and chemical production.

Table 18

**Distribution of Organization by the Estimated Age of Their Fixed Assets in 2010,
as % of the Total Number of Organizations**

	Buildings	Structures	Machinery and equipment	Means of transportation
Under 3 years	2	2	4	5
Over 3 and up to 5 years	3	5	11	14
Over 5 and up to 10 years	5	7	22	32
Over 10 and up to 15 years	6	8	26	20
Over 15 and up to 20 years	9	12	14	13
Over 20 and up to 30 years	25	24	14	4
Over 30 years	38	27	5	1
Mean age (years)	26	21	14	9

Source: Rosstat.

The withdrawal from operation of machines, equipment and means of transportation in 2010 due to their long service life and high rate of wear and tear was pointed to by 68 % of the organizations' directors, while 10 % pointed out as the cause of their withdrawal the low economic efficiency of their use.

The study has shown that new domestically produced machinery and equipment were acquired by 88 % of all organizations, imported products – by 35 % of organizations; domestic equipment on the secondary market was bought by 22 % of organizations, imported equipment – by 7 % of organizations. In the main, they purchased computer technologies, industrial complex and assembly lines, some separate technological units and means of transportation.

Shortage of their own financial means was the principal factor that suppressed, in 2010, the investment activity of organizations operating in the sector of extraction of mineral resources, in the processing industries, and in the production and distribution of electric energy, gas and water.

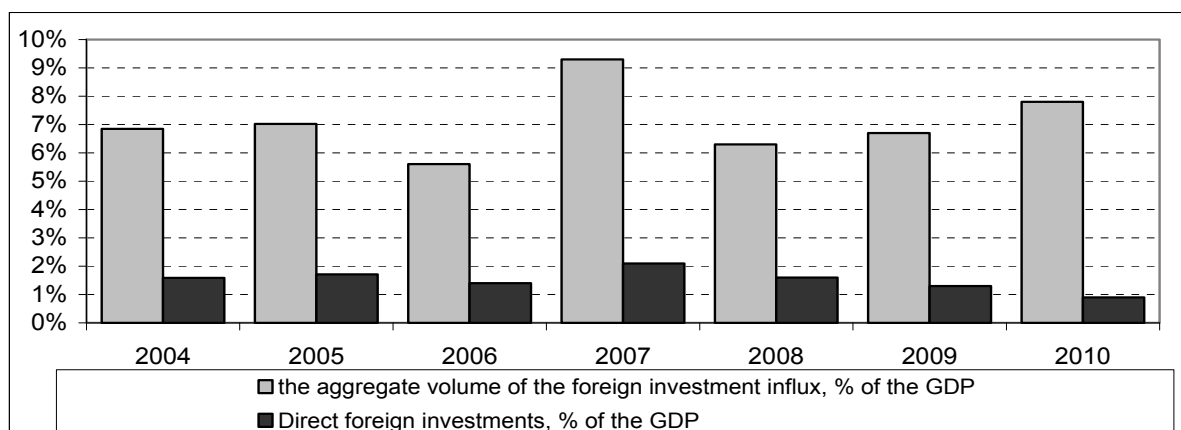
Table 19

Distribution of Organizations by the Estimated Factors Restricting Investment Activity, as % of Total Number of Organizations

	2000	2009	2010
Insufficient demand for products	10	29	19
Lack of their own financial resources	41	66	67
High interest on commercial credits	47	36	31
Complicated mechanism for getting credits needed for implementation of investment projects	39	19	15
Investment risks	35	23	23
Unsatisfactory technological base	18	7	5
Low rate of return on investments in fixed assets	8	10	11
Dubious economic situation in the country	49	48	32
Imperfect normative legal base for regulating investment processes	36	10	10

4.3.2. Foreign Investments

Most of the year 2010 is characterized by a drop in foreign investors' activities in the Russian Federation. In the investment sphere, crisis phenomena which were explicitly evident in 2009 kept prevailing in January-September 2010, while the influx of foreign investments in Russia decreased dramatically. In January-September 2010, the volume of foreign investments in the Russian economy fell by 13.2% as compared to that in the same period of 2009 and, by 46.0% as against the maximum level registered in January-September 2007. Due to substantial growth in foreign investments in the 4th quarter (a 150% increase as compared to the 4th quarter of 2009), the aggregate growth of 40.1% in foreign investments in the Russian economy as against the 2009 figure was registered (*Fig. 25*). At the same time, the outflow of the earlier invested capital continued. If in the 1st quarter of 2010 and the 4th quarter of 2010 the volume of the withdrawn funds (foreign investors' income which was transferred abroad as well as interest payments on loans and loan repayments) was equal to the volume of foreign investments into the country in the same period, in the 2nd quarter of 2010 and the 3rd quarter of 2010 it exceeded the latter by 12.1% and 22.7%, respectively. Furthermore, in 2010 Russian investments abroad exceeded the volume of foreign investments into the Russian economy. Such trends were typical of the first half of 2010 where such an excess in the 1st quarter of 2010 and the 2nd quarter of 2010 amounted to 72.6% and 64.9%, respectively. In the 3rd quarter of 2010 and in the 4th quarter of 2010, Russian investments abroad amounted to 28.0% and 60.0% of the volume of foreign investments in Russia in the same periods, respectively. It remains to be seen if the above factor is the trend's turning point.



The source: Rosstat.

Fig. 25. The level of the influx of foreign investments into the Russian economy in the 2004–2010 period. (% of the GDP)

In 2010, international rating agencies left Russia’s sovereign rating unchanged at the level below the pre-crisis one. At the same time, in December 2009 having registered some improvements in the Russian economy S&P, an international rating agency, raised Russia’s rating forecast from the negative one to the stable one and preserved the rating at the “BBB” investment level. In September 2010, having confirmed the current rating level the Fitch Agency upgraded the rating forecast to the positive one. According to Fitch, “the Russian economy is recovering after being seriously affected by the global financial crisis. Such a change of the forecast to the positive one reflects Fitch confidence that a switchover to a more flexible foreign exchange policy, substantial repayment of the foreign debt of the private sector, stabilization of the banking sector and growth in foreign exchange reserves should contribute to a decrease in the number of factors behind the country’s financial vulnerability”.

According to Moody's, another rating agency the Russia’s rating remains at the level of “Baa1”, while the rating forecast is “stable” (in the 2008–2009 period, unlike S&P and Fitch Moody's did not downgrade Russia’s rating, but cut only the rating forecast).

In 2010, foreign investments amounted to 140.1% and 105.8% as against the 2009 figure and the 2008 figure, respectively or USD 114.7 billion. (Table. 20).

In 2010, the largest growth in absolute indices (by USD 34.7 billion) was registered with the segment of other investments which were made on a return basis. Direct investments decreased by USD 2.1 billion. Such a drop took place due to a decrease in values of the following two components: contributions to the charter capital and loans from foreign co-owners of business entities. In 2010, the former fell by 3.7% to USD 7.7 billion, while the latter, by 28.4% to USD 4.6 billion. Thus, the unit weight of loans received from foreign co-owners in the structure of direct investments in the Russian Federation decreased from 40.5% in 2009 to 33.4% in 2010, while the share of contributions to the charter capital grew from 50.3% to 55.8%.

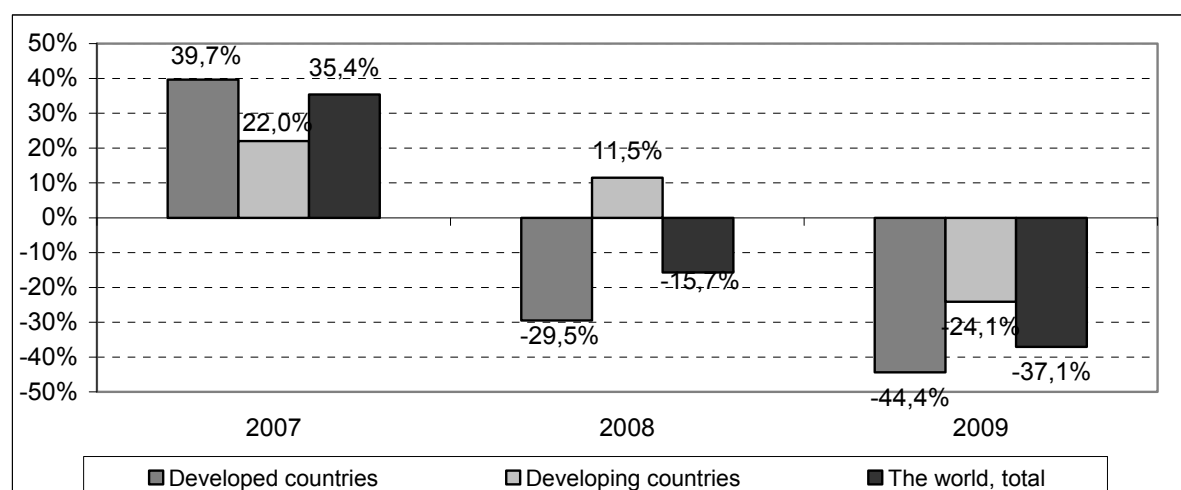
Table 20

**The volume and structure of foreign investments in the non-financial sector
of the Russian economy¹**

	In million USD.				% of the previous year			
	Total	Direct	Portfolio	Other	Total	Direct	Portfolio	Other
2006	55 109	13 678	3 182	38 249	102.7	104.6	700.0	95.3
2007	120 941	27 797	4 194	88 950	219.5	203.2	131.8	232.6
2008	103 769	27 027	1 415	75 327	85.8	97.2	33.7	84.7
2009	81 927	15 906	882	65 139	79.0	58.9	62.3	86.5
2010	114 746	13 810	1 076	99 860	140.1	86.8	121.9	153.3

The source: Rosstat.

According to the UNCTAD World Investment Report 2010 which was published in July 2010, as regards the volume of direct foreign investments in 2009 Russia is rated 6th in the world (it was rated 5th in 2008, 9th in 2007, 10th in 2006 and 15th in 2005). As in the previous year, among the developing countries Russia is rated 2nd after China. According to the above report, in 2009 Russia accounted for 3.5% of the global foreign investments (4.1% in 2008) and, for 8.2% of the direct foreign investments in developing countries (11.9% in 2008).

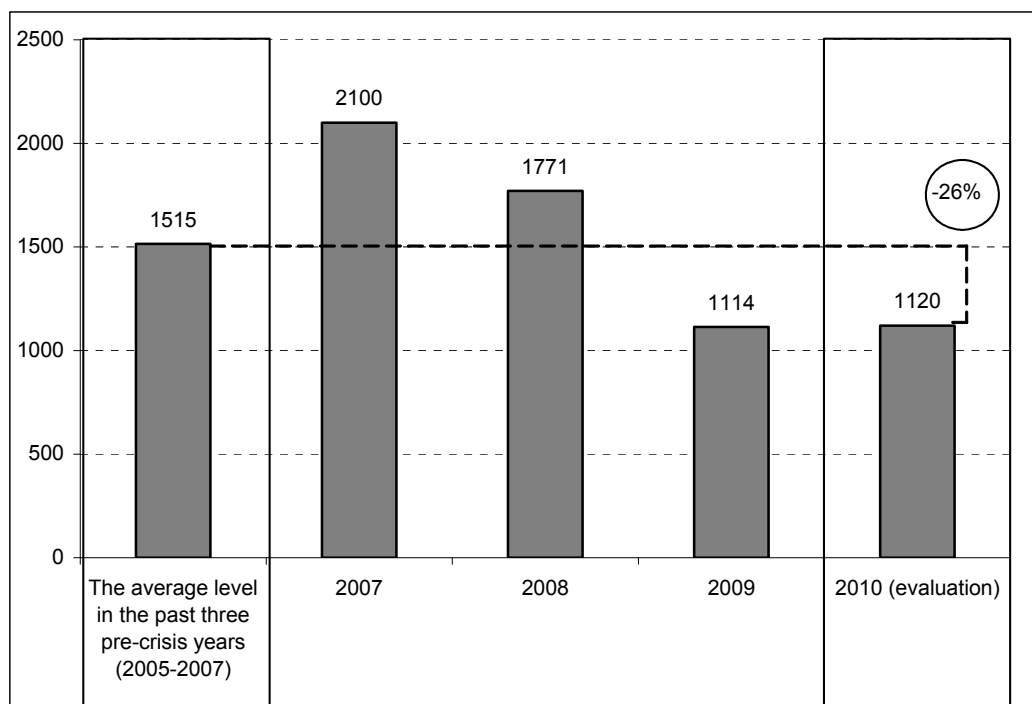


The source: UNCTAD World Investment Report 2010, July 22, 2010

Fig. 26. Changes in the influx of direct foreign investments
in the 2007–2009 period.

According to UNCTAD report, decrease in the aggregate volume of the global direct foreign investments was registered from 2008 (*Fig. 26*). According to preliminary estimates, in 2010 the aggregate volume of the direct foreign investments is virtually at the 2009 level, while in 2011 and 2012 it is expected to amount to USD 1.3–1.5 trillion and USD 1.6–2 trillion, respectively. (*Fig. 27*).

¹ Direct investments are investments in tangible assets and acquisition of a controlling interest or an interest which gives the investor the right to participate in management, while portfolio investments are investments in securities in order to receive income only; other investments are investments which are made on a return basis (loans of international financial institutions, trade loans and other).



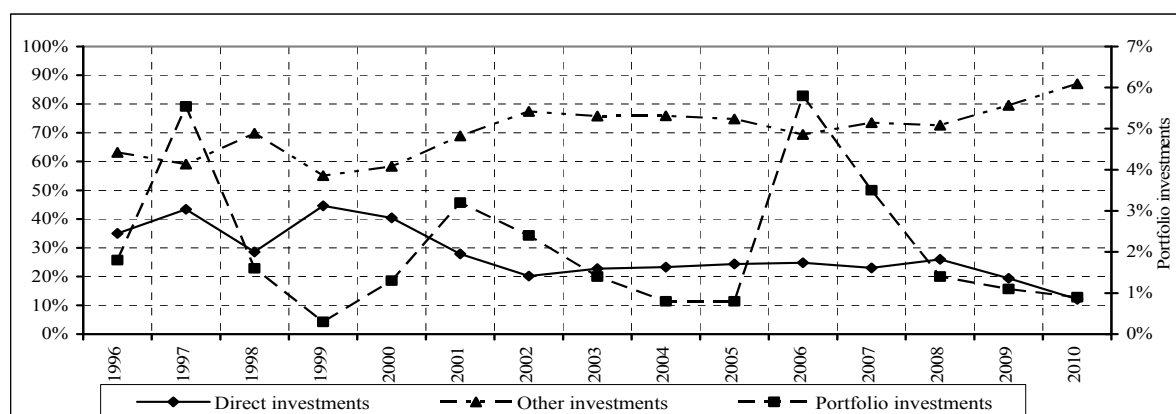
The source: UNCTAD Global Investment Trends Monitor, October 14, 2010.

Fig. 27. The global influx of direct foreign investments, billion USD.

As regards the segment of portfolio investments into the Russian economy in 2010, a 21.9% growth was registered as compared to that in 2009. At the same time, a decrease in the unit weight of investments in equities and shares from 42.9% in 2009 to 32.0% (against 95.5% of the volume of portfolio investments in 2007 and 79.6% in 2008) was observed.

In 2010, other investments grew by 53.3% as compared to the 2009 figure. The share of trade loans in the structure of other investments went down from 21.4% in 2009 to 17.6% in 2010 (against 21.5% in 2008). As regards the periods the investments were attracted for, the share of loans with a term of over six months fell to 38.0% as compared to 67.9% in 2009 (68.1% in 2008). The unit weight of loans with a term of less than six months increased up to 41.3% (against 10.1% in 2009 and 8.8% in 2008).

So, as compared to 2009 the structure of foreign investments into the Russian economy did not change much in 2010 (*Fig. 28*).



The source: Rosstat.

Fig. 28. The structure of foreign investments in the Russian economy in the 1996–2010 period.

In 2010, priorities of foreign investors by the type of business changed dramatically; a concentration of foreign investments in industry and the financial sector was registered. In 2010, foreign investments in industry and the financial sector increased by 44.2% and 1,330%, respectively, as compared to 2009.

In 2010, investors took less interest in trade, transport and communications. In 2010, foreign investments in trade decreased by 41.2%, while those in transport and communications, by 52.4%.

Breakdown of foreign investments into the Russian economy by the type of business is shown in *Table 21*.

Table 21

Breakdown of foreign investments into the Russian economy by the type of business in the 2008–2010 period

	In million USD			Change, % of the previous year			% of the total		
	2008	2009	2010	2008	2009	2010	2008	2009	2010
Industry	49 704	32 980	47 558	99.1	66.4	144.2	47.9	40.3	41.4
Transport and communications	4 861	13 749	6 576	72.5	282.8	47.8	4.7	16.8	5.7
Wholesale and retail trade; repair of motor vehicles, motor bikes, household appliances and personal items	23 905	22 792	13 334	50.5	95.3	58.5	23.0	27.8	11.6
Transactions with real property, rental and other services	15 378	7 937	7 341	182.8	51.6	92.5	14.8	9.7	6.4
Financial business	4 977	2 658	37 913	111.8	53.4	1426.3	4.8	3.2	33.0
Other industries	4 944	1 811	2 024	126.7	36.6	111.8	4.8	2.2	1.8

The source: Rosstat.

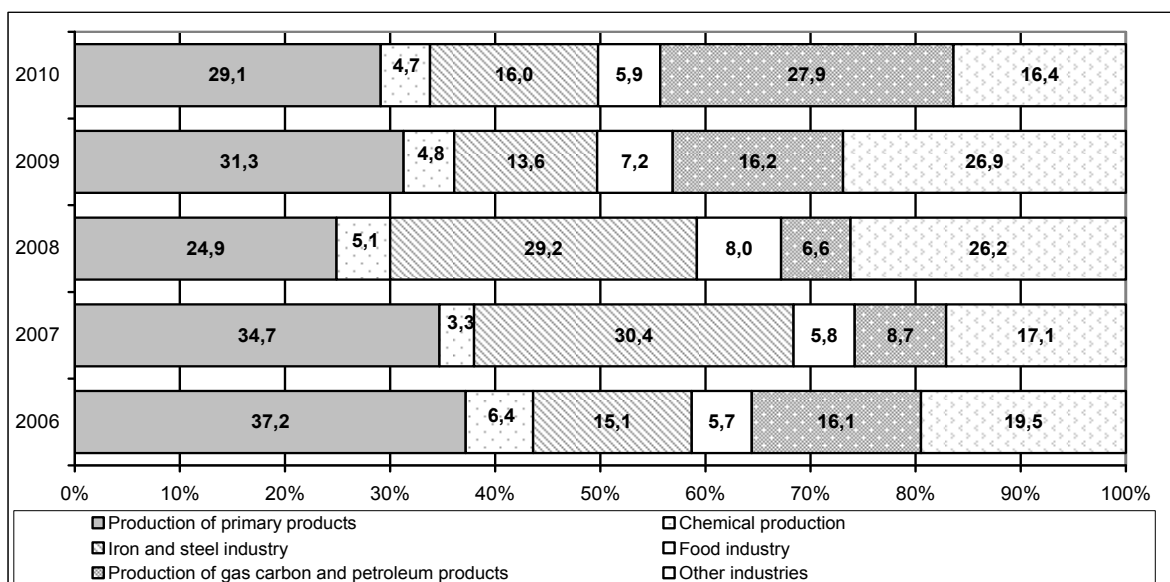
In 2010, in the structure of foreign investments in industry leaders of growth are manufacturing industries; as compared to 2009 investments in them grew by 49.2% (in 2009 a decrease amounted to 34.5%) (*Fig. 29*). Foreign investments in production of fuel and energy mineral resources increased by 43.2% (in 2009 a drop amounted to 16.0%).

In manufacturing industry, investments in production of gas carbon and petroleum products increased by 150%, while those in iron and steel industry, by 69.7%, thus amounting to USD 13.2 billion and USD 7.6 billion, respectively (in 2009 the growth in investments into

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production of gas carbon and petroleum products amounted to 63.7%, while investments in iron and steel industry fell by 68.8%). In 2010, foreign investments in chemical production increased by 41.3% to USD 2.2 billion as compared to 2009 (in 2009 a 37.6% drop in investments in that industry was registered).



The source: Rosstat.

Fig. 29. The breakdown of foreign investments in industry in the 2006–2010 period, %

In 2010, both direct investments and portfolio investments in industry decreased by 7.9% and 41.6%, respectively, as compared to 2009 (in 2009 they fell by 44.1% and 41.2%, respectively). As compared to 2009, other investments in industry grew by 62.0% (in 2009 a drop of 29.5% was registered). Thus, the unit weight of all other investments in industry grew from 75.6% in 2009 to 84.9% in 2010, while in the same period the share of the direct investments and that of portfolio investments fell from 22.4% and 2.0% to 14.3% and 0.8%, respectively.

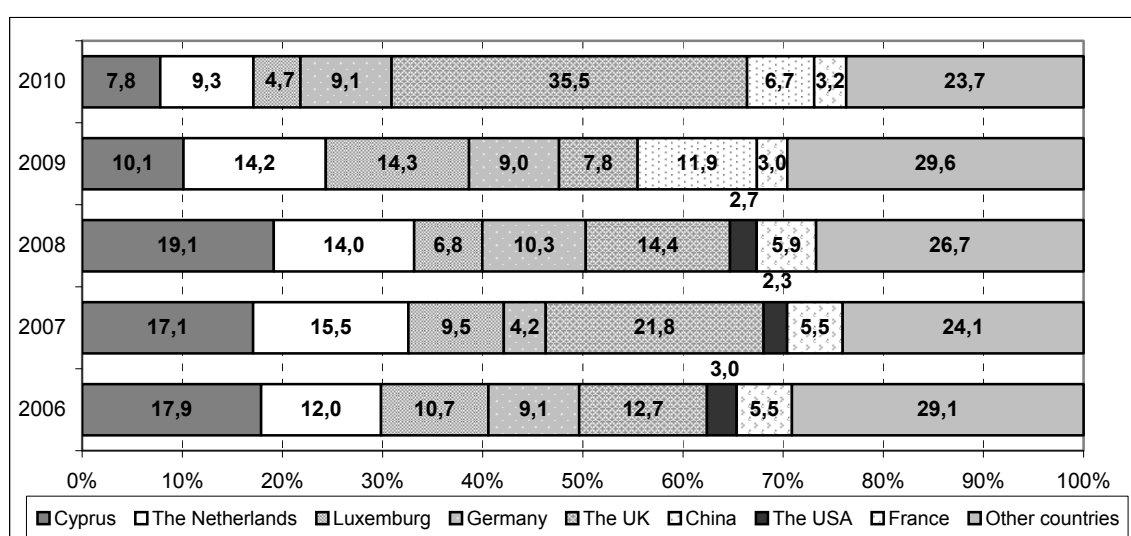
Changes in the structure of foreign investments by the type of economic activities in industry were registered. In production of primary products, direct investments kept falling and decreased by 35.9% to USD 2.0 billion. As a result, in 2010 the share of such investments in the aggregate investments in that industry fell to 14.7% (against 30.7% in 2009 and 40.2% in 2008). The share of other investments in production of primary products (in 2010 other investments grew by 70% to USD 11.8 billion) increased up to 85.0% (against 65.8% in 2009 and 59.0% in 2008).

In 2010, in manufacturing industry other investments accounted for a larger part of investments, too. As compared to 2009, such investments increased by 60% and amounted to 85.4% of all the investments in manufacturing industry in 2010 (against 80.6% in 2009). In 2010, direct foreign investments in manufacturing industry increased by 13.3%, while the unit weight of direct investments in manufacturing industry fell to 14.0% (against 18.5% in 2009).

As regards the geographic structure of foreign investments into the Russian economy in 2010, changes have taken place in the list of states which are the main exporters of the capital to the Russian Federation. In 2010, the largest volume of investments, that is, USD 242

40.8 billion (35.5% of the total volume of foreign investments into the Russian economy in the above period) was received from Britain and USD 10.7 billion worth of investments, from the Netherlands. In 2010, the top three leaders as regards investments in the Russian Federation included Germany as well, which country invested USD 10.4 billion in to the Russian economy.

In 2010, investments from Britain showed the highest growth of 530% as compared to that in 2009, while investments from Ireland increased by 240%. Investments from Germany and France rose by 41.7% and 48.6%, respectively. However, investments from Luxemburg, China, Japan and the Netherlands decreased by 54.2%, 21.8%, 63.3% and 8.1%, respectively. Differences in the dynamics of investments have resulted in changes in the geographic structure of foreign investments into the Russian economy (*Fig. 30*).



The Source: Rosstat. The data on investments from the USA in the 2009–2010 period and those from China in the 2006–2008 period is unavailable.

Fig. 30. The geographic structure of foreign investments into the Russian Economy in the 2006–2010 period, %

As of the end of December 2010, the accumulated foreign capital (without monetary regulation authorities, commercial banks and savings banks taken into account) including RUR investments calculated into US dollars amounted to USD 300.1 billion, which figure is 11.9% higher than the respective value as of the beginning of the year. From the beginning of the year, direct accumulated investments grew by 6.6% (*Table 22*).

In 2010, Cyprus, the Netherlands, Luxemburg, China and Germany account for a larger portion of the total volume of the accumulated foreign investments. The total share of the above countries amounted to 64.4% (against 66.3% in 2009). At the same time, the share of the above five leaders in the segment of other investments increased to 64.8% (against 62.9% in 2009), while in the segments of direct investments and the portfolio investments it is estimated to amount to 67.1% and 21.9%, respectively (against 69.0% and 85.1% in 2009).

Table 22

The accumulated foreign investments by the investor-country

	Accumulated as of January 1, 2011, million USD.			
	Total	Direct investments	Portfolio investments	Other investments
Ireland	11 488	568	4	10 916
Germany	27 825	9 254	11	18 560
Japan	9 022	824	2	8 196
Britain	21 578	3 501	4 481	13 596
Cyprus	61 961	44 737	1 732	15 492
The Netherlands	40 383	22 401	8	17 974
Luxemburg	35 167	661	203	34 303
China	27 940	942	0.1	26 998
Other countries	64 742	33 311	2 479	28 952
Total	300 106	116 199	8 920	174 987

The source: Rosstat.

Other investments prevail in the structure of foreign investments accumulated as of the end of December 2010. They accounted for 58.3%. A similar index as regards direct foreign investments amounted to 38.7%.

Considering the above, it may be concluded that the situation with investments in Russia started to improve by the end of 2010. Discernable growth in the volume of the accumulated foreign capital was registered. At the same time, a drop in the influx of the direct foreign investments in the Russian economy is a negative factor. Growth in foreign investments took place due to the segment of other investments which are made on a return basis. Thanks to lower interest rates and capital injection in the economy of countries which are the main investors in the Russian Federation, foreign businessmen took greater interest in the financial business in Russia.

In 2010, growth in profits of corporations was observed which factor according to UNCTAD “along with improvements of the situation on the stock markets will create a basis for financing direct foreign investments”. Interest of global investors in developing countries is constantly growing. “In particular, Brazil, the Russian Federation, India and China (BRIC countries) have good prospects of attracting direct foreign investments. In developing countries and countries with transition economy, apart from the most labor-intensive segments of the chain of creation of value, foreign investments will also be made far and wide into activities with a greater technological component”¹. Thus, with taking into account the registered growth in the foreign investments in the 4th quarter of 2010 a renewal of investments flows to the Russian economy may be expected in 2011.

Taking into account a considerable growth in prices on energy carriers late in 2009 and early in 2011, a substantial volume of investments into the fuel and energy complex can be expected. In addition to the above, both the ongoing liberalization of the legislation regulating foreign investments and measures aimed at making long-term projects more attractive may motivate foreign investors to make investments in other sectors of the Russian economy as well.

¹ UNCTAD World Investment Report 2010.

4.4. Oil-and-Gas Sector

The oil-and-gas sector has continued being the cornerstone to Russia's economy and as such it plays a pivotal role in forming the state budget revenue and the nation's balance of trade. In 2010, it was the situation in the global oil market, the one in the European gas market, and an objective deterioration of conditions of oil and gas production, decline in output at "old" fields and a considerably greater costs of development of new ones, particularly in the undeveloped regions with no infrastructure therein, that exerted the greatest influence on the national oil-and-gas sector's advancement.

4.4.1. The Dynamic of World Oil and Gas Prices

The recovery of the global economy in the aftermath of the financial and economic crisis had a determining impact on the situation on the global oil market in 2010. In 2008, on the eve of the global crisis, the world oil prices had hit an extremely high level. In July 2008, the average monthly oil prices overshoot USD 130/bbl., thus hitting their historical peak, both in nominal and real terms. The main factors propelling the price rise were: an increased demand for oil fueled by high growth rates of the global economy, China, India and other Asian economies' ones in particular, the OPEC's conservative policy in respect to its members' oil output, and low oil production rates outside OPEC. A serious factor that contributed to the oil price boom became a sizeable influx of speculative capital onto commodity exchange markets. In the last months of 2008, the deceleration of the global economic growth rates, decline in demand for oil in developed economies and the capital outflow from the commodity exchange markets sent global oil prices nosedive to USD 40/bbl in December 2008, ie more than thrice vis-à-vis their July 2008 figures (*Tables 23, 26*). In the conditions of a drastic downfall in world oil prices in the 2nd half 2008, in an attempt to maintain oil prices, OPEC made a number of decisions on contracting its members' output. However, in the conditions of decline in demand for oil in the developed countries as a consequence of the already started recession those measures had no visible effect on the market. In December 2008, OPEC ruled to cut the daily oil output by 4.2 mln.bbl vs. the September 2008 level, effective as of 1 January 2009.

In 2009, the contraction in oil demand in developed countries, which was caused by the financial and economic crisis (*Table 24*) was compensated by soaring demand on the part of emerging economies, China in the first place, and by the OPEC countries slashing their oil output, and some other oil producing nations (Norway, UK, and Mexico) followed the move. Over the last months of the year, the dynamic of oil prices found itself under a positive impact of renewed economic growth in the leading industrially developed nations. As a result, the world oil prices climbed from USD 40/bbl in the late-2008 up to USD 74-75/bbl in Q4 2009. In the circumstances, at its 2009 conferences OPEC ruled to retain its members' quotas, which had been set on 1 January 2009, unchanged.

In 2010, a steady economic growth in Asia, China in the first place, as well as a renewed economic growth in the OECD nations, primarily in the US, fueled a considerable rise in the global demand for oil (*Table 25*). Those factors were complemented by a relatively severe weather in the Northern hemisphere in Q4 2010. Propelled by the growing global demand, the OPEC production was on the upsurge, albeit at a gradual pace. It was Nigeria and Saudi Arabia that should take the bulk of credit for the rising OPEC's output. Overall, the 2010 OPEC's oil output was greater than the 2009 figures, but substantially lower than the 2008 ones. Nor-

way and UK saw their oil production at the fields in the North Sea continue to decline. Driven by the aforementioned factors, in the last months of 2010 the world oil prices left the range of USD 70-80/bbl., wherein they were over most part of the year and hit USD 90/bbl in December 2010. (Tables 26, Fig. 31). In 2010, Russia's Urals was traded on the global (European) market at the level of USD 78/3/bbl. on the average, or up by 28.4% vs. the previous year's level.

Table 23

World Prices of Oil in Nominal Terms in 2000–2010., as USD/bbl.

	2000	2005	2006	2007	2008
Price of Brent, UK	28.5	54.4	65.2	72.5	97.7
Price of Urals, Russia	26.6	50.8	61.2	69.4	94.5
Price of the OPEC oil basket	27.6	50.6	61.1	69.1	94.1

Table 23 (cont'd)

	2009 Q1	2009 Q2	2009 Q3	2009 Q4	2009
Price of Brent, UK	45.0	59.1	68.4	75.0	61.9
Price of Urals, Russia	43.7	58.1	68.0	74.3	61.0
Price of the OPEC oil basket	42.9	58.5	67.7	74.3	60.9

Table 23 (cont'd)

	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2010
Price of Brent, UK	76.7	78.7	76.4	86.8	79.6
Price of Urals, Russia	75.3	76.9	75.6	85.2	78.3

Source: IMF, OECD/IEA, OPEC.

Table 24

Global Oil Consumption in 2008–2009, as % to the Respective Period of the Prior Year

	2008	2009 Q1	2009 Q2	2009 Q3	2009 Q4	2009
The world, total	-0.6	-3.2	-2.5	-0.6	0.9	-1.3
OECD nations	-3.6	-5.2	-6.1	-3.6	-2.9	-4.5
Including:						
North America	-5.2	-5.4	-6.1	-1.3	-1.6	-3.6
Europe	-0.6	-2.9	-5.7	-7.1	-6.7	-5.6
APR	-4.0	-8.5	-7.2	-3.5	0.5	-4.8
Non-OECD countries	3.3	-0.6	1.9	3.0	5.8	2.5
Including:						
Asia (less Middle-East and ex-USSR countries)	1.7	-0.8	4.8	6.7	12.5	5.8

Source: OECD/IEA.

Table 25

Global Oil Consumption in 2010, as % to the Respective Period of the Prior Year

	2010 Q1	2010 Q2	2010 Q3	2010 Q4	2010
The world, total	2.3	3.3	3.8	3.5	3.2
OECD nations	-1.1	1.6	3.6	1.7	1.5
Including:					
North America	0.6	3.6	4.1	2.1	2.6
Europe	-4.9	-1.1	2.2	1.8	-0.5
APR	0.9	0.6	4.8	0.4	1.6
Non-OECD countries	6.5	5.2	4.0	5.5	5.3
Including:					
Asia (less Middle-East and ex-USSR countries)	9.9	6.5	3.8	6.9	6.7

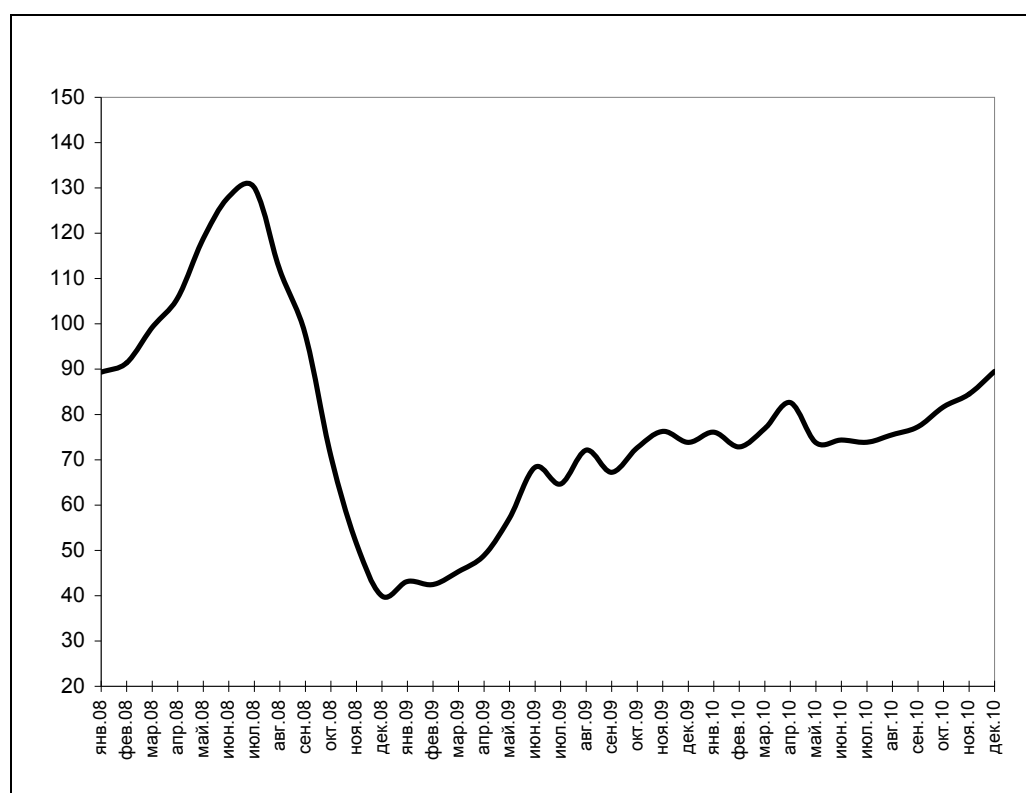
Source: OECD/IEA.

Table 26

Global Prices of Oil in 2010, as USD/bbl

	January	February	March	April	May	June	July	August	September	October	November	December
Price of Brent, UK	76.2	73.6	78.9	84.9	75.2	74.9	75.6	77.2	77.8	82.7	85.3	91.4
Price of Urals, Russia	76.1	72.9	76.9	82.6	73.8	74.4	73.9	75.5	77.3	81.7	84.5	89.5

Source: OECD/IEA, OPEC.



Source: The RF Ministry of Economic Development.

Fig. 31. Price of Urals in 2008–2010, USD/bbl.

Prices for natural gas on the global market are determined, as a rule, on the basis of prices of energy sources alternative to gas (chiefly AOD/diesel fuel, and fuel oil), which depend on world prices of oil. That is why the world prices for natural gas follow oil prices, but with a certain lag. On the European market, following the oil prices, the ones of the Russian gas likewise hit their peak value in 2008 and declined in 2009 (*Table. 27*).

In 2010, the gas prices were on the upsurge; however, in contrast to oil prices, if averaged over the year, they were below the 2009 figures. This can be ascribed to the impact of two factors. First, the lag between oil and gas prices determined the latter ones passing the price nadir at a moment of time later than that for oil prices. While the minimum quarterly prices for oil were noted in Q1 2009, those of gas – in Q3 2009 г (*Table. 28*). Second, the change of the situation on the European gas market – namely, a considerable rise in offer of gas, a size-

able growth in LNG supplies in tandem with a lower level of spot prices for gas vis-à-vis prices quoted in long-term contracts drove the 2010 Russian gas prices down.

In 2009–2010, the spot gas prices on the European market were lower than the ones of the Russian pipeline gas supplied under long-term contracts (*Table 29*). Behind the phenomenon were a growing offer of gas, primarily by Norway and Qatar, decline in demand for gas in the conditions of the recession, and a more flexible pricing policy with regard to LNG (contract prices of pipeline gas are determined on the basis of prices of substitute fuels over previous periods, which is why they react to the market situation with a certain lag).

The EU policy on diversification of sources of energy supplies, creation the European RLNG infrastructure, and lower LNG prices in 2009-2010 have entailed a certain decline in the proportion of the Russian gas on the European gas market. According to the East European Gas Analysis, Russia's share in gas imports from outside the EU to the European countries that hold membership i OECD plunged from 39% in 2008 to 33% in the first half 2010, while Norway's share soared from 23 to 27%, and that of Qatar– from 2 up to 8%.

Table 27

World Prices for Oil and Natural Gas in 2002–2010, as USD/bbl.

	2002	2003	2004	2005	2006	2007	2008	2009	2010
The average world oil price, USD/bbl	24.95	28.89	37.76	53.4	64.3	71.1	97.0	61.8	79.0
The prices of Russian gas on the European market, USD/Thos. c. m.	96.0	125.5	135.2	212.9	295.7	293.1	473.0	318.8	296.0

Source: IMF.

Table 28

Prices for Oil and Natural Gas on the European Market in 2009–2010, USD/bbl

	2009 Q1	2009 Q2	2009 Q3	2009 Q4	2010 Q1	2010 Q2	2010 Q3	2010 Q4
The price of Brent, USD/bbl.	45.0	59.1	68.4	75.0	76.7	78.7	76.4	86.8
The prices of Russian gas on the European market, USD/Thos. c. m.	503.5	309.6	229.8	232.2	273.2	291.4	306.5	313.0

Source: IMF.

Table 29

Contract Prices of Pipeline Gas and Spot Prices of LNG in 2010

	January	February	March	April	May	June	July	August	September	October	November	December
The average price of Russian pipeline gas in Europe, USD/USD/Thos. c. m.	273	273	273	301	283	290	305	309	306	311	314	314
Spot prices of LNG in Germany, USD/Thos. c. m.	230	214	182	194	222	237	270	255	268	287	295	360

Source: OAO «Gasprom», IMF.

4.4.2. Dynamic and Structure of Production in the Oil-and-Gas Sector

The rise in oil output in Russia in the early 2000s was propelled by extending opportunities for oil export, thanks to the creation of the Baltic pipeline system and the use of railroad transport in particular, as well as by intensification of development of existing fields and the oil companies' greater opportunities due to the price rise for oil. Later, though, the oil production growth rates plunged substantially. While in 2002-2004 the annual oil production increase rate was 8.9–11%, the 2006–2007 figures made up just 2,1%, and the year of 2008, for the first time over recent years, saw oil production decline. That was a clear sign of exhaustion of reserves to boost the nation's oil output at the expense of intensification of development of operating fields, which testifies to the need for more pro-active measures on developing new oil areas.

The growth in oil production renewed in 2009, though the increase rate was relatively low (1.2% vs. the prior year). In 2010, the increase rate accounted for 2.1% thus matching the 2005-2007 figures (*Tables. 30, 31*). The dynamic of oil output found itself driven by placement in operation of several new large oil fields in the north of Russia's European part and in Eastern Siberia as well as by enactment of a number of amendments to the Tax Code of RF aimed at lowering the tax burden on the oil sector, encouraging a more intense development of existing fields and developing new production areas.

Table 30

Oil Production and Refining in Russian Federation in 2000–2010

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Production of oil, including gas condensate, mln. tn.	323.2	348.1	379.6	421.4	458.8	470.0	480.5	491.3	488.5	494.2	505.1
Primary oil refining, mln. tn.	173	179	185	190	195	208	220	229.0	236.3	236.0	249.3
The share of oil refining in its production, %	53.5	51.4	48.7	45.1	42.5	44.3	45.8	46.6	48.4	47.8	49.4
Refining depth of petroleum feedstock, %	71	71	70	70	71	71.6	71.9	71.7	72.0	71.9	71.2

Source: the Federal State Statistics Service, the RF Ministry of Energy.

Oil processing has recently grown at a pace greater than its extraction, which can be ascribed chiefly to an accelerated growth in export of oil products, which was encouraged by export duties on oil products being lower than the ones levied on crude oil. Between 2005 and 2010 (except for 2009) the annual growth rates of primary oil refining accounted for 3.2–6.2% vis-à-vis the annual oil output growth rates that made up 1.2–2.2% (except for the 2008 figures). As a result, the proportion of refined oil in oil output surged from 42.5% in 2004 to 49.4% in 2010. That, however, was still way behind the 2000–2001 figures: at the time, more than a half of extracted oil was supplied to refineries. Meanwhile, the processing depth has practically remained unchanged over the past decade and accounted just for 71.2% in 2010, which basically quadrates with the 2000 figure (for reference: the respective rate in the leading developed economies accounts for 90-95%). Efficacy of oil refining and quality of Russian oil products still substantially fall short of matching international standards.

Table 31

**Production of Oil, Petroleum Derivatives and Natural Gas in 2000–2010,
as % to the Prior Year**

	2000	2001	2002	2003	2004
Oil, including gas condensate	106.0	107.7	109.0	111.0	108.9
Primary oil processing	102.7	103.2	103.3	102.7	102.6
Petrol	103.6	100.6	104.9	101.2	103.8
Diesel fuel	104.9	102.0	104.7	102.0	102.7
Black oil fuel	98.3	104.2	107.1	100.3	97.8
Natural gas	98.5	99.2	101.9	103.4	101.6

Table 31(cont'd)

	2005	2006	2007	2008	2009	2010
Oil, including gas condensate	102.2	102.1	102.1	99.3	101.2	102.1
Primary oil processing	106.2	105.7	103.8	103.2	99.6	105.5
Petrol	104.8	107.4	102.1	101.8	100.5	100.5
Diesel fuel	108.5	107.0	103.4	104.1	97.7	104.2
Black oil fuel	105.8	104.5	105.2	101.9	100.8	108.5
Natural gas	100.5	102.4	99.2	101.7	87.9	111.4

Source: the Federal State Statistics Service.

Atop the 2010 list of biggest oil producers in Russia were oil companies Rosneft, LUKOIL, THK-BP, Surgutneftegas, and Gazprom. Their aggregate share in the nation's total oil output accounted for nearly 75%. Meanwhile, medium-sized oil companies' (Tatneft, Slavneft, Bashneft, and Russneft) share made up 14.2%. Companies operating under PSAs produced another 2.9% of Russian oil, while the share of other oil producers (100-plus small oil extracting organizations) was 7.6% (Table 32). The proportion of state-run (belonging to the federal government) companies in the country's total oil output amounted to 30.8%. To put this in perspective, back in 2003, before their taking over private oil companies' assets, Rosneft and Gazprom combined produced only 7.3% of Russian crude.

Table 32

Oil Produced by Various Oil Companies in 2008–2010

	Oil output in 2008, mln. tn.	Share in total output, %	Oil output in 2009, mln. tn.	Share in total output, %	Oil output in 2010, mln. tn.	Share in total output, %
Russia, total	488.5	100.0	494.2	100.0	505.1	100.0
Rosneft	113.8	23.3	116.3	23.5	112.4	22.3
LUKOIL	90.2	18.5	92.2	18.7	90.1	17.8
THK-BP	68.8	14.1	70.2	14.2	71.7	14.2
Surgutneftegaz	61.7	12.6	59.6	12.1	59.5	11.8
Gazprom + Gazprom neft	43.4	8.9	41.9	8.5	43.3	8.6
Including:						
Gazprom	12.7	2.6	12.0	2.4	13.5	2.7
Gazprom neft	30.7	6.3	29.9	6.1	29.8	5.9
Tatneft	26.1	5.3	26.1	5.3	26.1	5.2
Slavneft	19.6	4.0	18.9	3.8	18.4	3.6
Bashneft	11.7	2.4	12.2	2.5	14.1	2.8
Russneft	14.2	2.9	12.7	2.6	13.0	2.6
NOVATEK	2.7	0.6	3.3	0.7	3.8	0.8
PSA operators	12.0	2.5	14.8	3.0	14.4	2.9
Other producers	24.1	4.9	26.0	5.3	38.2	7.6
Public companies, com- bined:						
Rosneft + Gazprom + Gazprom neft	157.2	32.2	158.2	32.0	155.7	30.8

Source: the RF Ministry of Energy, author's calculations.

Gazprom traditionally preponderated the gas production area. Meanwhile, as the decline in the national natural gas output can be chiefly ascribed to Gazprom's poorer performance, the company's share in 2009-2010 slid slightly (to 77.2%) vis-à-vis an increasing specific weight of other producers, including oil companies, NOVATEK, PSA operators, and other producers. The 2010 share of public (state-owned) corporations in the nation's gas output accounted for 79.8% (Table 33).

Table 33

Structure of Natural Gas Production in 2008–2010

	Gas output in 2008, bln. m.	Share in total output, %	Gas output in 2009, bln. m.	Share in total output, %	Gas output in 2010, bln. m.	Share in total output, %
Russia, total	664.9	100.0	596.4	100.0	665.5	100.0
Gazprom + Gazprom neft	553.1	83.2	466.6	78.2	513.9	77.2
Including:						
Gazprom	550.9	82.9	462.3	77.5	509.0	76.5
Oil companies	54.8	8.2	63.5	10.6	66.6	10.0
NOVATEK	30.8	4.6	32.8	5.5	37.8	5.7
PSA operators	8.5	1.3	18.3	3.1	23.3	3.5
Other producers	17.6	2.6	15.2	2.5	23.9	3.6
Public companies, combined:						
Rosneft + Gazprom + Gaz- prom neft	566.1	85.1	484.0	81.2	531.2	79.8

Source: the RF Ministry of Energy, author's calculations

The recently noted decline in the oil output growth rate should be ascribed to the objective deterioration of operating conditions in the first place. A considerable fraction of oil fields in Russia has entered the decollement stage, while new fields mostly display worse mining and geological conditions and geographic parameters, and their development requires greater capital, operating and transportation costs.

A drastic fall in gas production in 2009 (by 12.1% on a year-on-year basis) resulted from the drop in the domestic and external demand caused by the recession and a compulsory contraction of gas supplies to Europe in early 2009 because of the "gas conflict" with Ukraine. In 2010, Russia's gas output caught up with its 2008 figures, but export of gas still was far below the pre-crisis level.

4.4.3. Dynamic and Structure of Export of Oil and Gas

The 2010 aggregate net export of oil and oil products was on the rise against the backdrop of growth in oil production and is estimated to hit 376.6 mln. tn.. This is the historic peak for Russia's oil sector. (Tables 34, 35). The specific weight of net export of oil and oil products in oil production accounted for 74.6%. That said, Russia has substantially cut oil supplies to Belarus, as the counterparts could not agree on levying the export duty on the supplies (between January and November 2010 Russian oil supplies to Belarus plunged by nearly 41% on a year-on-year basis). In 2010, oil export accounted for 49.6% of the nation's oil output. The proportion of export in black oil fuel hit 90.9% between January and November 2010, and that in diesel fuel – 59.4%. The 2010 export of petrol plummeted 34.2%, while the share of export of petrol in the respective output slid to 8.5% (for reference: the 1999 figure was 7.2%, the 2005 one – 18.5, in 2008 – 12.5, and in 2009 – 12.6%).

Meanwhile, the year of 2010 saw a notable rise in import of oil products (up 2.4 times on a year-on-year basis) and growth in the share of import in satisfying the domestic demand. The

share of import in petrol resources soared from 0.6% in 2009 to 1.4% in 2010 (for reference: in the 1st half 1998 the respective figure was 8.7%, in 2008– 0.7%). The 2010 indices for diesel fuel and black oil fuel stood at 0.8 и 1.1%, respectively.

Table 34

**Export of Oil, Oil Products and Natural Gas from Russia in Natural Equivalent
in 2002–2010, as % on a Year-on-Year Basis**

	2002	2003	2004	2005	2006	2007	2008	2009	2010*
Oil, total	113.9	117.8	115.0	98.4	98.0	104.0	94.0	101.8	101.2
Including:									
Non-CIS countries	109.9	118.9	116.3	99.1	98.0	104.8	92.6	102.9	107.4
CIS countries	137.3	112.4	108.3	94.9	98.0	99.4	102.6	95.4	65.2
Oil products, total	118.5	103.6	105.5	117.9	106.3	108.0	105.0	105.3	105.0
Including:									
Non-CIS countries	119.1	102.6	104.9	119.1	104.5	107.6	102.0	107.1	108.4
CIS countries	102.8	132.3	117.9	94.6	148.8	115.3	152.2	86.8	61.5
Gas, total	102.4	102.0	105.5	103.7	97.6	94.6	101.8	86.2	106.1

* Estimated.

Source: the Federal State Statistics Service

After a sizeable (by 13.8%) contraction of oil exports in 2009 caused by the fall in export gas supplies to Europe, the next year Russian gas export surged thanks to an increase in supplies to the CIS countries. However, Russian gas export has not yet hit the pre-crisis level. Meanwhile, the specific weight of net export in gas production plummeted from 28.2% in 2008 to 25.6% in 2010.

Table 35

**Correlation between Production, Consumption and Export of Oil
and Natural Gas in 2000–2010**

	2000	2005	2006	2007	2008	2009	2010*
Oil, mln. tn.							
Production	323.2	470.0	480.5	491.3	488.5	494.2	505.1
Export, total	144.5	252.5	248.4	258.4	243.1	247.4	250.4
Export to non-CIS countries	127.6	214.4	211.2	221.3	204.9	210.9	226.6
Export to CIS countries	16.9	38.0	37.3	37.1	38.2	36.5	23.8
Net export	138.7	250.1	246.1	255.7	240.6	245.6	248.6
Domestic consumption	123.0	123.1	131.2	124.1	130.4	125.3	128.5
Net export as % to production	42.9	53.2	51.2	52.0	49.3	49.7	49.2
Oil products, mln. tn.							
Export, total	61.9	97.0	103.5	111.8	117.9	124.4	130.6
Export to non-CIS countries	58.4	93.1	97.7	105.1	107.6	115.4	125.1
Export to CIS countries	3.5	3.9	5.8	6.7	10.3	9.0	5.5
Net export	61.5	96.8	103.2	111.5	117.5	123.3	128.0
Oil and oil products, mln. tn.							
Net export of oil and oil products	200.2	346.9	349.3	367.2	358.1	368.9	376.6
Net export of oil and oil products, as% to oil production	61.9	73.8	72.7	74.7	73.3	74.6	74.6
Natural gas, bln. c.m.							
Production	584.2	636.0	656.2	654.1	664.9	596.4	665.5
Export, total	193.8	207.3	202.8	191.9	195.4	168.4	178.7
Export to non-CIS countries	133.8	159.8	161.8	154.4	158.4	120.5	108.6
Export to CIS countries	60.0	47.5	41.0	37.5	37.0	47.9	70.1
Net export	189.7	199.6	195.3	184.5	187.5	160.1	170.4
Domestic consumption	394.5	436.4	460.9	469.6	477.4	436.3	495.1
Net export as % to production	32.5	31.4	29.8	28.2	28.2	26.8	25.6

* Estimated.

Source: the Federal State Statistics Service, the RF Ministry of Energy, the Federal Customs Service, author's calculations.

With some growth in the proportion of oil products, the structure of Russia's oil export was still dominated by export of crude, which in 2010 accounted for 66.0% of the aggregate export of oil and oil products. The bulk of the export of oil products was formed by black fuel oil, which Europeans use for further processing, and by diesel fuel. The bulk of energy resources (in 2010 – as much as 90% of oil, 96% of oil products and 61% of gas) was exported to outside the CIS.

Analysis of the dynamic of Russia's oil export over a long period of time evidences an increase therein of the share of oil products, whose specific weight grew from 18.2% in 1990 to 34.0 % in 2010 r. (*Table 36*). With a drastic decline in the domestic consumption (our calculations show it plunged from 269.9 mln. tn. in 1990 to 128.5 mln. tn. in 2010), the specific weight of net export of oil and oil products in oil output increased from 47.7 to 74.6% over the period in question.

Table 36

Net Export of Oil Products in 2002–2010

	2002	2003	2004	2005	2006	2007	2008	2009	2010*
Net export of oil products, mln. tn.	74.8	78.2	81.4	96.8	103.2	111.5	117.5	123.3	128.0
Share of oil products in net export of oil and oil products, %	29.2	26.8	24.3	27.9	29.5	30.4	32.8	33.4	34.0

* Estimated.

Source: the Federal State Statistics Service, the Federal Customs Service, author's calculations.

The above data evidence a substantial intensification of the oil sector's export orientation against the pre-reform period. That said, it should be noticed that the process in question is associated not only with increase in absolute export volumes, but with a sizeable contraction in the domestic consumption of oil due to the market transformation of Russia's economy, as well. In the period prior to the financial and economic crisis of 2008–2009 the pace of economic growth was high, while the volume of domestic consumption remained fairly stable. This evidences a certain decline in oil intensity rate of Russia's GDP.

The oil price boom in 2008 sent the oil sector's proceeds upswing substantially (*Fig. 32, 33*). That year, aggregate proceeds from export of oil and main kinds of oil products (petrol, diesel fuel and black fuel oil) accounted for USD 228.9 bln., which was a record-breaking amount ever posted over the whole post-reform period. (*Tables 37, 38*). It can be noted for reference that the minimum level of oil export proceeds (USD 14 bln.) was recorded in the conditions of the 1998 price downfall. The fall in oil prices in 2009 likewise resulted in a substantial contraction of export revenues, while the subsequent price rise in 2010 made export proceeds bounce upwards substantially. Between January and November 2010 the aggregate proceeds from export of oil and oil products hit USD 173.6 bln.

Table 37

Export Proceeds from Oil and Oil Products in 2000–2010, as USD Bln.

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010 (11 mec.)
Export gains from oil and main oil products	34.9	33.4	38.7	51.1	74.6	112.4	140.0	164.9	228.9	141.2	173.6

Source: calculated on the basis of the Federal State Statistics Service's data.

Table 38

Proceeds from Export of Oil and Oil Products in 2008–2010, as USD Bln.

	2008 Q1	2008 Q2	2008 Q3	2008 Q4	2009 Q1	2009 Q2	2009 Q3	2009 Q4	2010 Q1	2010 Q2	2010 Q3
Export gains from oil and main oil products	53.2	64.4	68.9	42.4	25.6	30.6	39.2	45.8	45.2	47.9	46.2

Source: calculated on the basis of the Federal State Statistics Service's data.

Affected by increasing world prices for oil and gas, the proportion of fuel-and-energy commodities in Russian's exports in 2008 hit 68.6%, including crude – 34.4% (Table 39). In 2009, the share of these commodities in the nation's export dropped slightly, but remained high nonetheless. In 2010, the proportion of fuel-and-energy commodities in Russia's exports accounted for 67.5%, including crude – 34.0%.

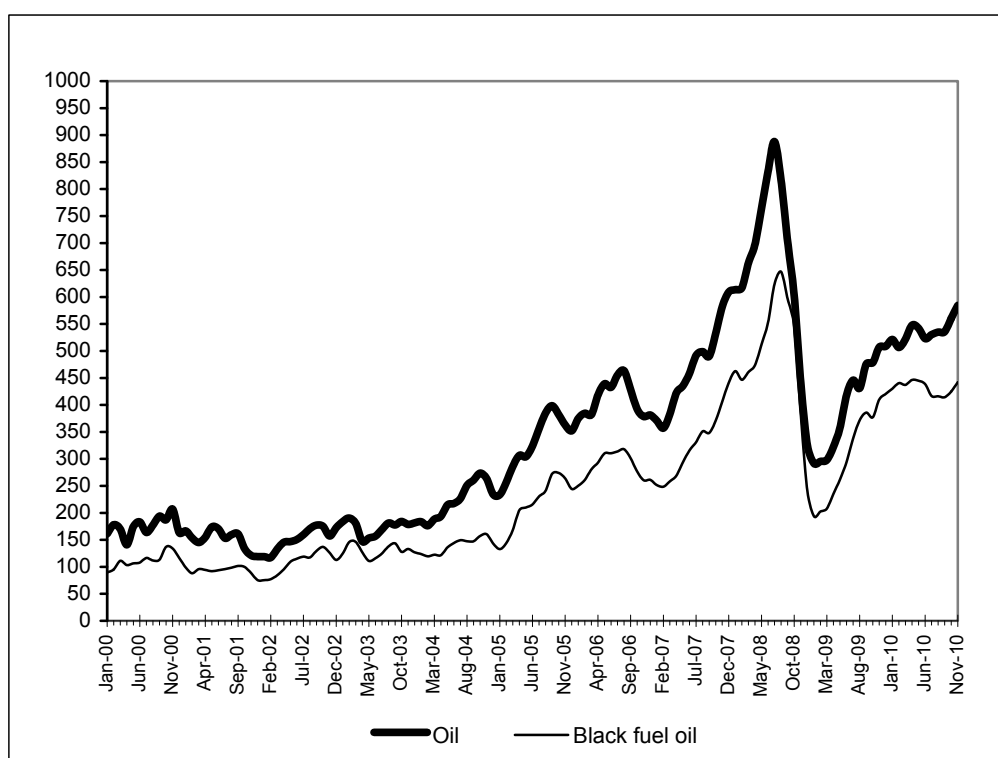
Table 39

Value and Specific Weight of Export of Fuel-and-Energy Commodities in 2005–2010

	2005		2008		2009		2010	
	USD bln.	%*	USD bln.	%*	USD bln.	%*	USD bln.	%*
Fuel-and-energy commodities, total	154.7	64.1	321.1	68.6	201.1	66.7	267.7	67.5
Including:								
oil	83.8	34.7	161.2	34.4	100.6	33.3	134.6	34.0
Natural gas	31.4	13.0	69.1	14.8	42.0	13.9	47.6	12.0

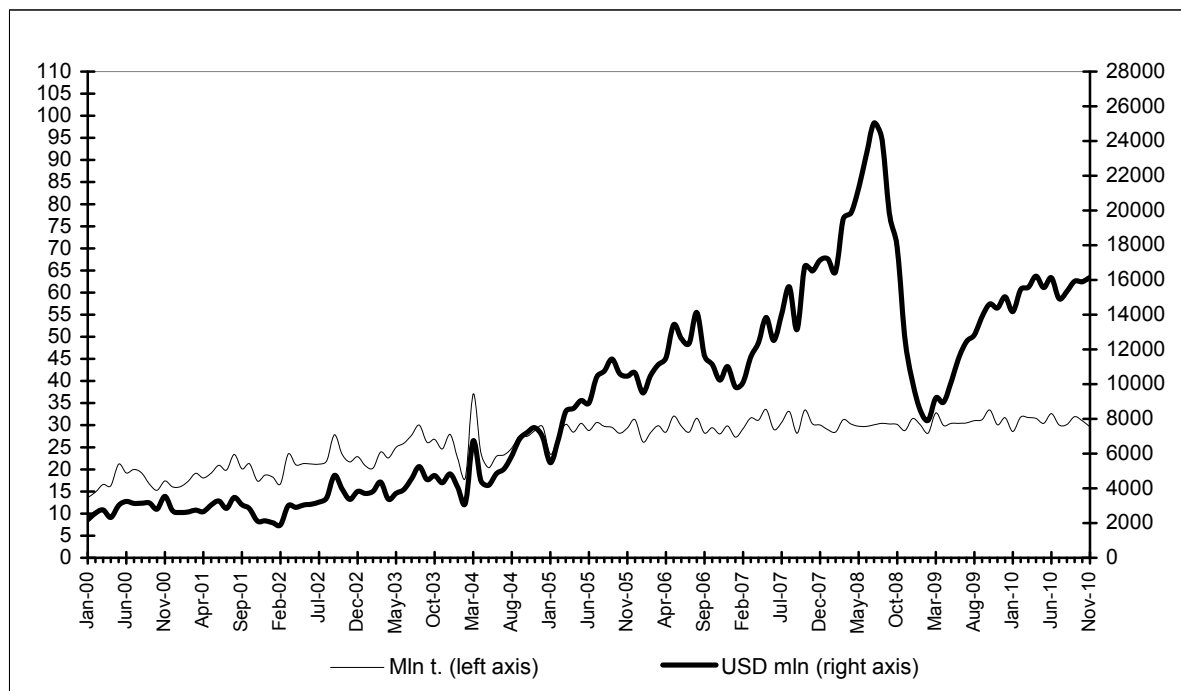
* As % of the total volume of Russian exports.

Source: the Federal State Statistics Service.



Source: calculated on the basis of the Federal State Statistics Service

Fig. 32. Average Export Prices of Oil and Black Fuel Oil in 2000–2010, USD/ton



Source: calculated on the basis of the Federal State Statistics Service's data.

Fig. 33. Export of Oil and Oil Products in Natural and Value Equivalent in 2000–2010, Mln. T/, USD Mln.

4.4.4. Price Dynamic for Energy Commodities on the Domestic Market

Propelled by rising oil prices in 2008, the domestic prices of oil and oil products in Russia likewise were on the upsurge. In the summer of 2008, the prices for oil, petrol, diesel fuel and black oil fuel hit their absolute peaks over the post-reform period. In July 2008, the average domestic price of oil (producer price) in USD equivalent hit USD 410.2/ton, while the one of petrol – USD 810.3/ton. Between September and December 2008, and in the early 2009, the plummeting world oil prices and depreciating Ruble sent domestic prices of oil and oil products in USD equivalent nosedive. In 2009, the domestic price of oil and oil products in USD equivalent notably bounced upwards as a result of rising world oil prices and eventually over-ran the 2008 figures. (*Table 40, Fig. 34, 35*). In 2010, the world prices of oil and light oil products continued climbing up and fueling a further increase in the domestic prices of oil and light oil products in USD equivalent.

Table 40

Domestic Prices of Oil, Oil Products and Natural Gas in USD equivalent in 2000–2010 (Average Producer Prices, as USD/ton)

	2000 December	2005 December	2006 December	2007 December	2008 July	2008 December
Oil	54.9	167.2	168.4	288.2	410.2	114.9
Petrol	199.3	318.2	416.5	581.2	810.3	305.1
Diesel fuel	185.0	417.0	426.1	692.5	902.8	346.5
Black oil fuel	79.7	142.7	148.8	276.5	392.8	125.0
Gas, USD/ c.m.	3.1	11.5	14.4	17.6	23.8	18.1

RUSSIAN ECONOMY IN 2010

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Table 40 (continued)

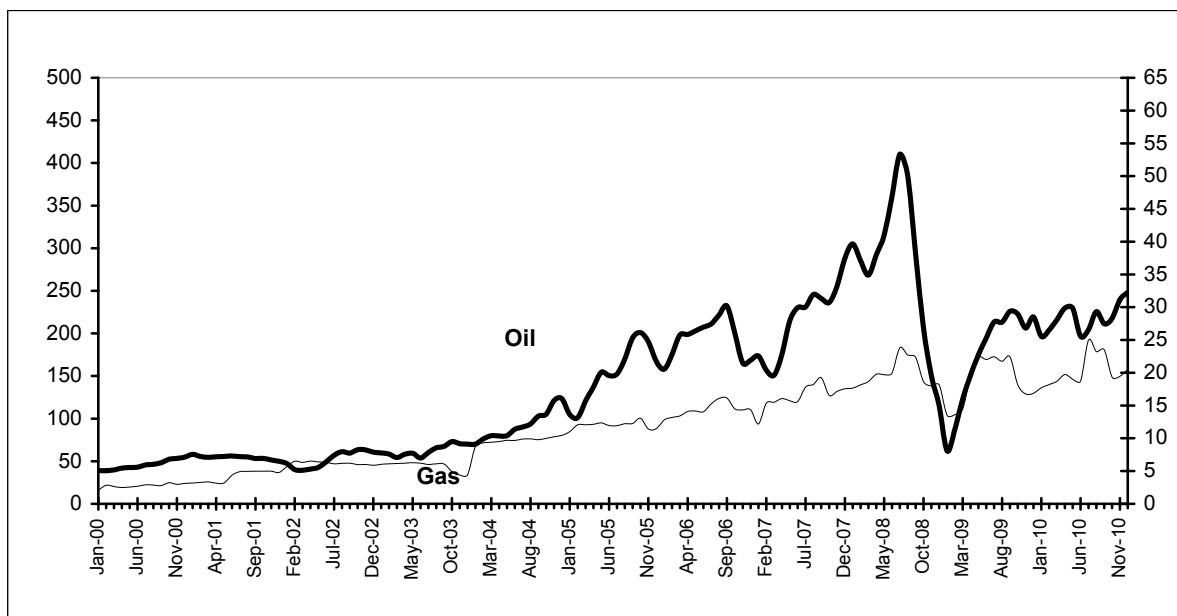
	2009 January	2009 March	2009 June	2009 September	2009 December
Oil	62.2	122.9	194.7	225.9	219.3
Petrol	244.3	318.8	481.5	593.2	457.4
Diesel fuel	306.2	343.1	382.1	388.2	394.8
Black oil fuel	107.2	145.9	210.8	265.8	250.8
Gas, USD/ c.m.	13.5	14.5	22.0	22.4	16.9

Table 40 (continued)

	2010 January	2010 March	2010 June	2010 September	2010 December
Oil	196.5	216.3	196.7	211.2	248.2
Petrol	483.0	507.3	529.2	544.0	547.9
Diesel fuel	429.5	431.3	406.7	423.8	536.1
Black oil fuel	195.3	229.0	236.3	246.2	246.3
Gas, USD/ c.m.	17.7	18.7	18.7	23.5	20.5

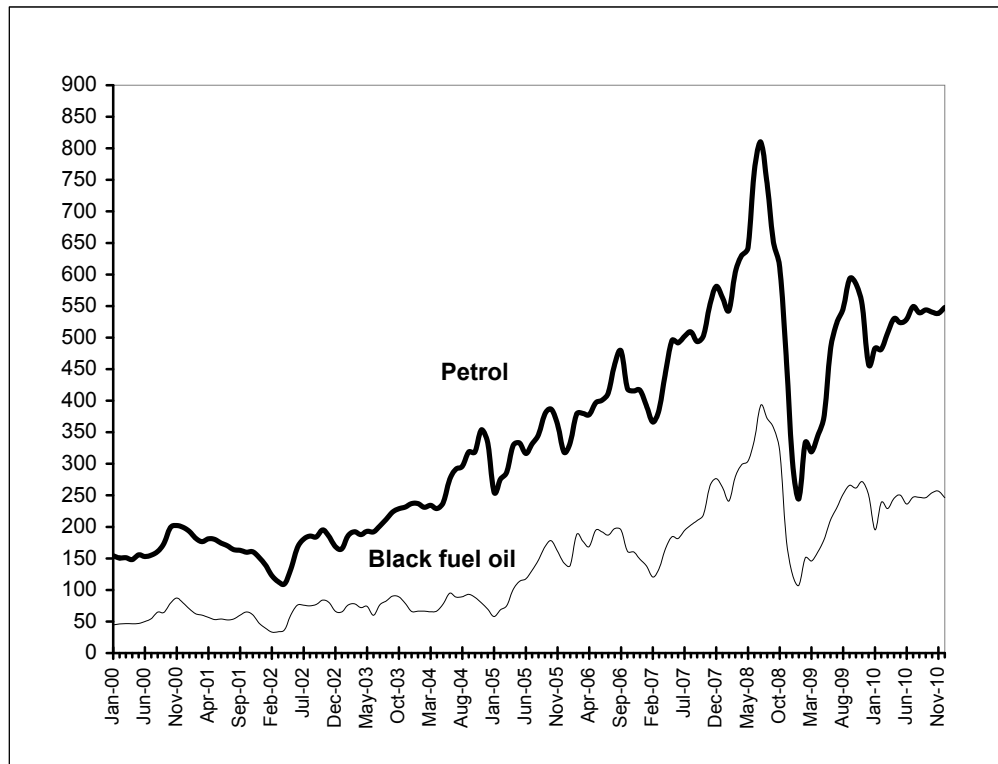
Source: calculated on the basis of the Federal State Statistics Service's data.

Meanwhile, domestic oil prices in Russia still are substantially lower than the world ones. Behind the gap are such objective conditions as the existence of an export customs duty and additional transportation costs. Against such a backdrop government regulators kept keeping a watchful eye on domestic gas prices. It is envisaged to transit, within coming years, to a stage-by-stage increase of domestic gas prices to a level securing the same profitability rate from its sales in Russia as the one ensured by overseas sales. If the move is successful, the gap between domestic and world prices should narrow, with the domestic prices of gas still being lower than the world ones (given the export duty and transportation costs), nonetheless.



Source: calculated on the basis of the Federal State Statistics Service's data.

Fig. 34. Average Producer Prices of Oil and Gas in USD Equivalent in 2000–2010, USD/Ton, USD/Thos.c.m.



Source: calculated on the basis of the Federal State Statistics Service’s data.

Fig. 35. Average Producer Prices of Petrol and Black Fuel Oil in USD Equivalent in 2000–2010, USD/Ton

4.4.5. Tax Regulation of the Oil-and Gas Sector

Since 2009 amendments were made to the Tax Code of RF. They are aimed at alleviation of the tax burden on the oil-and-gas sector, encouragement of a more intense development of deposits in operation and development of new oil fields in underdeveloped regions and at the continental shelf. Specifically, in the formula calculating the Rp ratio that reflects the world oil prices and is applied to the basic mineral tax rate on produced oil, the exempted price minimum was increased from USD 9/bbl. to 15/bbl. (*Table 41*), which resulted in a substantial decrease of the effective mineral tax rate on extracted oil. As well, the requirement to use the direct method of accounting the volume of oil output at a specific mining allotment was abolished to ensure the decreased ratio is applied to the mineral tax rate (Kb) employed at oil fields with a high reserves depletion rate. That allowed the benefit in question to cover all the worked-out deposits, which stimulates extension of their operational deadlines and gives boost to an additional oil production.

To give a fillip to development of new oil-and-gas provinces for new oil deposits located in Eastern Siberia, in Nenetsky Autonomous Okrug, in Yamal peninsula (Yamalo-Nenetsky Autonomous Okrug), at the continental shelf of the Russian Federation north of the Arctic Circle, as well as in the Sea of Azov and Caspian Sea, the Government has granted tax holidays in regard to the mineral tax. Specifically, corporations developing new oil deposits of the Eastern-Siberian oil-and-gas province within the borders of the Republic of Sakha (Yakutiya),

Irkutsk oblast and Krasnoyarsk krai now can enjoy zero rate of the mineral tax until they hit the accumulated volume of oil production of 25 mln. tn. at a given mining allotment, provided they meet the 10-year reserves development deadline, or for 10 years for an E&P license and 15 years – for a complex E&P and production license effective since the date of its public registration. (Table 42).

Table 41

The Mineral Tax Rate on Oil Extraction in 2005–2010

	2005	2006	2007	2008	2009	2010
The basic mineral tax rate levied on oil extraction, Rb/ton	419	419	419	419	419	419
The ration characterizing the world oil prices dynamic (Rp)		(P-9) x R/261			(P-15) x R/261	
Reserves depletion ratio of a mining allotment (Kb)		-		3,8 – 3,5 x N/V		

Note: P – the price level for Urals in USD/bbl equivalent averaged over the tax period; R - set by the CBR USD-to-Rb. exchange rate value averaged over the tax period; N – cumulative oil production at a mining allotment; V –initial recoverable reserves of categories A, B, C1 и C2 at a mining allotment.

Source: the Tax Code of RF, Federal Act of 22.07.2008 № 158-FZ, Federal Act of of 27.07.2006 № 151-FZ, Federal Act of 07.05.2004 № 33-FZ.

To additionally encourage development of oil deposits in Eastern-Siberian oil-and-gas province since 1 December 2009 the RF Government set zero oil export duty rate effective through 1 July 2010. The Government subsequently transited to apply lowered export duty rates to the East Siberian oil and since December 2010 extended the effect of the leverage to cover deposits located in Caspian Sea.

Table 42

Regions of Application and tax Holidays Parameters of the Mineral Tax on Oil Extraction

Region	Accumulated volume of oil production at a mining allotment, mln. tn.	E&P license validity period, years	E&P license validity period, years	Date as of which the benefit became effective
1. Republic of Sakha (Yakutia), Irkutsk oblast, Krasnoyarsk krai	25	10	15	01.01.2007
2. Continental shelf north of the Arctic Circle	35	10	15	01.01.2009
3. Nenetsky AO, Yamal peninsula	15	7	12	01.01.2009
4. Sea of Azov Caspian Sea	10	7	12	01.01.2009

Source: the Tax Code of RF.

In 2010, the RF Government produced a string of new proposals (amendments to Part 2 of the Tax Code of RF) on modifications in taxation of the oil-and-gas sector consequently adopted by the Federal Assembly of RF and promulgated since 2011. The amendments provide for some increase in the mineral tax rate in regard to oil and a substantial increase of the mineral tax rate on natural gas. The basic mineral tax rate on oil will be subject to indexation with account of the projected inflation rate in 2012–2013, that is, they will be raised up to Rb.446 /ton in 2012 and further up to Rb. 470/ ton in 2013. The mineral tax rate on gas will be raised way more substantially. It has remained unchanged since 2006, while since then wholesale gas prices have risen 2.12 time. As a consequence, the mineral tax rate on gas slid considerably both in real and nominal terms (as percentage of its price).

At this juncture we believe a logical move would be to have the mineral tax rate on gas production indexed according with the price rise for gas in the domestic market. The Government, however, tried a more conservative approach: since 1 January 2011 the rate of the tax in question is to be indexed 1.61 times, which de facto quadrates with the inflation accumulated over 2007–2010. The gas mineral tax rate is to be further increased in 2012–2013 to catch up with the projected inflation rate. As a result, since 1 January 2013 the mineral tax rate on gas production will make up Rb. 265 /Thos. c.m. (*Table. 43*).

Table 43

Mineral Tax Rates on Oil and Natural Gas Production in 2010–2013

	2010	2011	2012	2013
Mineral tax rate on oil, Rb/ton	419	419	446	470
Mineral tax rate on gas, Rb/Thos. c.m.	147	237	251	265

Source: the Tax Code of RF

In order to encourage development of small oil deposits, in 2010 the Government prepared amendments to Art. 342 Part Two of the Tax Code of RF on introducing to the mineral tax rate of oil production a special decreasing coefficient that characterizes the amount of field reserves at a given mining allotment, *aka* C_r . It is suggested to calculate this coefficient by a special formula and apply to mining allotments with initial recoverable oil resources up to 5 mln. tn. and a field depletion rate up to 0.05.

The procedure of calculation of the mineral tax on oil extraction currently does not provide for any correlation between taxation differentiation with the volume of oil reserves at a given mining allotment. As a result, development of small oil deposits with the volume of recoverable resources under 5 mln. tn., as a rule, proves inappropriate from the economic perspective, as specific capital and operational costs remain high. That said, the government list of mining resources comprises some 1,000 oil deposits, which can be classified into the group of small ones, with recoverable resources under 5 mln. tn. and the depletion rate under 5%, whose aggregate reserves account of 1 bln. tn. of oil.

Once applied, C_r should create conditions for development of new small oil fields, which would not be developed otherwise. That should allow extraction of additional oil reserves concentrated therein. The RF Government's calculations show that the use of C_r should result in a 10.2 mln. tn. of extra oil production at such fields in the first year of application of the benefit and 214 mln. tn over the first 10 years.

In the frame of implementation of the policy on encouragement of new regions of oil production, the RF Government coined proposals on employing already effective in a number of regions tax break regime in regard to the mineral tax to new oil fields located in Yamalo-Nenetsky Autonomous Okrug, north of the 65° of northern longitude. It is proposed to apply to mining allotments in that region (except for those located in Yamal peninsula) zero rate of the mineral tax until they hit the accumulated volume of oil production of 25 mln. tn. at a given mining allotment, provided they meet the 10-year reserves development deadline, or for 10 years for an E&P license and 15 years – for a complex E&P and production license effective since the date of its public registration.

If passed, the bill should establish much-needed economic conditions of development of the local deposits, which otherwise would appear unprofitable under the general taxation regime, because of the need to secure huge volumes of capital investments in infrastructure, as dictated by the local deposits' geographic and geological peculiarities.

A differentiated alleviation of the tax burden for certain regions whose specificity lies in increased development costs, appears justifiable in the frame of the present tax law, as it allows a necessary rate of return on investment in development of new deposits. That said, while being a simple mechanism from the perspective of tax administration, the tax break regime seems fairly imperfect. The problem is, it implies a uniform averaged approach to all deposits located in a given region (continental shelf), with no account whatsoever of significant differences in costs of development of each of them.

Plus, as far as relatively small-sized deposits are concerned, during the period of tax holidays, the oil production at them, under a normal pace of development, will be substantially below the set margin, so tax holidays generate incentives to expedite their development to exempt from taxation a maximum volume of produced oil. Hence, a possible drop in public revenues and a fall in the ultimate recovery efficiency rate.

Taxation of additional income, or super profit, seems a more perfect form of taxation. Whereas all geological and geographical characteristics of a given deposit are ultimately reflected in the income from its development, such an approach secures an automatic differentiation of the tax burden, depending on concrete conditions of oil extraction. It also enables one to factor into both the producer's gross income and costs of oil extraction at a concrete deposit.

In the case of highly efficient projects, taxing super profits ensures a progressive withdrawal of the resource rent in favor of the government coupled with improvement of conditions of implementation of low efficient projects. If employed, such a regime allows creation of necessary conditions for development of new deposits that require greater capital, operational and transportation costs.

4.5. Russian agrifood sector in 2010: performance and trends

4.5.1. General outline of agricultural performance in 2010

One of the priority targets of Russia's social and economic policies is the development of national agrifood sector. In the beginning of 2010 the RF President approved the Doctrine of Food Security worked out in the framework of the Strategy of National Security of the Russian Federation till 2020 (enacted by the RF President Decree No. 537 of May 12, 2009). For the first time the Doctrine treats food security not as the self-sufficiency in domestically produced agricultural products but the way it is defined by international institutions – as “the provision of the country's population with safe agricultural products, fishery and other products from aqua bioresources (hereinafter referred to as fishery products) and foodstuffs”. Domestic production is regarded as a guarantee of population's access to safe food products. The concept of “*food security*” as “the covering of demand by domestic production of agricultural products” has transformed into the concept of “*food independence of the Russian Federation*” – “sustainable domestic production of food products in quantities not below the set thresholds of its share in commodity resources of respective products on the domestic market”. For the first time the document contains such notions as “indicators and criteria of food security”, “economic availability of food products”, “physical availability of food products”, the systematization of risks and threats to the RF food security. Besides, the guidelines of state economic policies in the field of ensuring Russia's food security are formulated¹.

¹ <http://www.kremlin.ru/acts/6752>

Food security is treated as “the country’s economic performance when food independence of the Russian Federation is ensured, each citizen is guaranteed physical and economic availability of food products corresponding to requirements of the Russian Federation’s law on technical regulation and in quantities not below the rational norms of consumption of food products necessary for active and healthy way of life”.

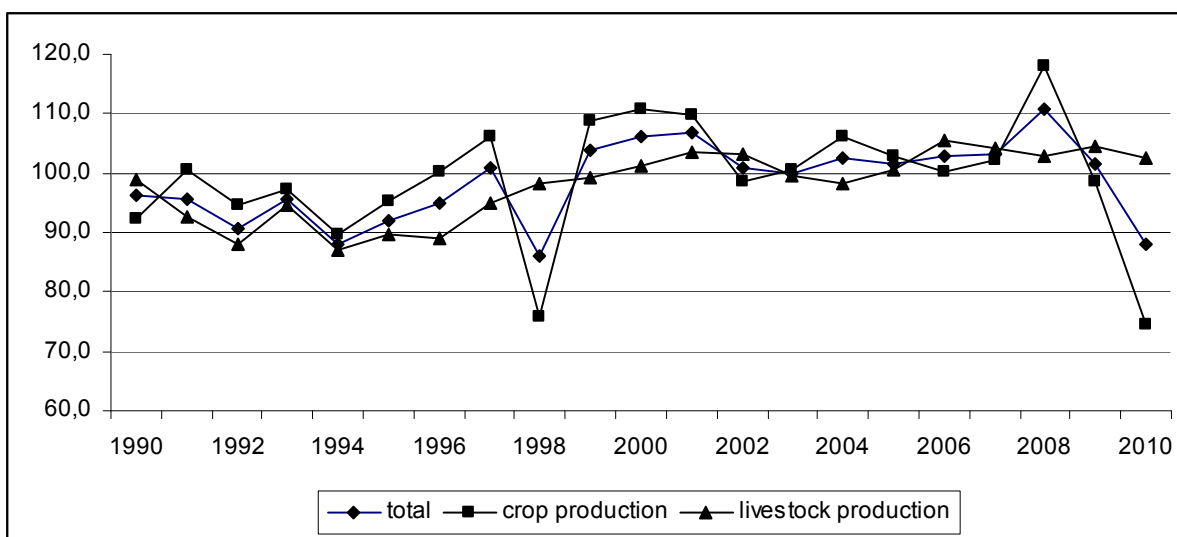
Despite the application of standard international terms, the Doctrine of Food Security in its part addressing guidelines of state economic policies for ensuring food security of the Russian Federation in the field of producing agricultural and fishery products, raw materials and foodstuffs envisages measures formulated similarly to the ones typical for times of centrally planned economy. Thus, efforts should focus on the following directions: improvement of soil fertility and yields, enlargement of areas planted in farm crops by cultivating non-used arable lands, reconstruction and construction of meliorative systems; accelerated development of livestock production; expanded and more intensive use of aqua biological resources and new technologies of their industrial production, etc. So, the declared task is not to support and encourage the increase of farm output and the sustainability of rural economy but to improve, to reconstruct, etc. The exception are market-oriented definitions of some measures such as the perfection of market regulation mechanisms and elimination of price distortions on the markets of agricultural and fishery products and farm inputs. But the experience of recent years shows that it’s the current practice of market regulation that is obviously not efficient enough for supporting economic sustainability of agricultural development. The proposed indicators of food security are also questionable. For instance, among them there are disposable household incomes, nutritive value, consumption of basic products, availability of sites for retailing and catering, etc. Although these indicators have a certain impact on food security, they are not the evidence of its attainment. It’s not clear what should be the value of an indicator (for instance, the availability of sites for retailing and catering per 1000 persons) to mean that the food security of Russia is strengthening. So, in order to be informative these indicators should be tied to food security criteria with set values. But one specifies other indicators as the criteria, i.e. indicators of domestic output’s share in commodity resources. Meantime, there are no indicators describing the access of population to foodstuffs (e.g. the share of population unable to buy or secure consumption of certain quantities or caloric value of food). Despite the use of modern terminology commonly accepted in the world, the document sticks to traditional Russian ideology as regards indicators, criteria and methods of improving agricultural production. This relates not only to the definition of food security (the attainment of threshold levels of self-sufficiency in basic products) but also to the formulation of state economic policy’s guidelines in the field of producing agricultural and fishery products, raw materials and foodstuffs.

The key factor determining agricultural performance in 2010 was natural conditions. A very hot summer¹ has blown up plans for increasing production and yields as well as for improving the economic availability of food products for population. The heat and the consequent fires affected agricultural performance in 43 regions of the Russian Federation:

¹ The head of Roshydromet Alexander Frolov says that such an abnormally hot weather has not been observed on the territory of Russia for at least a thousand years and is an absolutely unique event (<http://www.pogoda.ru.net/news/5184>). The head of RF Hydrometcenter Roman Vilfand notes that according to paleoclimatic research data there has not been such a summer on the territory of Russia for over one or probably for even five thousand years (<http://www.ami-tass.ru/article/68230.html>).

- farm crops perished on 13 million 300 thousand hectares, i.e. 30% of areas planted in these regions (17% of the total areas planted and 30% of the total grain acreage in the Russian Federation);
- 25 thousand farms suffered from drought, mainly in Volga and Central federal districts.

The reported direct loss of farm producers exceeds 41 billion rubles¹. It's clear that the amount is largely underestimated. Such a hypothesis can be advanced if one compares the value of loss with data on the share of perished farm crops in more than half of RF regions. The loss is reported to amount to only 41 billion rubles while the total agricultural output in 10 months of 2010 equals 2032.3 billion rubles², i.e. the loss is as small as 2% of the output in current prices. Meantime, crops perished on 13.3 million hectares out of 74.8 million hectares of planted acreage (Rosstat data)³, i.e. on 18% thereof. This means that farm producers may count on compensation of only a minor part of their damage and the result will be a further weakening of agricultural sector in the future.



Source: Rosstat.

Fig. 36. Index of agricultural production

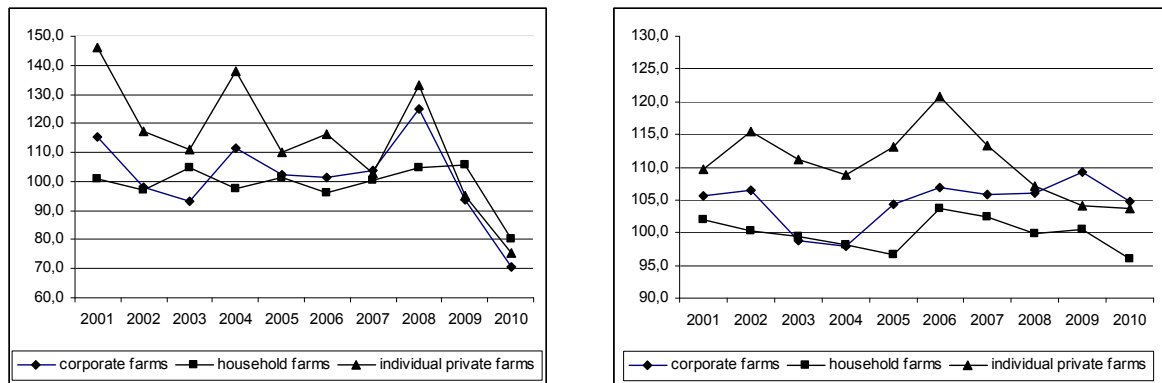
Index of agricultural production as percent of the previous year fell down to 88.1% (Fig. 36). This decrease was due to smaller crop production – its index plunged to 74.6%. Livestock production was still unaffected and by the end of 2010 even showed growth by 2.6% as compared with the previous year. However, this increase is the smallest in the five recent years. If examined by types of farm producers, the general production decline down to 88.5%-88.6% was observed in corporate and household farms. Agricultural output of individual private farms fell more dramatically – down to 82.5%. This is due to the sectoral structure of agricultural production therein. Production of grain and industrial crops as well as pig and poultry production is concentrated in corporate farms. Household farms also focus on livestock

¹ The report of RF Minister of Agriculture E.B.Skrynnik in the Council of Federation on October 27, 2010. www.mcx.ru.

² Rosstat, http://www.gks.ru/bgd/regl/b10_01/IssWWW.exe/Stg/d10/2-1-4-1.htm

³ Rosstat, 2010.

production and on growing of potatoes and vegetables. Individual private farms produce mainly grain and industrial crops. Because of the small share of livestock production therein, it could not help to slow down the decline driven by the crop sector.



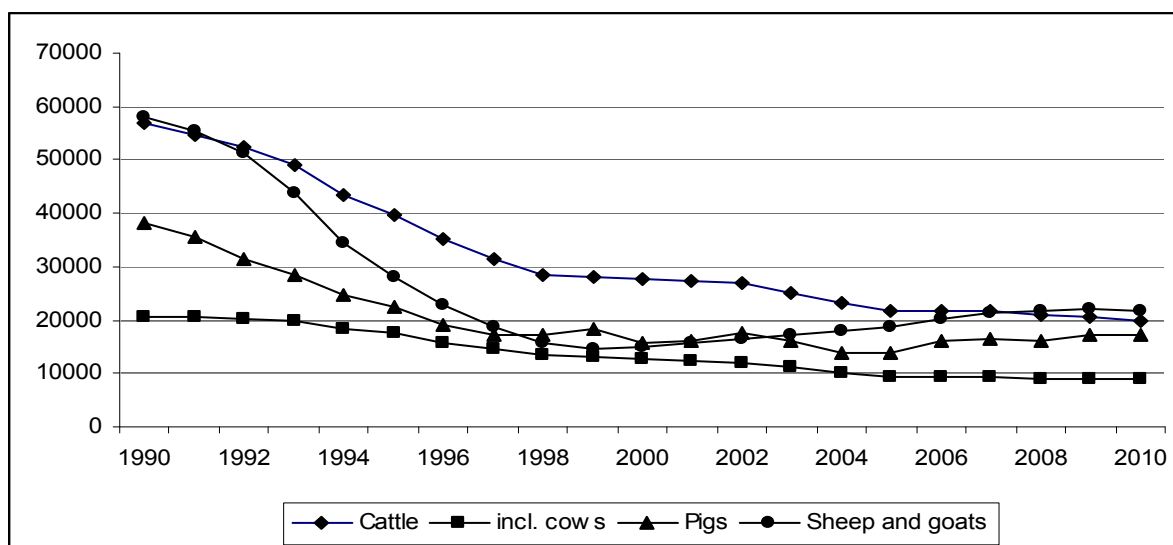
Source: Rosstat.

Fig. 37. Indices of crop and livestock production by types of farm producers

In 2010 the biggest decreases as compared with 2009 were observed in the production of grains (by 37.3%), potatoes (32.1%), flax fiber (31.3%), sugar beets (25.5%), sunflower seeds (16.5%) and vegetables (9.4%). The data on sowing of winter crops in autumn of 2010 suggest potential decline of grain production in Russia in 2011 versus relatively good 2009¹: according to Rosstat the acreage sown in winter crops by November 1 was almost 21% below the previous year indicator – 10.5 million hectares².

Earlier the decrease of livestock inventories whose dynamics till 1998 were dramatic was halted and a clear upward trend shaped in some sub-sectors (breeding of poultry, pigs and sheep till 2009). From 2009 to 2010 the number of animals reduced but this reduction was insignificant (Fig. 38): from 0.5% for pigs to 3.1% for cattle. However, the drop of grain output by over one third and the rise of prices for it pre-condition a sharp decrease of livestock inventories and as a result – a growth of meat production in the short run. The data on feed stocks for winter season of 2010/2011 support this suggestion: by November 1, 2010 their size amounted to 1000 kg of feed units per conventional animal unit in only 33% of the RF regions. In 2009 such stocks were accumulated in 58% of the RF regions. By the beginning of January 2011 the availability of feeds in corporate farms was 25.2% below the 2009 level. Taking into account that the share of fodder grain (except for corn) in the structure of grain production reduced, the situation with feed supply raises concern. The ban of export of wheat will entail larger offering of expensive food grain for feeding purposes. But it won't help to solve the problem of livestock producers since they are constrained by solvent consumer demand and the use of such grain for feeding is not cost-effective.

¹ 2009 was chosen as the basis for comparison since 2010 was the year with abnormally bad climatic conditions.
² At the same time the RF Ministry of Agriculture reported this acreage to be 14 million hectares and promised to increase the area under winter crops up to 15.5 million hectares. The report of RF Minister of Agriculture E.B.Skrynnik in the Council of Federation on October 27, 2010.



Source: Rosstat.

Fig. 38. Livestock inventories in all types of farms, thousand head

Until recently only the population of poultry was primarily concentrated in corporate farms; at present the bigger part of cattle and pigs is also kept there. Household farms still account for slightly over one half (51.4%) of sheep and goat inventories, for 46.8% of cattle and for about one third (32.7%) of pig population. However, corporate farms intensely increase stocks of not only pigs (by 4.1%) and poultry (by 5.6%) but also of sheep and goats (by over 6% per annum). A small reduction of cow number in all types of farms (by 2.3% as compared with 2009) goes in line with rising of their productivity – the average annual production of milk per cow grew by over 110 kg up to 3910 kg per head. It's well above the indicators of early 1990s (1.4 fold higher as compared with 1990) but still remains dramatically lower than in developed countries of the world¹. However, the growth of average milk yields has not resulted in bigger milk output – it reduced by 2.1% down to 31.9 million tons. The current trends in livestock and poultry inventories entailed larger sales of meat (by 5.2% - up to 10.5 million tons) and eggs (by 2.9% - up to 40.6 billion pieces) in 2010.

The drop of crop production influenced prices received by farm producers. They didn't grow much by the end of the year. By November 1, 2010 the index of prices for crop products received by corporate farms was 109.5% while that for livestock products – only 104.1%.

Taking into account that by November 1, 2010 consumer prices rose by over 9% as compared with December 2009, there are grounds to suggest that incomes of farm producers were re-distributed to the benefit of other links of the food chain. The Rosstat data support this suggestion as well: the indicator of current liquidity in corporate farms equaled 169.1% (while in the country at large – 178.8% given the recommended value of 200%), the availability of own circulating assets – minus 36% (minus 17.9% and plus 10% respectively), the equity-assets ratio – 35.2% (minus 46% and plus 50% respectively). So, the indicators of financial sustainability of corporate farms are below the averages for economy at large and far below the rec-

¹ In 2006 average milk production per cow in Canada reached 7.6 tons, in the US – 9.1 tons, in Mexico – 6.4 tons, in Finland – 7.5 tons, in Germany – 6.4 tons, in China – 3.0 tons (<http://statinfo.biz/Geomap.aspx?region=world&act=6243&lang=1>).

commended levels. Although last year the share of profitable corporate farms increased up to 68.2% (versus 66.6% in 2009), the total amount of their profit reduced by 9.3% while the amount of loss grew by almost 55%. Financial performance of individual private farms is not monitored. But the sharp reduction of their output as compared with 2009 – by almost one fourth – gives grounds for suggesting that this type of farm producers faced serious financial problems.

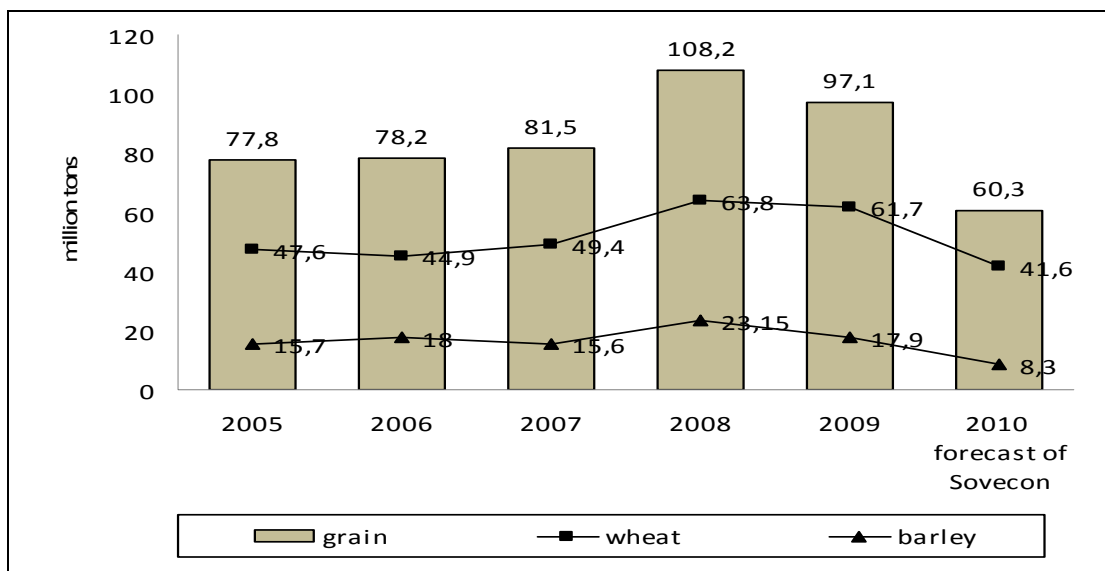
The drop of farm producers' incomes in 2010 and unfavorable price situation in 2009 precluded them from repaying credits due in these years. Banks restructured the debts. By the end of October 2010 the amount of extended credits was 4.4 billion rubles¹. Meantime the total amount of overdue bank credits and loans reaches 7 billion rubles², i.e. about 37% of all overdue credits have not been restructured and their holders can be subjected to debt recovery by means of enforcement and bankruptcy proceedings. This is an evidence of aggravating instability in agricultural sector of the economy.

One should also note that as compared with 2009 the amount of investments in the farm sector in 2010 reduced insignificantly – by less than 3%. The reduction was due to smaller domestic investments while foreign investments in 2010 grew by 6.7% up to 2.24 billion dollars.

4.5.2. Situation on selected agricultural and food markets

Grain market

Grain crops were the most affected by the abnormal heat and drought in summer 2010. Their output dropped to the lowest level beginning from 1999 – down to 60.3 million tons (Fig. 39). The gross output of wheat fell by 20 million tons – down to 41.6 million tons, that of barley – more than two fold (down to 8.35 million tons).



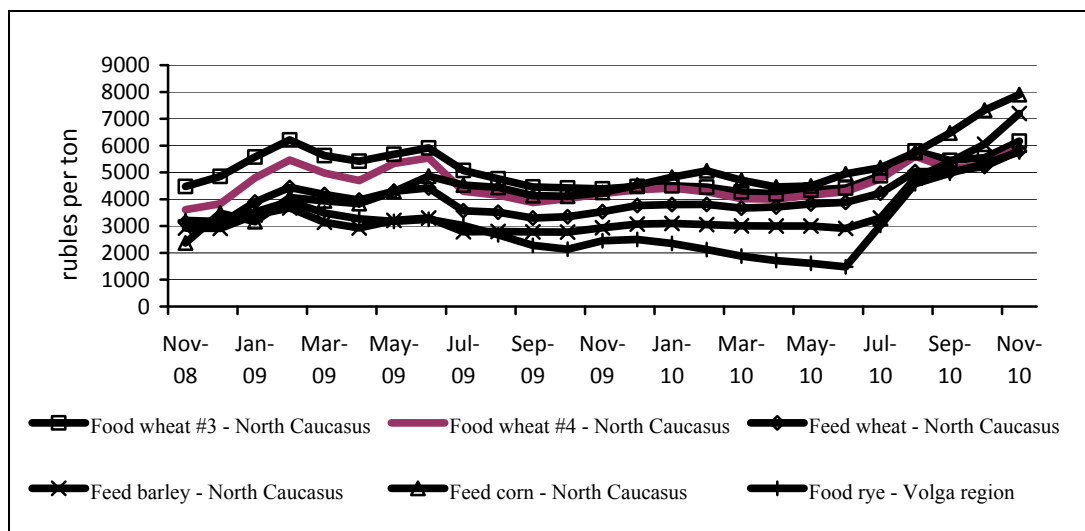
Source: Sovecon.

Fig. 39. Grain production in Russia in 2005-2010

¹ The report of RF Minister of agriculture E.B.Skrynnik in the Council of Federation on October 27, 2010.

² Rosstat, as of November 1, 2010.

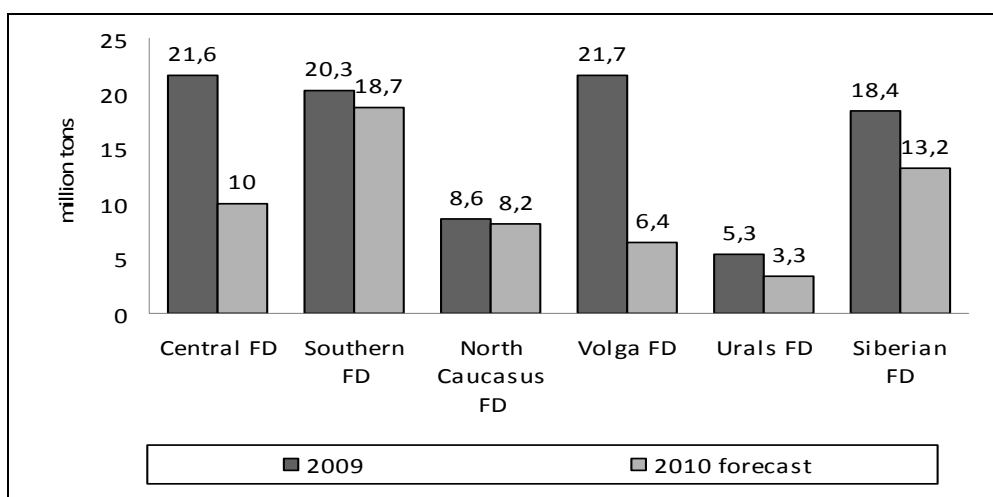
The most difficult situation was observed on the market of fodder grain since outputs of feed wheat, barley and corn fell at the same time. The shortage of fodder grain was compensated by larger use of food wheat for feeding purposes and as a result by the end of 2010 the difference between prices for fodder and food grain started to shrink. The basic trend on the Russian grain market this year was the strengthening of prices for all grain crops beginning from August. Prices for barley and corn displayed the highest growth rates (Fig. 5).



Source: Sovecon.

Fig. 40. Average offer prices for grain crops in 2008-2010 (VAT included, EXW)

In the Central Black Soil and Volga areas the output of grain fell dramatically (Fig. 41). As a result the supply of the whole Russian grain market depended on three Southern (Krasnodar, Stavropol and Rostov) and four Siberian regions (Altay, Novosibirsk, Omsk and Krasnoyarsk).



FD- federal district.

Source: Sovecon.

Fig. 41. Grain output in basic producing federal districts in 2009-2010

Concerned about the potential shortage of grain on the domestic market and the speculative growth of prices, the Russian government imposed a temporary ban on export of wheat, meslin, barley, rye, corn and wheat or wheat-rye flour from the 15th of August till the end of the year¹. The restriction of Russian grain export had an immediate effect on the world market where grain balance was tight as it was – world prices for wheat started to escalate. From July to December 2010 prices for wheat (soft, France, f.o.b.) surged from 190 to 330 USD per ton, prices for corn (USA, f.o.b.) – from 170 to 250 USD per ton².

The imposition of embargo first of all affected producers in export-oriented regions in the South of Russia where grain crop was not bad. Producers in the Southern and North-Caucasian federal districts had to re-orient their deliveries from the foreign to domestic market. But when the embargo came into effect, grain sales in the South actually stopped. There was poor demand for Southern grain taking into account the cost of delivering it to drought-afflicted regions. As a result the purchase prices for wheat from the country's South automatically fell by the amount of transportation costs. But the price to be paid by drought-afflicted regions didn't suit Southern producers.

The Siberian regions that also became suppliers of grain to drought-afflicted areas were less affected. This is due to the fact that logistical costs of delivering grain from these regions to the European part of the country are comparable to those of delivering it to ports. So, due to logistical factors the supply of grain from the Southern regions was less competitive than that from the Siberian regions. In order to improve the market situation the government lowered tariffs for transporting the Siberian and Southern grain to other regions of the country. From September 1 till December 31, 2010 the tariff for deliveries from Siberia to the distances above 1,100 km was reduced from 50 to 30% of the standard one and for deliveries from the South – from 100 to 50% of the standard one for the distances above 300 km. As a result for most regions-consumers the railway tariffs for grain from the North Caucasus fell more than those for grain from Siberia. The lowering of tariffs supported growth of prices for grain in the North Caucasus and somewhat pulled down prices in the Central Russia.

The drought and the imposition of embargo had a negative effect on the future 2011 crop. The long-drawn drought in some regions led to arrears in sowing. Smaller areas sown in winter crops will result in their smaller output next year. Besides, due to the export ban purchase prices for grain in the South of Russia fell (as mentioned above) thus undermining producers' incentives to make investments in production (as a result - smaller purchases of farm machinery and fertilizers, transfer to reduced technologies).

Tension on the grain market could be alleviated by massive imports and commodity interventions.

In 2009/2010 Russia imported 0.35 million tons of grain, in 2008/2009 – 0.6 million tons. According to forecasts of Sovecon in 2010/2011 about 4.0 million tons of grain (including flour in grain equivalent) can be imported. Kazakhstan and Ukraine were regarded as potential suppliers. But in October 2010 Ukraine imposed quotas on export of grain till the end of 2010 to the amount of 2.7 million tons, including quota on export of corn – 2 million tons. At the end of 2010 import of grain from Kazakhstan was economically inefficient due to its high price. Import deliveries of grain to Russia are also possible in the framework of intergovern-

¹ RF Government Resolution No.599 of August 5, 2010.

² Sovecon data.

mental agreements. The basic components of potential Russian imports can be wheat, rye and barley.

As to the commodity interventions, experts and market operators expect them to be carried out not earlier than February 2011. However, according to estimates of Sovecon even a complete sale of feed wheat and barley intervention funds (3-3.5 million tons) won't be sufficient for relieving tension on the market of fodder grain at large. It will lead only to the stabilization (temporary) in regions where this grain will be sold.

Table 44

Estimate of grain supply and demand balance in 2009/2010 and its forecast for 2010/2011 (million tons)

	2008/09	2009/10 (estimate)	2010/11 (forecast)
Supply (resources)	116.65	117.1	84.5
Beginning stocks	7.85	19.65	20.2
Including intervention stocks	0.2	8.25	9.5
Market stocks	7.65	11.4	10.7
Production	108.2	97.1	60.3
Imports*	0.6	0.35	4.0
Consumption, total	97.0	96.9	76.8
Domestic consumption	73.5	75.0	72.5
Exports*	23.5	21.9	4.3
Intervention purchases	8.05	1.75	-
Ending stocks	19.65	20.2	7.7
Including intervention stocks	8.25	9.5	3.5
Market stocks	11.4	10.7	4.2

* Including flour in grain equivalent.

Source: data of Sovecon.

Potato market

In addition to grain crops, dry spring and hot summer largely affected potato production. In 2010 all types of farms harvested 21.1 million tons of potatoes which is 32.2% less than in the previous year (Table 45). Households continue to account for the major share of output in the structure of potato production by types of farms: in 2010 – 84%, in 2009 – 81%. Gross output in household farms fell by 29.3%.

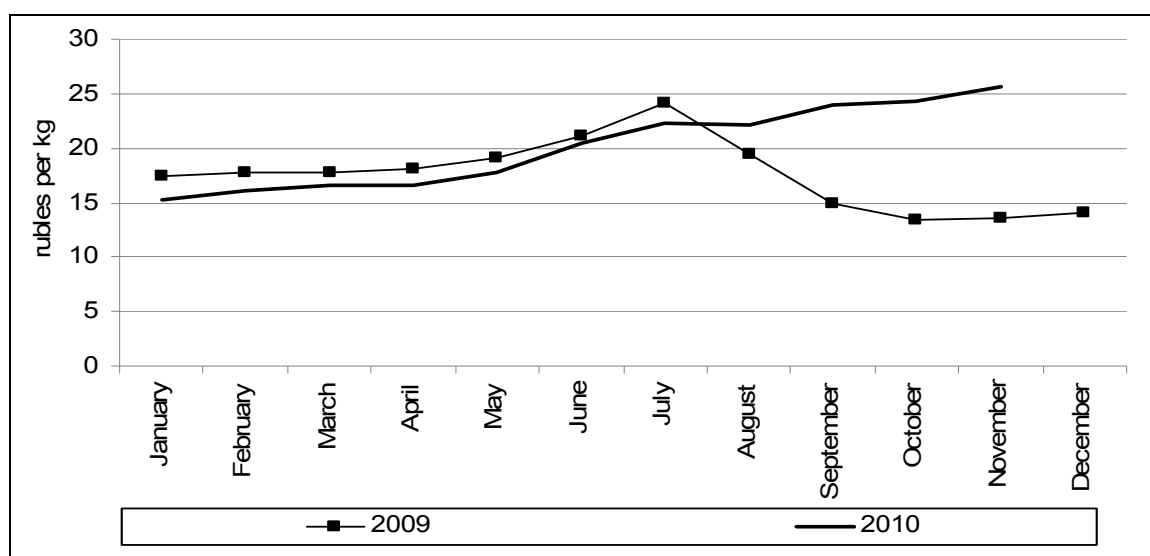
A typical trend is the seasonal lowering of prices for potatoes in July-September but in 2010 they grew due to the poor crop – almost two fold as compared with 2009. In November 2010 retail prices for potatoes averaged 25.6 rubles per kg while in November 2009 – 13.5 rubles per kg.

Table 45

Potato production in 2007-2010, million tons

	2007	2008	2009	2010	2010 as % of 2009
Potato production	27.2	28.8	31.1	21.1	67.8

Source: Rosstat.



Source: Rosstat.

Fig. 42. Russia: dynamics of average consumer prices for potatoes in 2009-2010

In the previous years Russia's self-sufficiency in potatoes was 95% and imports didn't exceed 850 thousand tons. The total domestic demand for potatoes is estimated at 27-29 million tons of which about 16 million tons is used for personal consumption and the rest – for production purposes (planting potatoes and potatoes for industrial processing).

Given the shortage of home-grown potatoes their imports in the 2010/2011 MY may increase. Deliveries can be made from Belarus and Ukraine. Traditional suppliers of fresh potatoes to the Russian market are the Netherlands, Azerbaijan, Egypt and China (they account for about 70% of the Russian potato imports). In order to cope with market deficit the RF government abolished import duties on potatoes including planting potatoes from November 2010 till July 2011¹.

The deficit of potatoes in Russia and poor crop in some European countries triggered growth of potato prices in Europe. In the beginning of 2011 the stocks of domestic potatoes on the Russian market will be exhausted and the imported product will be offered for sale thus determining the price. So, in 2011 the upward price trend on the Russian potato market will persist.

Meat market

The effect of the drought has not yet impacted the annual indicators of livestock sector performance in 2010. But this effect is only postponed and will affect the performance of livestock farms already in the beginning of 2011.

According to Rosstat data (*Table 46*) in 10 months 2010 output of livestock and poultry (live weight) in all types of farms increased by 6.3% up to 7.8 million tons. The most dynamic sector was pig production – during this period the output of pork in corporate farms grew by 20.3% (up to 1292.6 thousand tons live weight). Positive trends in poultry production observed throughout the last 10 years preserve – the output in corporate farms increased by

¹ Decision of the Customs Union Commission No. 475 of October 14, 2010.

13.3% (up to 2787.7 thousand tons). Meantime the production of beef fell by 0.8% (down to 785.4 thousand tons).

Table 46

Russia: meat production in all types of farms in 2007-2010, million tons

	2007	2008	2009	Jan.-Oct. 2010	Jan.-Oct. 2010 as % of Jan.-Sept. 2009
Slaughter livestock and poultry, live weight	8.7	9.3	9.9	7.8	106.3
including:					
beef	3.0	3.1	3.0	n.a.	n.a.
pork	2.5	2.7	2.9	n.a.	n.a.
poultry meat	2.6	3.0	3.4	n.a.	n.a.

Source: Rosstat.

The mentioned growth in meat sector based on the investments of previous years. In 2010 thanks to the pre-crisis investments new pig breeding complexes were put into operation and reached projected capacities and so also did some of the existing ones that had been reconstructed. An additional growth factor was lower prices for feeds due to the weakening of prices for grain in 2009.

Besides, domestic producers of poultry meat were able to enlarge supply owing to the temporary withdrawal from the market of the US products, the import of which was banned from January to August 2010. This restriction was due to the introduction of new RF sanitary regulations forbidding import and marketing of poultry meat treated with chlorine-containing substances.

The US quota in 2010 equaled 600 thousand tons or 77% of the total poultry meat imports. After the restriction of US imports a part of this quota (150 thousand tons) was redistributed between other countries. Within these limits deliveries were primarily made from Europe and Brazil. However, these and other countries have failed to make full use of the allowed volumes due to the deficit of poultry meat supply on the world market and the high prices as compared with prices for poultry from the US.

The non-delivery of US poultry meat to the market was compensated by the output of domestic producers. As a result despite the reduction of imports (by 60.1% in January-September 2010) the capacity of the market remained actually the same¹. Table 47 illustrates the dynamics of meat imports.

Poor crop of grain in 2010 entailed high prices for it and consequently – for compound feeds. Livestock farms started to feel their pressure already by the end of 2010 when earlier stocks of cheap 2009 fodder grain were exhausted. As of the end of October 2010 940 kg of feed units per conventional animal unit were stored up while in the previous year - 1 230 kg².

Higher prices for compound feeds will largely affect the cost of pork and poultry meat production. The likely consequences of larger feed costs are higher prices for meat and decline of meat producers' profitability. Non-efficient farms with poor feed conversion rate may become loss-making and disappear from the market. In the coming years the pig farms' margin will also reduce due to the stronger market competition following the expected growth of domestic pork production. As noted above, in 2010 the major part of new pig breeding complexes reached their projected capacity.

¹ According to data of IKAR (the Institute for Agricultural Market Studies) in 7 month 2010 the capacity of poultry meat market fell by only 3%.

² According to data of Rosstat.

Table 47

Imports of meat to Russia in 2007-2010, thousand tons

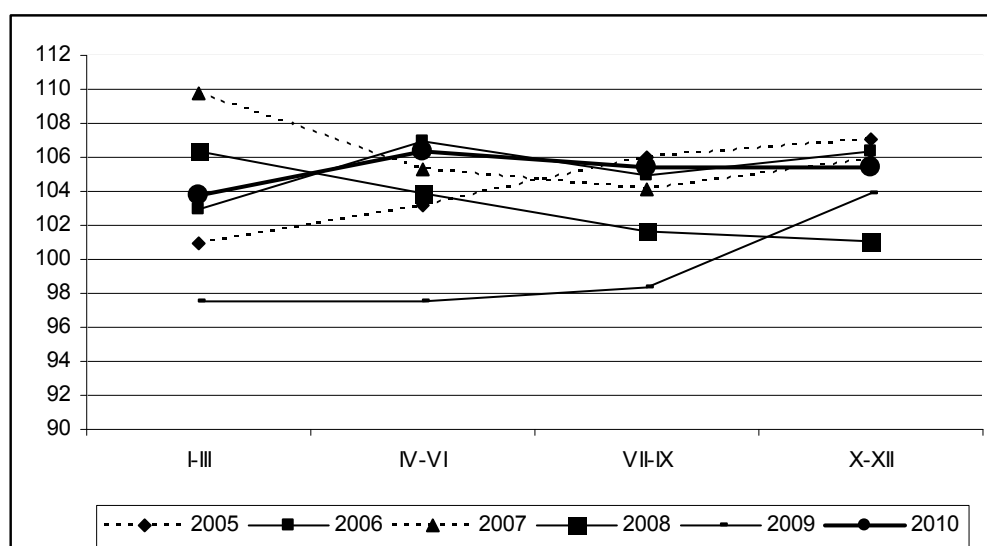
	2007	2008	2009	Jan.-Sept. 2010	Jan.-Sept.2010 as % of Jan.-Sept.2009
Meat, fresh and frozen	1489.4	1710.9	1437.1	1031.3	106.2
Poultry meat	1287.0	1218.0	964.8	259.1	39.9

Source: Rosstat.

Beginning from 2003 meat is imported to Russia within the set tariff quotas. According to the approved regime of import regulation for 2011, the amount of pork and beef quotas won't change as compared with 2010: the quota for fresh and chilled beef will be 30 thousand tons, for frozen beef – 530 thousand tons, for pork – 472.1 thousand tons, for pig trimmings – 27.9 thousand tons. The quota for poultry meat import will reduce more than two fold – from 780 to 350 thousand tons. Besides, beginning from January 1, 2011 Rospotrebnadzor (the Federal Service for Customers' Rights Protection and Human Well-Being Surveillance) imposes the ban on utilization of frozen poultry meat for industrial food production. Actually this means a full ban on import of foreign poultry meat that is usually used in meat processing and as a rule is cheaper than the domestic one. This can lead to higher prices for non-expensive meat and sausage products containing poultry meat. Besides, this forces Russian poultry producers to have quite developed logistics to manage deliveries of chilled meat to long distances taking into account the extended country's territory.

4.5.3. Production of food products

The food industry responded to crisis developments back in 2008: the index of food production fell till the second quarter of 2009. From the second quarter of 2009 till the end of 2010 it was growing. The 2010 dynamics was very much like that of 2006 (*Fig. 43*). The quarter increases in 2010 ranged from 3.8 to 6.4%.



Source: Rosstat.

Fig. 43. Index of food (including beverages and tobacco) production as % of the comparable period previous year

Table 48

Production index for selected groups of food products, %

	2010 as % of 2009
Slaughter livestock meat and edible by-products	115.6
Poultry meat and edible by-products	114.7
Sausage products including stuffed	105.4
Sausage products out of heat treated ingredients	116.0
Fish and fish products, processed and canned	102.7
Processed and canned potatoes	105.9
Fruit and vegetable juices	127.9
Crude sunflower oil and its fractions	91.7
Crude soybean oil and its fractions	115.8
Liquid milk, processed	111.4
Kefir	111.9
Wheat and wheat-rye flour	96.5
Buckwheat groats	82.1
Bakery products not for long storage	99.5
Mineral water, non-sweetened and non-flavored	118.6

Source: Rosstat.

Production of sunflower oil, flour, bakery products and buckwheat groats in 2010 reduced as compared with 2009 (Table 48).

Smaller output of vegetable oil was primarily due to the curtailed production of crude oil. In the group of dairy products the biggest decrease is observed in production of condensed milk while its imports doubled as compared with 2009.

Fixed capital investments in food industry in 2010 were 7% smaller than in 2009 and the increase of foreign investments was below 1%.

In general the financial performance of food industry deteriorated. The number of loss-making enterprises decreased slightly (by 1.8%) but the profits of profitable ones fell by more than 9% and the loss grew by 30.7%. The indicators of current liquidity (143.9%) and availability of own circulating assets (-21.3%) as well as the equity-assets ratio (30.3%) in food industry are far below the values considered normal (200, 10 and 50%, respectively). At the same time according to Rosstat data the profitability of food processors' sales and their assets actually hasn't changed.

At present several state support tools are applied to encourage the development of food industry. Among them there are protectionist measures in order to defend domestic producers from food imports, greater support of input sectors, tariff policies aimed at supporting import of equipment having no domestic analogues and other equipment for food industry, subsidizing of interest rate on credits for purchasing domestic raw inputs and for re-equipment. Besides, target programs "Development of Russian sugar beet sub-sector in 2010-2012", "Development of primary livestock processing in 2010-2012", "Development of butter and cheese production in Russia in 2011-2013" were developed. These programs are aimed at the solution of specific problems associated with forming of sustainable input basis and development of food industry enterprises.

4.5.4. Modification of agricultural policies in 2010

The specific conditions of 2010 forced authorities to take urgent measures for regulating agriculture. Revisions were made in the State program for agricultural development and regulation of agricultural and food markets in 2008-2012 (hereinafter referred to as the State pro-

gram) – the five-year plan of the sector’s development adopted by the RF Government Resolution No. 446 of July 14, 2007.

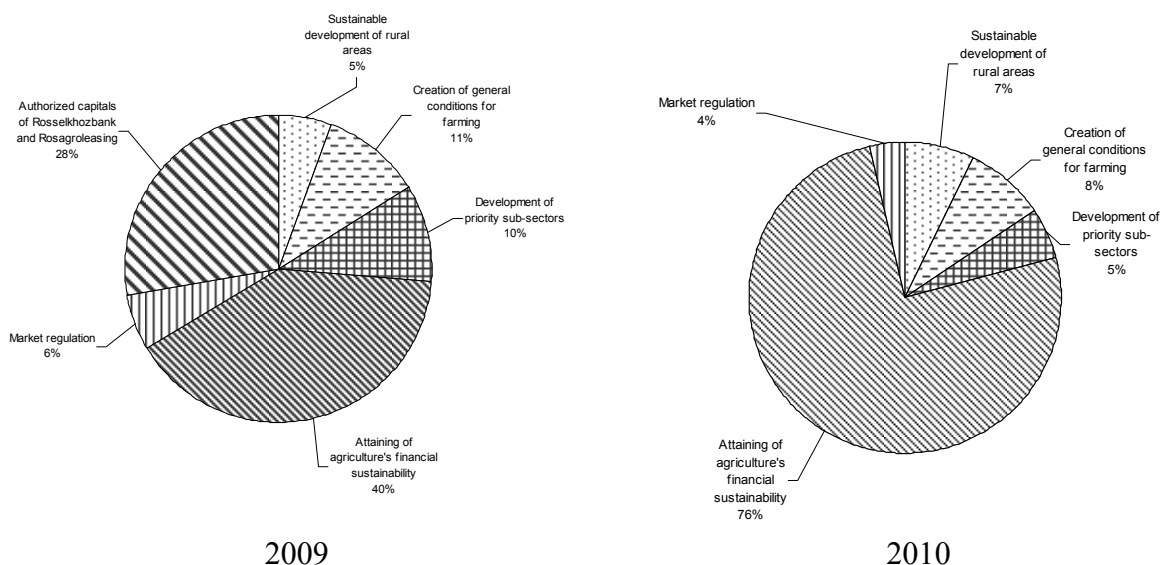
The State program sets five guidelines for allocating funds:

- I – Sustainable development of rural areas.
- II – Creation of general conditions for farming.
- III – Development of priority agricultural sub-sectors.
- IV – Attaining of agriculture’s financial sustainability.
- V – Regulation of agricultural and food markets.

The projected financing of the State Program in 2008-2010¹ amounted to: 296.3 billion rubles from the federal budget, 290.1 billion rubles from the regional budgets and 311 billion rubles from non-budget sources. But actually these amounts were largely revised each year in the process of adopting budgets for the next fiscal year.

The initial project envisaged prioritized financing of measures to support rural social and engineering infrastructure and to provide for subsidizing of interest rate on loans in order to improve access to credit funds for the most efficient producers.

However, in 2010 budget funds were primarily allocated to subsidizing of interest rate on credits – the share of this measure in the total State program’s financing increased from 40% in 2009 to 76% in 2010 (*Fig. 44*). The financing of other measures was notably revised downwards.



Source: State program, the RF Ministry of Agriculture.

Fig. 44. The structure of expenditures under the State program in 2009 and 2010

The financing of section “Sustainable development of rural areas” was cut most severely. According to the initial version of the State program it was to get 20% out of 552 billion rubles projected for 2008-2012. In 2010 7.7 billion rubles were allocated for the improvement of social and engineering infrastructure in rural areas – instead of the initially adopted 23.9 billion rubles (*Table 49*).

¹ Resolution No. 446 as in force on July 14, 2007.

Table 49

Basic indicators of the State program's implementation in 2010

Guidelines	The indicator's value for 2010		Financing from the federal budget, million rubles	
	Planned*	Revised	Planned*	Actual**
1. Efficiency indicators				
1.1. Index of agricultural production in farms of all types as % of the previous year (in comparable prices)	104.1	89.3	X	X
1.2. Index of physical volume of investments in agriculture's fixed capital, %	110.2	95.5	X	X
1.3. Disposable monthly incomes of rural households, rubles per one member of household	10 388.0	9 780.7	X	X
1.4. Share of domestic output in available resources of				
1.4.1. meat and meat products, %	65.7	72.6	X	X
1.4.2. milk and dairy products, %	79.9	80.7	X	X
2. Sustainable development of rural areas				
2.1. Financing of measures to improve social and engineering infrastructure in rural settlements, total	X	X	23 943	7 720
3. Creation of general conditions for farming				
3.1. Total financing under the section	X	X	13 781	8 961
3.2. including subsidies to farm producers for the purchase of domestically produced mineral fertilizers and pesticides	X	X	4 120	4 720
3.3. including creation of system of state informational support to agriculture	X	X	1 021	261
3.4. including development of consultative assistance to farm producers	X	X	1 055	0
4. Development of priority agricultural sub-sectors				
4.1. Development of livestock production				
4.1.1. Subsidies to support pedigree livestock breeding	X	X	4 420	3 549
4.1.2. Supply of pedigree livestock to Rosagroleasing, thousand head	30 000	7 640	X	X
4.1.3. Supply of equipment for livestock production to Rosagroleasing, thousand stalls	65 000	6 415	X	X
4.2. Development of crop production				
4.2.1. Subsidizing of measures to support elite seed breeding	X	X	490.3	472.1
4.2.2. including financing of measures to support farm producers in Extreme North regions	X	X	1 000	0
4.2.3. including financing of measures to support flax production	X	X	595.8	16.0
4.2.4. including financing of measures to support rape production	X	X	975.7	11.9
4.2.5. including financing of measures to establish perennial plantations	X	X	1 367.9	0
5. Attaining of agriculture's financial sustainability				
5.1. Total amount of subsidized credits (loans), billion rubles	290	374.2	X	X
5.1.1. including short-term credits	150	258.8	X	X
5.1.2. including investment credits	140	115.4	X	X
5.2.1. Subsidizing under short-term credits	X	X	10 000	13 700
5.2.2. Subsidizing under investment credits	X	X	28 445	54 197
5.3. Amount of subsidized credits received by smallholder farms	35	33.3	X	X
5.4. Subsidizing of interest rates on credits (loans) received by smallholder farms	X	X	8 027	5 800
5.5. Purchase of tractors by all types of farms, units	35 000	10 565	X	X
5.6. Purchase of grain harvesters, units	11 000	3 677	X	X
5.7. Purchase of fodder harvesters, units	3 500	1 187	X	X
TOTAL	X	X	120 000	97 940

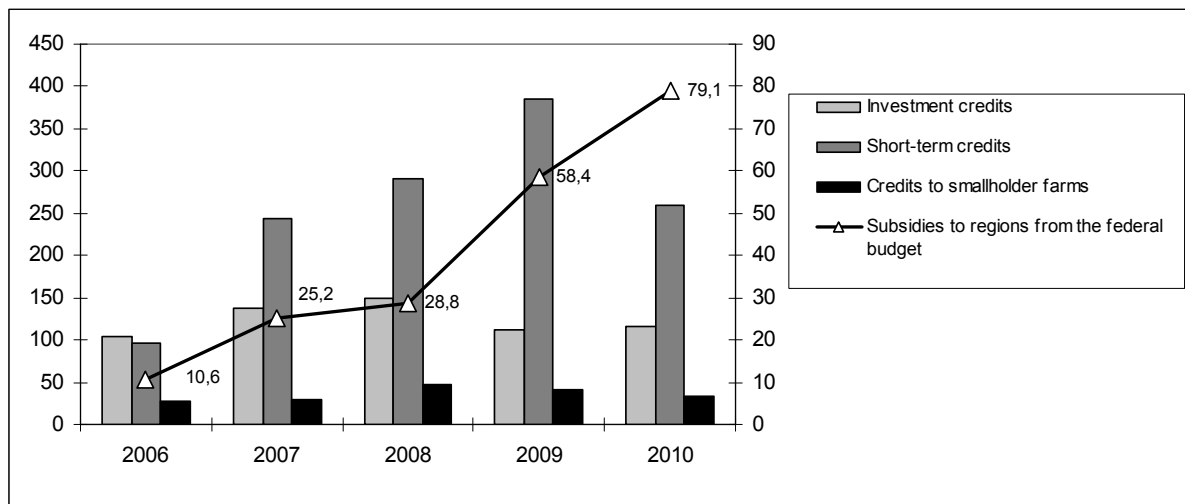
* Resolution No. 446 as in force on July 14, 2007.

** RF Ministry of Agriculture, preliminary data.

The analysis of preliminary indicators of State program's implementation and their comparison with the planned ones leads to the conclusion that in the 2010 budget financing of all efforts was rechanneled in favour of subsidizing interest rate on credits and loans (primarily investment ones) taken by farm producers. The amount of subsidies for reimbursing interest

rate in 2010 was almost twice above the initially projected (*Table 49*). 71% of such subsidies from budgets of all levels are allocated to the support of investment projects.

In the framework of these efforts borrowed funds to the total amount of 407.6 billion rubles were found eligible for subsidizing, including short-term credits to the amount of 258.8 billion rubles, investment credits – 115.5 billion rubles and credits to smallholder farms – 44.4 billion rubles (*Fig. 45*).



Source: National report on implementation of State program in 2009, preliminary data of the Ministry of Agriculture for 2010.

Fig. 45. Amount of credits eligible for reimbursement of interest rate in 2006-2010, billion rubles

At the same time the financing of efforts to develop priority agricultural sub-sectors was reduced: in livestock production – by 3 billion rubles, in crop production – 9 fold (from 4.4 billion rubles to 500 million rubles). Funds aimed to support farm producers in Extreme North regions and to establish perennial plantations were cut down to zero, those to encourage flax and rape production – almost to zero (*Table 49*). An actual withdrawal of support to rape producers is an indirect sign of no wish to develop alternative energy sources (for instance, in the US the amount of subsidies to farmers for the production of crops to be processed into bio-diesel grows year after year).

Following the reduction of subsidies for partial compensation of expenditures on crop insurance the share of insured areas in the total crop acreage continues to decline – in 2010 it fell down to 13%. The monopoly of regional insurance companies in this field remains very strong. The technical modernization of agriculture slows down – in 2010 the number of purchased new tractors and harvesters of all types was 3 fold below the planned indicator (*Table 49*).

In the section “Creation of general conditions for farming” only one indicator – subsidies to farm producers for the purchase of domestically produced fertilizers and pesticides – displays stable growth. Capital investments in building, reconstruction and restoration of meliorative systems are falling. Allocations to create the system of state informational support to agriculture dropped 4 fold. Financing of consultative assistance to farm producers and re-

training of agricultural specialists ceased completely despite the most acute deficit of skilled labour.

A special section of the State program specifies measures to improve financial sustainability of smallholder farms whose aim is to increase output and sales of agricultural products by individual private and household farms and to raise incomes of rural residents.

Federal budget funds for subsidizing interest rate on credits and loans to smallholder farms in 2010 amounted to 6 091.2 billion rubles – somewhat below the 2009 indicator (6 327.2 billion rubles) but 1.2 fold above the level of the first year of the State program’s implementation (in 2008 subsidies to smallholder farms equaled 5 227.2 billion rubles).

The access of smallholder farms to credits and loans improved – in 2010 the total amount of subsidized credits and loans extended to them exceeded 110 billion rubles (taking into account carry-over credits and loans of previous years). Household farms accounted for the major part of these subsidized credits and loans (65%), individual private farms – for 28% of them, agricultural consumer cooperatives – for 7%. Smallholder farms of the Southern and Volga federal districts got the biggest shares of these credits – 35.5% and 26.3%, respectively.

According to preliminary data submitted by regions the amount of subsidized credits received by individual private and household farms and agricultural consumer cooperatives reached 44.4 billion rubles.

In 2010 the Volga, Urals and partially Southern and Central federal districts were afflicted by drought. Taking into account this situation on the 23rd of June, 2010 emergency team was formed in the RF Ministry of Agriculture aimed to assist farm producers that suffered from drought. The Ministry made an expert estimate of information submitted by regions. According to conclusions of this analysis, farm crops perished on the territory of 13.3 million hectares, 25 173 farms in 895 areas in 43 regions-constituent members of Federation were found afflicted by the 2010 drought. The documented direct loss according to the expert estimate totaled 41.8 billion rubles.

To cope with the aftermath of 2010 drought some measures were adopted to help the affected farm producers. They include the financial assistance rendered in compliance with order of the RF Government Chairman V.V.Putin to the amount of 35 billion rubles, of which:

- 25 billion rubles are budget credits for the term up to 3 years for the partial compensation of regional budgets’ deficits;
- 10 billion rubles are subsidies to regional budgets aimed to support their balance.

An additional measure to support drought-afflicted farm producers being currently considered is the extension of bank credits and leasing payments. For instance, Sberbank of Russia decided to extend credits to the amount of 9.6 billion rubles, “Rosselkhozbank” – to the amount of 6.4 billion rubles.

Low percentage of insured farm producers implies the lack of a system of their complex insurance protection. This is due to a whole set of factors:

First, at present the state-supported agricultural insurance is applied in crop production but does not cover livestock farms and farm producers’ property. Thus not all agricultural sectors are protected against possible risks.

Second, the cessation of activities of a single insurance organization in some RF regions (for instance, in Altay kray) resulted in complete absence of insured crop areas therein.

Third, the lack of a complex system of re-insurance in the sector results in regional cumulation of risks that strongly deters not only the development of agricultural insurance system

but also the implementation of regional policies for supporting agriculture and its selected sub-sectors.

Finally, the most important factor is that corporate and individual private farms are often unable to pay the insurance rate in due amounts and time.

4.5.5. Conclusions and outlook

1. The Doctrine of food security despite the modern definition of this term still remains the document targeted at increasing the share of domestic output in the country's commodity reserves instead of being the regulation directly ensuring population's access to food products. Because of that its definitions, indicators and criteria of food security contradict each other. These indicators and criteria should be brought into compliance with the notion of "food security" as "the provision of the country's population with safe agricultural products, fishery and other products from aqua bioresources (hereinafter referred to as fishery products) and foodstuffs". Otherwise some tools of state economic policies in the field of ensuring Russian Federation's food security cannot be applied – for instance, monitoring of food security situation in the RF regions. It's also necessary to continue efforts in the framework of the adopted strategy and to define specific tasks for each economic policy guideline. The current version of the strategy is too general and the implementation of its goal – the provision of population with food products and their availability – cannot be monitored.

2. In 2011 the practice of unreasoned rechanneling of budget funds from one section of the State program to another should be discontinued and the budget adopted in 2007 should be executed more strictly. The Ministry of Agriculture should limit the growth of subsidies for compensating interest rate and focus not only on protectionism and import substitution but also on measures supporting competitiveness, investments, innovations and rural development.

3. The increase of investment index in agriculture will be below the State program's objectives due to the slower growth rates of farm producers' incomes and the reducing attractiveness of agrifood sector for outside investors.

4. Next year one can expect the following trends on selected food markets. According to forecast of the Institute for Agricultural Market Studies, the gross output of grain can reach 85 million tons. In this case the ban on grain export should be lifted – otherwise it will result in overstocking of grain in the country's southern regions. The government can introduce export quotas. But the basic bottleneck of this regulation is the difficulty of administrating quotas.

2010 displayed high profitability of potato production. In the coming 3-4 years this trend will continue.

In recent years import substitution was progressing on the pork market supported by import restrictions in the form of tariff quotas. Higher prices for feeds following the drought will force unprofitable pig farms out of the market. First of all the livestock numbers will decrease in households and small farms (with less than 2 thousand animals). This will in turn enlarge the market for highly efficient commercial sector – industrial pig complexes with modern production technologies and capacities for slaughter and primary processing.

5. Measures for regulating grain market cannot be regarded as successful. Federal Law No. 264-FZ of December 12, 2006 "On development of agriculture" sets minimal prices to be used for intervention purchases at commodity exchange for supporting producer prices. When the law was drafted, the minimal price set by the state was supposed to be the bottom purchase price providing guarantee for farm producers. But the law's implementation revealed

several bottlenecks that were highly detrimental for farm producers both in good and poor crop years. First, the timing of interventions. When they are carried out, producers no longer have grain – the bulk of it has already been bought by resellers. Second, the law's definitions allow to bid the established minimal price at Dutch auctions. As a result the minimal price becomes the maximal one and purchases are made at prices below this minimum. Third, farm producers have no access to exchange trade because of the location of tender sites and the size of lots. Only about 2 thousand sellers take part in exchange auctions – less than 3% of 68 thousand farms producing commodity grain. Fourth, at intervention auctions grain is purchased by the United Grain Company acting as a representative of state. At the same time it has the right to purchase it for its own needs, mainly for resale. This is a stimulus for lowering prices¹. Fifth, the state spends 1 billion rubles a month for storing the purchased grain². Sixth, the law does not envisage any limits for the volume of grain to be purchased at minimal prices. But this limit is applied when carrying out purchase interventions.

In order to cope with these bottlenecks it would be rational to announce the minimal prices before the start of next crop sowing. It's necessary to determine terminals for collecting grain at minimal prices, to inform all producers about them, to engage a special organization or local authorities in forming of lots for auction sale, to ensure electronic or other access to tenders for farm producers³.

4.6. Foreign Trade

4.6.1. State of the Global Economy

The year of 2010 saw the global economy continue to recover after the 2008-09 crisis. As many as 20 out of 23 nations that are leading importers of Russian goods posted growth in their GDPs vs. the same period of 2009, while in another three ones (Hungary, Spain and Lithuania) GDP continued to decline. Growth in GDP on a quarter-on quarter basis was constantly noted since Q3 2009 in such economies as the US, the Euro zone countries, Switzerland; since Q4 the same tendency was reported by the UK and Japan. In Q1 2010, the aggregate GDP growth rate of the group of Russia's leading trading partners was down, but, propelled by the acceleration of growth in GDP in the Euro zone, it bounced back substantially in the next quarter.

The National Bureau of Economic Research announced on 20 September 2010 that the longest economic slump in the post-WW II history of the US had come to an end in June 2009. Its length was 18 months (the past recessions of 1973-75 and 1981-82 lasted for 16 months each). The 18 month long recession cost the US 7.3 mln. jobs, the 4.1% fall in the industrial output and 21% of the nation's wealth⁴.

A stage of the business cycle is defined on the basis of the dynamic of industrial output, employment, sales volume, and the population's real disposable incomes. In the period since the start of the recession the minimal value of industrial output was registered in June 2009, the one of employment - in December 2009, that of the population's real disposable incomes – in October 2009, and the nadir of volume of sales – in March 2009.

¹ Uzun V.Ya. <http://www.rg.ru/sujet/571.html>

² http://www.kazakh-zerno.kz/index.php?option=com_content&task=view&id=19279

³ Uzun V.Ya. <http://www.rg.ru/sujet/571.html>

⁴ <http://www.nber.org/cycles/sept2010.html>

That June 2009 was picked as the end date of the recession can be explained by the fact that GDP had been climbing up in the prior months, while minimal employment often was a typical feature of the period right after the end of the US recession. NBER noted, though, that the end of the recession does not herald the arrival of favorable conditions of economic development and that business activity typically is below normal at early stages of economic recovery.

Since June 2009 the US reported a practically unstoppable (except for a short interregnum in February 2009) growth in industrial output. Meanwhile, the employment still was on a relatively low level. Jobs were on the upswing between February and May 2010, but tumbled again between June and August. The real disposable incomes were growing between February and June and plummeted in July 2010. The sales volumes were on the rise between April 2009 and April 2010, plunged between May and June and bounced upwards in July 2010.

The US's real GDP has been growing during four quarters in a row since Q3 2009. The growth rates hit their peak in Q4 2009 and crayfished over the next two quarters. Their drop in Q1 2010 was chiefly ascribed to the negative effect of net export driven by the slowdown in growth in exports and expansion of import of goods and services.

According to the US DoC data, in Q4 2010 the nation's GDP posted a 3.2% growth in annual terms vs. the previous quarter. This is just the first GDP estimate out of three, and it might be substantially revised later on. In Q3, the US economy grew by 2.6%, and in Q2 - by 1.7%. So, the tendency of acceleration of the pace of economic growth after the recession is there.

The growth in the US's GDP in 2010 was fueled by more robust consumer spending, exports and the federal administration's mass spending. While imports contracted in the last quarter of the year, they ultimately grew over the year, nonetheless.

The World Bank estimates the 2010 global GDP growth rate at 3.9% and forecasts its slowdown to 3.3% in 2011 and some better performance (up to 3.6%) – in 2012. In its statement, the World Bank holds the global economy is in transition from the post-crisis recovery phase to the one of a slow but steady growth, which should last for next two years. The major feature of the future period should be a half of the global growth being propelled by emerging economies. It is envisaged that they combined should post a 7% growth rate in 2010, 6% - in 2011 and 6.1% - in 2012. Thus, in this respect they should outpace high-income nations with their projected growth rates being 2.8% in 2010, 2.4% - in 2011 and 2.7% - in 2012¹.

After a very painful downturn in 2009, the global trade expanded notably in 2010. The WTO experts believe that after verification of statistical data the last year's increase in global exports should be in the region of 13.5%. If so, it is going to be the all-time high rate ever registered since the beginning of running such statistics in the 1950s. The previous highest growth rate in global trade (12.2%) was registered in 1976. That said, in all fairness, this astounding accomplishment is noted against a very low benchmark.

It is envisaged that emerging economies should post export growth rates higher than developed nations (16.5% vs. 11.5%), with Asian tigers being particularly active (up by some 27%) vis-à-vis other country groupings in this regard.

¹ <http://go.worldbank.org/88GN6SUPU0>

4.6.2. Conditions of Russia's Foreign Trade: Situation with Prices for Major Russian Exports

The 2010 pricing environment for major Russian exports was favorable, with most commodity markets being all bulls.

The positive oil price dynamic in the global market in 2010 was stirred by the renewal of demand for oil which practically hit the 2007 level. Plus, China and other Asian economies were particularly thirsty for oil, forecasts of demand for oil for 2010-2011 were optimistic, and the leading global forex and security markets were in an optimistic mood.

In the first months of 2010, the world oil prices mostly were on the upswing, and on 3 May were at their 19-months highs (with Brent traded at USD 88.94/b). They subsequently dwindled to USD 74/b on fears triggered by the national debt crises in some EU countries and a slowdown of China's growth, uncertainties with the US economy's development, and because of a lax demand for energy resources in Europe.

In July 2010, oil prices picked their growth and on 23 December the official price of Brent stood at its 26-months high (since October 2008) – at USD 93.65/b.

The year of 2010 ultimately saw a 28.7% price rise for Brent on a year-on-year basis, but when compared with 2008, it slid by 18.4% (*Table 50*).

The price dynamic for oil products was basically following the oil prices. In 2010, the prices of oil products were on average up by 51% on a yearly basis, with gasoline prices adding 26.8%, but losing 21.2% vs. the 2008 figures.

Table 50

Average Annual World Prices

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Oil (Brent), USD/b.	28.19	24.843	25.02	28.83	37.4	54.38	65.15	72.32	97.64	61.86	79.64
Natural gas/ European market raz, USD/1 mln. BTU	4.344	3.976	3.23	3.86	4.4	6.6	9.03	8.93	13.41	8.71	8.29
Gasoline USD/gallon	0.887	0.792	0.755	0.891	1.197	1.508	1.81	2.06	2.703	1.68	2.13
Copper, USD/ton	1864	1614	1593	1786	2808	3606	6851	7119	6970	5150	7537
Aluminum, USD/ton	1550	14457	1351	1425	1693	1871	2619	2639	2576	1665	21731
Nickel, USD/ton	8624	5966	6175	9581	13757	14692	22038	37230	21108	14655	21809

Source: calculated by data London Metal Exchange (London, UK), Intercontinental Oil Exchange (London, UK), International Monetary Fund (IMF).

European prices for natural gas picked their growth in August 2009 and have been soaring through Q1 2010. However, due to the seasonal contraction of demand, they slid slightly in Q2 and resumed their rise in the second half of the year, which ultimately resulted in their adding 2.7%. Meanwhile, they remained at 4.8% lower than in the previous year (while in 2009 they were down by 35% against the 2008 figures).

The markets for metals in 2010 found themselves seriously propelled by the general recovery of the global economy and industrial sector and by the situation in China as the hugest consumer of metals in particular. The boom in China's construction sector, launch of ambitious infrastructure projects in India and other emerging economies heralded a bright future for the steel market until 2013, even regardless of a possible slowdown of the global economic advancement rate.

After a drastic fall in aluminum production in 2009, the respective demand began to surge dramatically: after hitting the bottom in February 2009 (1,330 USD/ton) the prices had skyrocketed by more than 80% by the spring of 2010 and outshot the mark of 2,445 USD/ton.

The situation on the copper market in 2010 likewise remained favorable. Over the year, the inventories were shrinking and demand was on the upswing against the backdrop of increasingly optimistic forecasts for the global economy. After their fall in Q2 2010, copper prices picked growth in August and continued to surge through the end of the year. As a result, by December the average monthly price had hit USD 9,147.26/ton against 7,386.25 /ton in January 2010 (3,453.2 USD/ton in Q1 2009). The average 2010 price of copper thus made up 7,535 USD/ton.

The 2010 nickel prices mirrored the most intense recovery dynamic. Plus, there has been no increase in offers on the market. As a result, the average 2010 price of nickel was up by 64.5% more vs. the 2009 figures and accounted 21,809 USD/ton

The price dynamics of food stuffs and agricultural raw materials on the global markets were multidirectional: in early 2010, prices for grain crops, vegetable oil and sugar were chiefly on decline, while meat prices were soaring. That said, the world price level for the foods stuffs and agricultural raw materials was on average higher than in 2009

Prices for grain crops (except for barley) were down because of earlier accumulated considerable global reserves and an increase of estimates of carry-over stocks of grain, and growing export supplies from Russia, Ukraine, Kazakhstan, Turkey and other regions of the world. In the first half 2010, prices for the US wheat and corn sank by 23 and 6.5%, respectively, Canadian wheat was down by 17%, barley was traded at 18% higher than in the first half of the prior year (in 2009, the prices of the said grain crops were down by 36, 28, 41 и 46% respectively).

After hitting their peak in January 2010, sugar prices have been dipping drastically until June. As a result, in just five months after hitting their all-time highs, the prices for raw sugar were down 1.9 times and the ones for refined sugar – 1.6 times. Behind such a dramatic downfall were more optimistic forecasts of harvest and the anticipation of greater sugar supplies from Brazil and India in the 2010-11 agricultural year. As well, the appreciation of the USD also sent the prices nosedive. Despite the downfall, the price level of sugar on the world market remained high. In the first half 2010, sugar was traded 1.5 time higher than in the same period of 2009 (in the first half 2009, it was nearly 1.2 times costlier than the year before).

The price dynamics on global markets for food stuffs and agricultural raw materials changed in mid-2010: the month of June saw prices of sugar, Canadian wheat and barley picking growth; in July, they were followed by the US wheat, corn, rice and vegetable oils. By the end of the year prices for soya beans and products of their processing, wheat and corn hit their 2.5 year highs.

Expectations of a considerable fall in the harvest of grain crops because of extremely unfavorable weather conditions (draught in Russia, Kazakhstan, Ukraine; torrential rains in Canada, a number of Asian countries and some European ones; unheard-of chills in some Latin American countries) drove grain prices up drastically. Russia's ban and Ukraine's restrictions on grain exports boosted the trend. As a result, in 2010 the price rise for the US SRW accounted for 23.5%, corn – 12.3%, Canadian wheat –3.9%, barley –23.0% (*Table 51*).

Table 51

Dynamics of Average World Prices on Some Agricultural

	2006	2007	2008	2009	2010
Wheat, USD/ton					
Canadian, CWRS	216.8	300.4	454.6	300.5	312.4
US, HRW	192.0	255.2	326.0	224.1	223.6
US, SRW	159.0	238.6	271.5	186.0	229.7
US corn, USD/ton	122.9	163.0	223.1	165.5	185.9
Barley, USD/ton	117.0	172.0	200.5	128.3	158.4
Soya beans, USD/ton	268.4	384.0	523.0	437.0	450.0
Soya bean oil, USD/ton	598.6	881.0	1258	849.0	1005.0
Thai rice, USD/ton	304.9	326.4	650.1	555.0	488.9
Raw sugar in US, import price, CIF New York, US cents/kg	48.76	45.77	46.86	54.88	79.25

Source: World Bank.

While the biggest meat importing nations found themselves better off and on the road to recovery, consumption of beef was up worldwide and in the Asian countries in particular. The Republic of Korea, Hong Kong, Japan and Malaysia became forerunners in this regard, and the 2010 beef prices posted a 27.12% growth vis-à-vis the prior year.

Prices for veal were also up; however, the price rise so far has been more moderate and accounted for 16.8%. Meanwhile poultry prices have not changed since 2009.

Contraction in the harvest of oil-plants due to unfavorable weather conditions drove prices of vegetable oils on the global markets upwards. Meanwhile, the anticipation of high yields of soya beans in a number of regions had a constraining impact on the prices. As a result, the average 2010 prices for palm oil were at 27.4% higher than in the same period of the prior year.

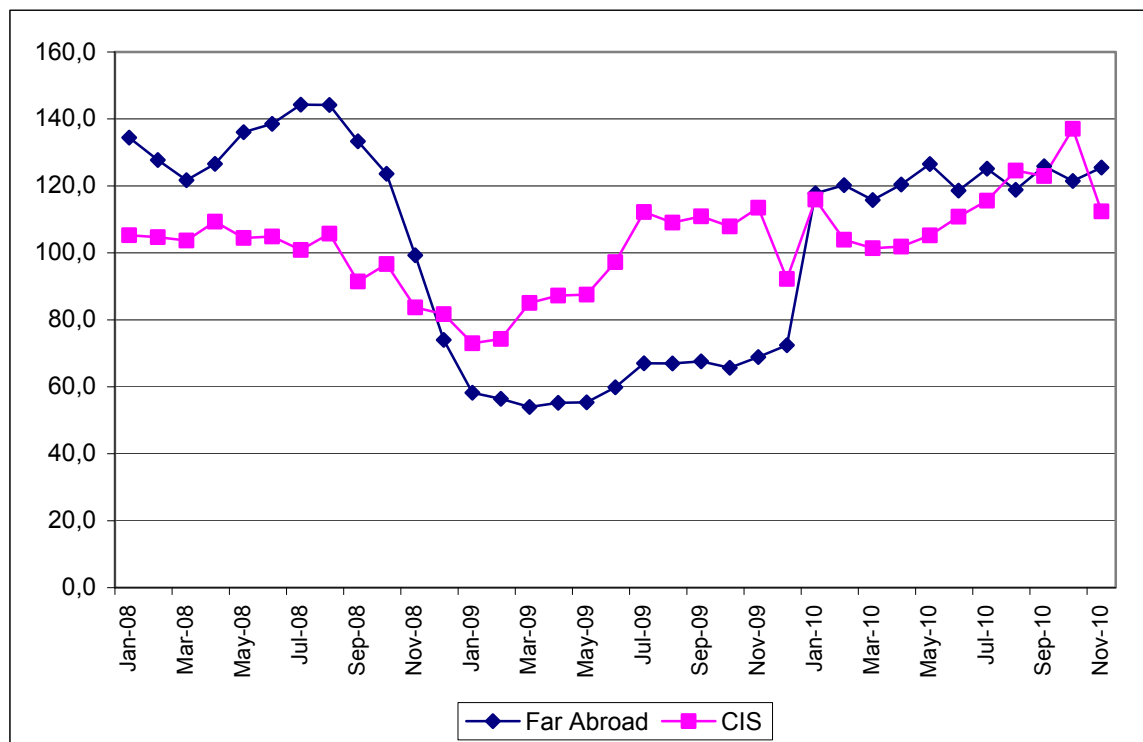


Fig. 46. Index of Foreign Trade Conditions

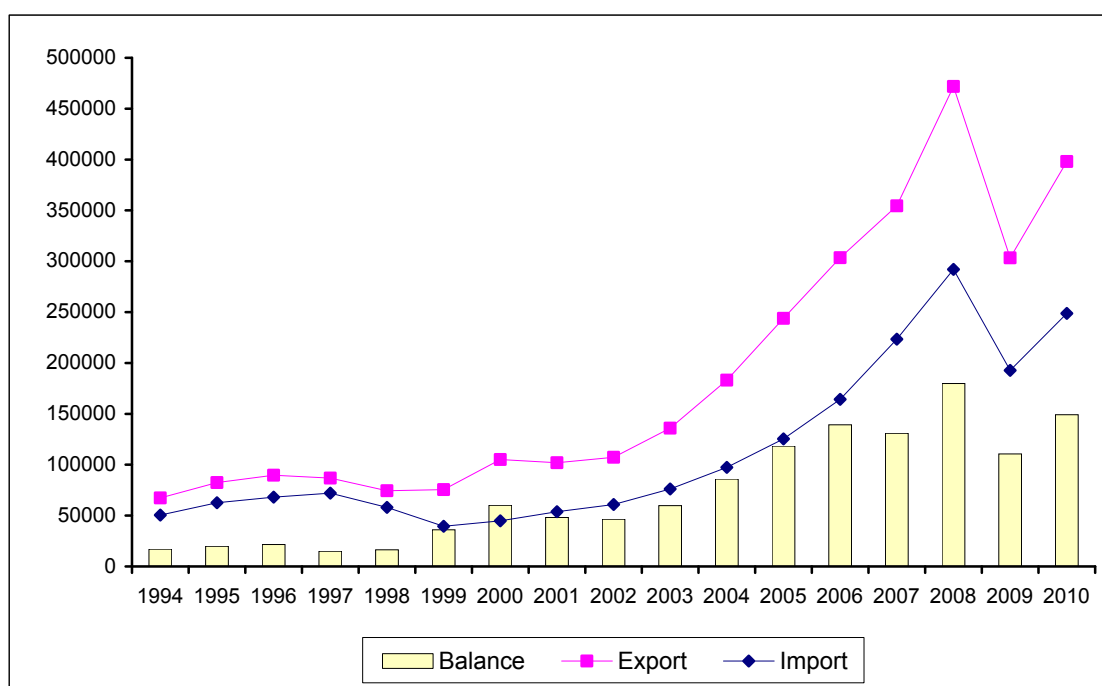
In 2010, it was raw sugar that posted the greatest price rise rate of 44.4% (because of a rapid price rise in the second half of the year), thanks to which the sugar prices hit their 30-year highs.

Because of the advanced growth rates of export prices vis-à-vis import ones, Russia's foreign trade conditions were favorable in 2010. The trade condition index accounted for 117.9 points (in 2009 – 116.0). After a significant deterioration of foreign trade conditions between late-2008 and early 2009, the export-to-import price ratio began improving since the first months of 2010. That said, it was foreign trade conditions with Far-Aboard countries that posted a faster growth rate (*Fig. 46*).

4.6.3. Main Indicators of Russia's Foreign Trade

In 2010, Russia's foreign trade turnover calculated by the balance-of-payments methodology hit USD 648.4 bln. vs. 495.2 bln. reported in 2009, ie was up by 30.9%. The growth in trade was fueled primarily by improving conditions of foreign trade. Specifically, Russian exports were propelled by the renewed demand for them and a better pricing environment for Russian exporters on world markets. The restoration of the value volumes of import should be ascribed to the growth of Russia's economy, rising real disposable incomes, and a real appreciation of the national currency.

With all these factors in place, Russia failed to catch up with the pre-crisis level, nonetheless: when compared with 2008, the nation's foreign trade turnover contracted 15.1%. So, the 2008 figures stand unbeatable over the whole period of observations. (*Fig. 47*).



Source: CBR.

Fig. 47. Main Indicators of Russia's Foreign Trade (as USD mln.)

The growth in the volume value of export was fueled mostly by the better pricing environment for Russian exporters, while the main factor behind the increase in the value volume of import was its growing physical volumes. (*Table 52*).

Table 52

Indexes of Russia's Foreign Trade (as % to the Respective Period of 2009)

	Q1 2010		1 st half-year 2010		January-September 2010		2010	
	Physical volume	Average prices	Physical volume	Average prices	Physical volume	Average prices	Physical volume	Average prices
Export	120,4	119,5	109,6	119,4	110,2	116,9	110,0	119,8
Import	112,9	103,1	122,6	101,8	130,8	101,2	135,4	101,6

Source: the RF Ministry of Economic Development

The foreign trade data over the recent months show the continuation of the trend to a fast growth in import vs. the subsiding dynamic of export. As a result, the year of 2010 saw a month-to-month contraction in the balance of trade. In August, it was USD 8.3 bln., ie. the 16-month low.

In all, Russia's 2010 balance of foreign trade was positive and accounted for USD 151.6 bln., or up by 35.9% vs. the 2009 figure (USD 111.6 bln.), but 15.6% less than the 2008 one (USD 179.7 bln.).

The 2010 disequilibrium in trade ratio (balance to trade turnover) was 0.234 vs. 0.225 reported in the prior year.

4.6.4. Structure and dynamic of export

In 2010, Russian exports increased up to USD 400.0 bln., or by 31.9% against the prior year (*Table 53*). The increase was fueled largely by rising contractual prices. The dynamic of exported goods over 2010 evidenced decelerating growth rates vis-à-vis the respective periods of 2009.

The volume of export in Q4 2010 was a maximum one over the year and accounted for USD 112.7 bln. vs. 92.2 bln. in Q1, 97.4 bln. in Q2, and 97.7 bln. in Q3. That said, export growth rates were falling gradually vs. the respective periods of 2009: while in Q1 2010 the value volume of export was up by 61.1% vs. Q1 2009, the Q2 figure was 43.0%, Q3 – a meager 18.5%, and in Q4 – just 17.9%. This is ascribed largely to the fading low-base effect of the prior year.

Table 53

Dynamic of Russian Export

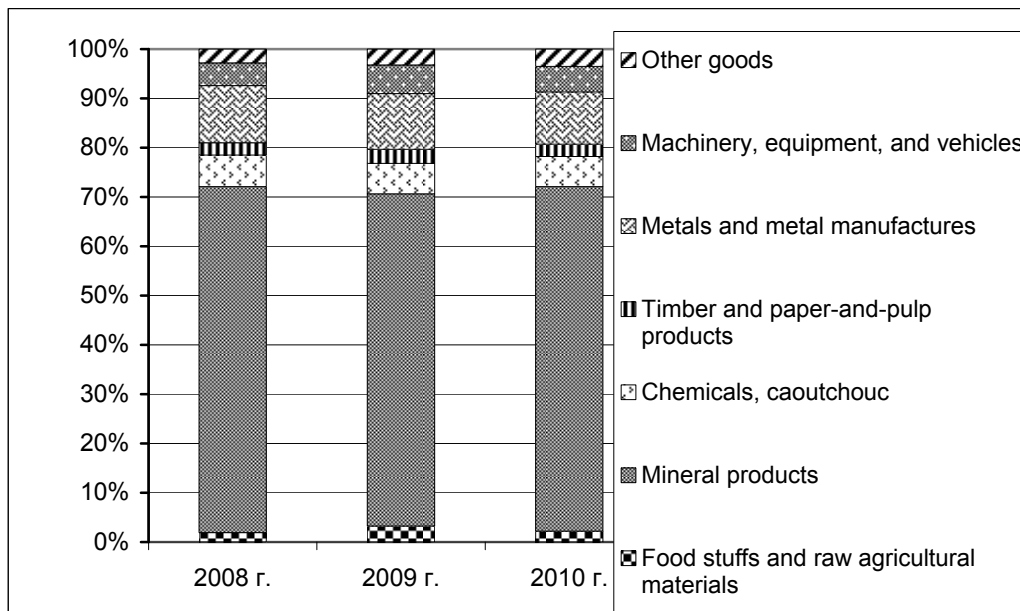
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Export, USD bln.	75.6	105.0	101.9	107.2	135.4	183.2	245.3	303.9	355.2	471.6	303.4	400.0
Including:												
Far Abroad	63.6	90.8	86.6	91.0	113.9	152.9	211.6	260.6	301.5	400.5	255.3	337.7
Growth rates, as % to the prior year												
Physical volume index	109.4	110.2	104.2	115.0	109.5	110.7	104.7	105.8	105.0	96.8	97.0	110.0
Price index	92.1	128.2	93.8	86.0	113.4	122.7	126.9	119.7	110.9	137.4	76.4	119.8

Source: CBR, the RF Ministry of Economic Development.

Export supplies of the most significant group of goods – that is, fuel and energy commodities - accounted for USD 257.4 bln. Against the background of fairly low value volumes of 2009, the 2010 export of crude and oil products posted an intense growth (1.4 and 1.5 times, respectively). The growth was fueled solely by the global price environment. The physical

volume of exported crude rose just by 3.6%, oil products – by 8.9%, while contractual prices for these commodities rose by 33.3% and 36.2%, respectively. With contractual prices for natural gas adding 9.1% and the physical volume of its exportation increasing by 1.3%, its export value was over USD 43.5 bln., or by 10.5% up vs. the 2009 figure. The aggregate export of the three fuel and energy staples – namely, crude, oil products and natural gas, rose in 2010 by 34.7%, while their proportion in the structure of export soared from 59.6% in 2009 to 64.9% (Fig. 48).

Metallurgical exports rose by 22.8%, up to USD 39.5 bln. According to FCS, physical volumes of raw aluminum plunged by 7.8%, nickel – by 1.8%, copper – by 10.3%. Despite the fall in the physical volumes, the value of export supplies of non-ferrous metals was on the rise, thanks to the price rise for them on the global market. Driven by a simultaneous increase in export prices and supplies in quantitative equivalent, the value volume of ferrous metals surged by 28.4%. When compared with 2009, the 2010 aggregate specific weight of metals, including metal manufactures, in the overall volume of export supplies was down by 0.7 p.p. – to 10.6%.



Source: FCS.

Fig. 48. Commodity Structure of Russian Export (%)

The chemical industry and its supplier/consumer industries increased its supplies by 30.3%, up to USD 22.8 bln., while the specific weight of goods of this group tumbled from 6.2% to 6.1%. nonetheless.

Export of timber and paper and pulp products soared by 13%, up to USD 9.2 bln., with export of processed timber products adding 16% - up to USD 3.0 bln, which in physical terms was equivalent of 9.9 mln. ton, or by 9.4% up vs. the respective index of 2009. The volume of export of unprocessed timber surged by 0.9% - up to USD 1.8 bln. The 2010 export of unprocessed timber in natural equivalent slid to 21.2 mln. m³., or by 1.9% against the 2009 figure.

By contrast to the 2009 trend of a substantial rise in export supplies of food stuffs, in 2010, export of food stuffs and agricultural raw materials slid by 2.9%. Supplies of goods of this particular group are estimated at the level of USD 8.1 bln., while their proportion in the aggregate export plummeted from 3.3% to 2.2%. The 2010 physical volume of export of wheat and meslin plunged by 29.4% on a year-on-year basis and accounted 11.8 mln. ton. As a reminder, in the summer of 2010, in anticipation of a poor harvest the RF Government imposed a temporary ban on export of wheat, barley, rye, corn and flour (effective between 15 August and 31 December 2010). The reason behind the move was an unheard-of drought and wild-fires that seriously affected the volume of the harvest.

After its substantial contraction in 2009, the value volume of export of machinery and equipment rose by 1.7% in 2010 and accounted for USD 19.6 bln. The increase was fueled chiefly by a 21.3% growth in supplies to Far-Abroad countries; however, because of an advanced growth in value volumes of export supplies of raw materials, the proportion of machine-engineering products in export slid from 5.8% to 5.2%.

Nearly a half of export of goods of this group fell on weaponry. According to estimates made by the Federal Service for Military-Technical Cooperation (FSMTC), in 2010, Russia cashed in as much as USD 10 bln.- plus from sales of arms and military hardware and now breathes the US's neck in this respect. However, one should not anticipate a further increase in arms sales, as, first, the global market for arms is expected to shrink in the years to come and, second, the Russian MIC corporations seem to increasingly fall behind their competitors overseas, which gradually lowers competitiveness of its manufactures.

So, Russian export showed no signs of change in its goods structure. The improvement of its qualitative indicators rests mostly upon the growing demand and rising prices of hydrocarbons and crude, ie. the economy remains dependent on the state of affairs on the world market for minerals.

4.6.5. Structure and Dynamic of Import

Against the background of the stalled growth in physical volumes of export (practically across all the key goods) imports were increasing substantially. In 2010, import supplies into the territory of Russian Federation were worth a total of USD 248.8 bln., or up by 29.7% on a year-on-year basis (*Table 54*). It should be noted that import increase rates in individual months of the summer of 2010 were over 30% vs. the 2009 figures, while in August the respective rate accounted for 53.2%. As a result, it took the share of import in the domestic consumption just several months to bounce back to its pre-crisis level.

In the conditions of a moderate price rise in import prices the increase was secured chiefly by growth in physical volumes of import supplies.

Table 54

Russia's Import (USD bln.)

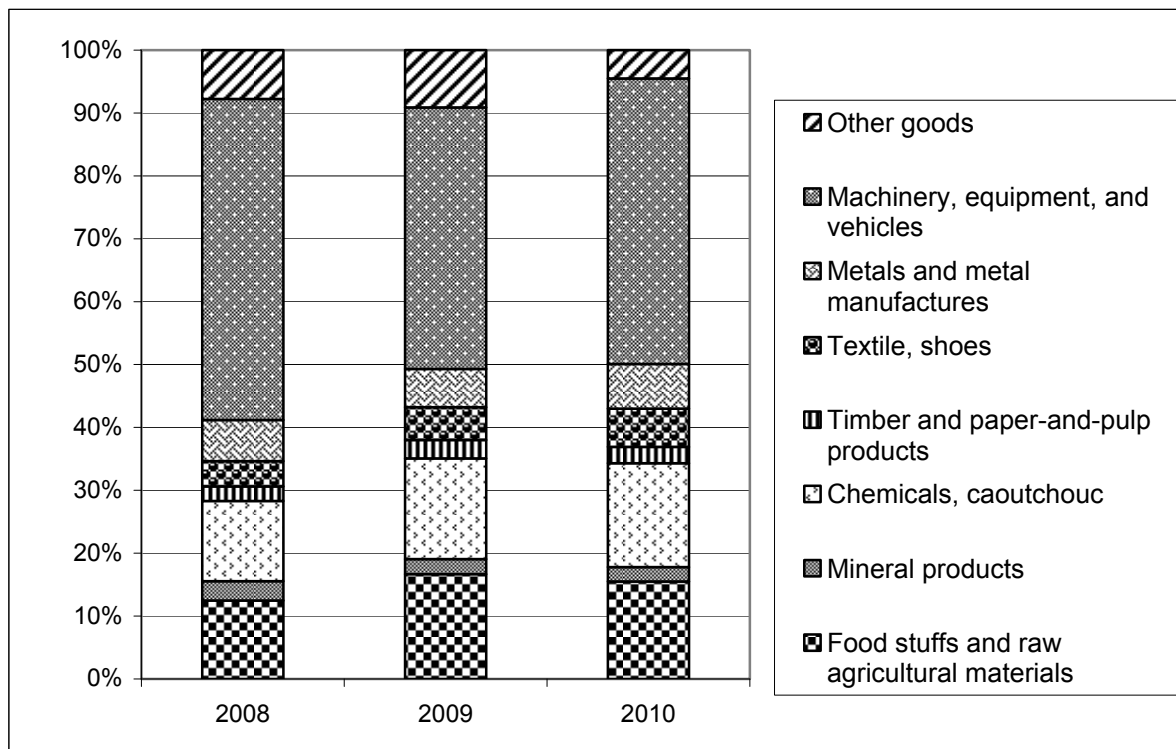
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Import, USD bln.	39.5	44.9	53.8	60.5	76.1	97.4	125.3	163.9	223.1	291.97	191.8	248.4
Including:												
Fra-Abroad countries	29.2	31.4	40.3	48.2	60.1	76.4	103.5	138.6	191.2	253.1	167.7	213.3
Increase rate, % on a year-on-year basis												
Physical volume index	84.4	129.2	129.1	117.6	119.2	124.2	122.4	130.1	127.1	113.5	63.3	135.4
Price index	82.1	86.7	94.3	93.4	98.7	106.1	106.5	105.5	107.6	117.8	99.1	101.6

Source: CBR, the RF Ministry of Economic Development.

Since early 2010 import of goods has been consistently on the rise: in Q1 2010 vs. Q1 2009- by 18.8%, in Q2 vs. Q2 2009– by 32.5%, Q3 – 39.8%, while in Q4 the increase rate was down to 25.8%. That said, it was Q4 when the value volume of import was the biggest one in 2010 and accounted for USD 75.9 bln. (68.6 – in Q3, 58.2 bln. – in Q2, 45.7 bln. – in Q1). Such a notable increase in import supplies became possible thanks to the Rb. appreciation.

In contrast to the negative dynamic of import supplies in 2009, the year of 2010 saw the value volume across all the enlarged items of the trade classification surge.

Import of machinery, equipment and vehicles increased considerably – by 39.7%, up to USD 98.6 bln. The specific weight of machine-building products in the structure of import rose from 43.9% up to 45.4% (Fig. 49). Within this particular group, increase was noted across most of items: the import value of passenger cars was up by 33.8%, while the one of trucks - 2.3 times. The physical volume of importation of passenger cards increased by 33.8% on a year-on-year basis, while that of trucks – 2.2. times.



Source: the RF Ministry of Economic Development

Fig. 49. Goods Structure of Russian Import (%)

In 2010, the nation purchased food stuffs and agricultural raw materials from overseas in volumes at 19.1% greater than in 2009. That said, import of food stuffs from the CIS countries soared by 22.5%, while the one from Far-Abroad countries – by 18.7%.

Physical volumes of import supplies of condensed milk and cream surged nearly 6-fold, barley – 3.4 times, sunflower seed oil – 2/6 times, raw sugar – 1.7 times.

Meat imports were down by 15.7%, or by 345,000 tons. In 2009 the country imported 2.2 mln. ton of meat. It was poultry supplies that suffered a serious blow due to the ban on impor-

tation of poultry processed with the use of chlorine-containing preparations, which suspended for long supplies of chicken legs from the US. The ban was lifted only in mid-August after the US producers complied with Russian requirements, but import supplies failed to fully recover and their volumes ultimately dropped by 36.5% (by 340,000 tons). In 2009, import supplies accounted for 942,000 tons.

The beef import was down by 2.5% (16,000 tons) vs. the 2009 figure of 636,000 tons. Meanwhile, pork supplies remained practically unchanged when compared with the 2009 figure of 633,000 tons. As a result, the proportion of imported meat on Russia's domestic market accounted for 20.6% in 2010. It is beef which remains the meat product Russia still most strongly depends on: the specific weight of import supplies of beef in 2010 matched the prior year's level (26.7%). Imported pork held 20% of the market in 2010 vs. 23% reported in 2009, while chicken broiler -17% vs. 27%.

Import of chemicals and products of related industries increased by more than one-third – up to USD 35.9 bln. Import supplies of medicines were up by 30.9%. While the chemical sector is considered a leader of the renewed growth, the dynamic of import evidences no import substitution processes in the sector. Back in 2008, the proportion of imported chemical products on the domestic market was 13.3%, while in 2010 – already 16.5%; so, domestic producers lost a fraction of the national market to their Western rivals.

A similar situation is noted with regard to textile, textile garments, and footwear: the share of import of these items rose from 4.2% in 2008 up to 6.7% in 2010, while the 2010 value volume of the respective import supplies was up by 49.5% on a year-on-year basis. That can be ascribed to increase in the physical volume of import of clothing, cotton fabric and leather footwear, as well as the price rise for cotton hair and leather footwear.

In the 1st half 2010 CBR estimated the proportion of import goods in the retail sector's inventories to soar by 0.5 p.p. and stand at 43%. The increase rate in imported food stuffs was 1 p.p. and accounted for 35%.

Today, Russian producers of investment and consumer goods have no capacity to substantially boost the output of competitive products. Hence, there is no possibility to meet the growing investment and consumer demand without attracting sizeable volumes of imports. A further appreciation of the national currency and the overall rise of economic activity in the country should propel a further expansion of imports.

4.6.6. Regulation of Russia's Foreign Trade

The rise of the Customs Union formed by Russia, Belarus and Kazakhstan made the headlines in 2010. The Union now embraces over 60% of the populace of the whole post-Soviet zone and produces over 85% of its GDP, while the volume of GDP of the three nations combined is over USD 2 trln.

The year of 2010 saw the work on development of the Union's customs law, including the Customs Code, international treaties and decisions made by the Commission of the Customs Union, be in progress.

The forging of a new normative and legal base of regulation of the foreign trade sphere is carried out in compliance with the strategic document of the member states of the Union "Stages and timelines of formation of the single customs territory of the Customs Union of the Republic of Belarus, the Republic of Kazakhstan and the Russian Federation".

The main stages of formation of the single customs territory of the Customs Union and the respective timelines are as follows:

1. The preliminary stage (until 1 January 2010).

During that stage, the work was in progress on designing a normative and legal base and organizing a stage-by-stage transfer of the agreed upon types of government control, except for the border one, onto the external contour of the single customs territory.

The draft Customs Code of the Customs Union had been developed by 1 October 2009. By that time, there three nations had also crafted proposals on amending the normative and legal base with regard to developing provisions of the Customs Code relating to a uniform employment of forms and methods of customs control and customs clearance procedures.

As well, the parties developed and prepared for adoption international treaties on collection of VAT and excise taxes in the territory of the Customs Union in the absence of customs clearance and customs control procedures.

The parties have been coining the Uniform Customs Tariff and a uniform system of non-tariff regulation measures in the frame of the Union; they were devising a mechanism of accrual and allocation of future customs duties and a uniform methodology of running the foreign trade statistics and the one of mutual trade between the Union member states.

On the basis of an analysis of the effective trade regimes of the three member states with regard to third nations the parties identified existing discrepancies and came to an accommodation of their unification. They also evaluated the effective constraining measures of economic nature in mutual trade and reached an agreement on conditions of their cancellation and replacement with uniform rules of competition, subsidizing and other forms provision of state support.

The parties developed measures that should secure a sustainable functioning of the single customs territory after the transfer of the agreed upon types of the state control onto the external borders.

2. The first stage (1 January – 1 July 2010)

Since 1 January 2010 the uniform customs and tariff (including tariff benefits and preferences) regulation and the non-tariff one came into effect, including:

- The uniform customs tariff and the system of non-tariff regulation measures;
- Abrogation of the existing constraining measures of tariff and non-tariff nature in the mutual trade between the three nations;
- Launch of exercise of the joint control at the Russian-Kazakh border.

Functions in the sphere of customs-tariff and non-tariff regulation were mandated to the Commission of the Customs Union as a single regulatory body.

While shaping the Customs Union, a major challenge was agreeing upon the Uniform Customs Tariff (UCT) rates, for originally the three countries found only 40% of their rates matching each other. So, they were compelled to launch a long process of unification of rates on nearly 11,000 commodity headings.

However, the parties failed to ensure a 100% consensus across all the tariff rates, primarily because Kazakhstan was not ready to change (increase, actually), nearly 55% of its national customs tariffs. That is why Kazakhstan reserved a list of 400 commodity headings, the customs levies on which should remain on a lower (or zero) level through 2014, including medicines, plastic, cardboard and paper, aluminum manufactures, among others.

Russia, too, substantially modified (mostly lowered) its customs duty rates since 1 January 2010. Specifically, the rates were zeroed on 300 more headings of technological equipment, devices and mechanisms. The rates on meat and dairy products, and ferrous metals were raised insignificantly.

It is worthwhile noting that the UCT rates are subject to revision. Specifically, duty rates on some commodity headings the Custom Union member states attribute to the group of 'sensitive' ones may become subject to modification, provided the three nations have mobilized consensus in this respect. This mostly concerns food stuffs, clothing, wooden manufactures, fabrics, etc.

The pilot project on operating and fine-tuning the information exchange between the three national customs agencies for the sake of controlling of moving of goods and vehicles across the single customs territory (the domestic and international transit control) and running the statistics of mutual trade kicked off on 1 April 2010.

3. The second stage - since 1 July 2010

- the Customs Code of the Customs Union implemented and a uniform methodological base developed in its furtherance;
- the exercise of customs clearance of goods and vehicles began with the use of uniform forms of documents by the customs agency of the Union member state whose resident is a participant in foreign economic activity;
- the conduct of statistics of foreign trade and statistics of mutual trade was ensured;
- international treaties relating to indirect taxes and mechanism of information exchange between tax agencies came into effect.

With regard to administering export:

- the Union member states retain the possibility to independently determine export customs duty rates;
- respective amounts of export customs duties are collected to the budget of the Union member state wherefrom the goods originate;
- the Union member states retain the possibility to independently determine and apply non-tariff regulation measures in respect to individual kinds of goods (military and dual-purpose manufactures, natural commodities);
- the possibility to pursue an independent policy in the noted areas of export regulation is secured by execution of mutual obligations in the frame of the international treaty framework of the Customs Union.

The bill "On customs regulation in Russian Federation", which was supposed, once passed, to substitute for the Customs Code of RF, was envisaged to be implemented since 1 July 2010. Its passage was delayed, though: the first draft was developed by FCS under the name "On customs regulation" and the RF Government declined the bill in May, as it seemed to increase the administrative pressure on business. The RF Ministry of Economic Development prepared its own version, but much time was wasted on obtaining other government agencies' approval. Plus, the bill suffered fairly numerous controversies and comprised some 300 reference provisions which would require creating a plethora of various by-laws. As a result, the law has been under development until November 2010.

4. Third stage (since July 2011) envisages:

- transfer of the agreed upon kinds of state control from the Russian-Kazakh border to external borders of the Republic of Kazakhstan and the Russian Federation. At this point, a transitional period was provided for, during which at customs clearance locations in the territory of the Republic of Kazakhstan where monitoring of the exercise of customs clearance procedures will be carried out, along with a temporary retention of individual forms of customs control along the Russian-Kazakh border;

- completion of negotiations with third countries on unification of trade regimes on the basis of earlier reached agreements.

It is envisaged that since 1 July 2011 customs clearance procedures will be abrogated with regard to goods originating from third countries and released for a free circulation in the territory of the Republic of Belarus, Republic of Kazakhstan and the Russian Federation and goods transited within customs territories of the Republic of Belarus, Republic of Kazakhstan and the Russian Federation.

This is the final element of the formation of a single customs territory that secures, within its borders, a free moving of goods originating from therein, as well as goods originating from third countries.

So, the customs regulation of the Customs Union rests upon six blocks of documents that match respective decision making levels:

- 1) The Customs Code of the Customs Union;
- 2) International treaties adopted on the basis of CC of CU;
- 3) Decisions of the Commission of the Customs Union;
- 4) Customs legislation of the Customs Union member states;
- 5) Decisions made by national governments of the said states; and
- 6) Normative and legal acts by their competent government agencies.

The Customs Code of the Customs Union appears substantially different from the RF one. More specifically, the conceptual framework underwent certain modification:

- The term of ‘customs broker’ was replaced by ‘customs representative’;
- The term of ‘customs regime’ was changed for ‘customs procedure’;
- A new term, ‘express cargo’, was introduced;
- Such terms as ‘free circulation’, ‘status of goods and vehicles for customs purposes’, ‘customs clearance’ were excised.

The Customs Code of the Customs Union provided for new forms of customs control:

- Account of goods under customs control;
- Examination of the goods accounting and reporting system;
- Customs audit (conducted both in-office and on-site one) instead of customs examination.

The Customs Code of the Customs Union now comprises a chapter that regulates procedures of seizure of goods and respective papers in the course of the exercise of customs control.

Declaring goods at the customs should be made solely in writing and in the electronic form with the use of the customs declaration. The oral and tacit forms of declaring goods are not permitted.

For the sake of encouragement of export of hi-tech goods, the Code provides for a reduced and closed list of documents to be submitted along with the declaration on such goods to make them eligible for the customs export procedure.

The Customs Code also provides for a possibility to identify supranational areas of risks which may prove sensitive to all the Union member states. Such areas will be identified by the Commission of the Customs Union.

When compared with the Tax Code of RF, timelines of customs authorities’ various operations underwent modification. For instance, they were reduced with regard to the following operations:

- Release of goods – from 3 days to 2 days, while as to goods exported from the Customs Union's territory and exempt from export customs duties, the timeline now is 4 hours;
- Registration by the customs agency of the transit declaration – from 2 hours to 1 hour;
- The maximum term of extension of release of goods was reduced to 10 days from the date following the date of registration of the customs declaration; the document also unequivocally set conditions of such an extension - namely, the need to exercise or complete a form of customs control.
- The following timelines were extended:
- Submission of goods to the customs office under the procedure of their declaring in advance – from 15 to 30 days;
- Processing of goods in the customs territory – from 2 to 3 years;
- The term allowing to place under the customs procedure of re-export the goods earlier placed under the customs procedure of release for the domestic consumption – from 6 months to 1 year.

The document also set timelines with regard to processes for which timelines had not earlier existed:

- The timeline of organization of customs escort by the customs office (within 24 hours from the moment the decision was made);
- The timeline of registration or refusal of registration of the customs declaration (no more than 2 hours from the moment it was submitted; in Russia's Customs Code, the respective timeline was the day of receipt of the customs declaration by the customs agency);
- The timeline of completion by the parties concerned of operations relating to placement of goods under temporary storage or their declaring at the customs (3 hours from the moment of presentation of goods).

As well, changes affected matters associated with the enforcement of customs procedures. For instance, the procedure of the internal customs transit was excised, and the goods transited across the customs territory, including those shipped from one domestic customs authority to another one, will be placed under the customs transit regime (procedure). Presently the shipment of goods starts right at the Customs Union's external border and extends through its recipient's location, regardless of his state of residence. Meanwhile, transport operators, including customs ones, enjoy the right to move across the whole territory of the Customs Union without being subject to the intra-state control in the territory of each of the Customs Union member states. At the same time, the railroad operator in the preemptory order is exempt from depositing a shipment guarantee.

Yet another peculiarity of the Customs Code of the Customs Union lies in the possibility for a concurrent placement of goods under two customs procedures– that is, customs transit and re-export (provided the obligatoriness of exportation of the goods in question) or customs transit and re-export (in the cases set forth by the CC of CU).

Substantial changes occurred with regard to activities relating to running registers. The customs authorities of each Union member state maintain registers of entities that carry out operations in the customs business area. The Commission of the Customs Union forms common registers of such entities at the supranational level. That said, the customs authorities were not tasked to conduct registers of banks, credit organizations and insurance companies.

The conditions of inclusion of entities in the registries were modified too. For instance, there appeared requirements on the absence, as of the date of addressing the customs agency,

of unredeemed arrears with regard to customs payments and fines, and facts of imposition of administrative sanctions for abuses in the customs business area within 1 year from the date of the previous addressing the customs agency. Meanwhile, the insurance contract against torts liability risks was crossed out from the list of conditions under which entities can be included in the register of customs transport operators.

Another novelty became a possibility for establishment by the national law of instances and procedures of suspension and renewal of legal entities' operations in the capacity of customs representatives, owners of a temporary storage warehouse (TSW), customs warehouse and duty-free stores, and authorized economic operators.

The Customs Union law introduces a new model – namely, the Institution of the authorized economic operator (AEO), which is supposed to simplify relationships between *bona fide* participants in foreign trade and customs authorities. Specifically, a procedure of release of goods prior to submission of the customs declaration and temporary storage of goods in-door, outdoor and in other AEO's territories without including the AEO in the register of owners of TSWs is provided for AEOs. The Institution of AEO rests upon principles stipulated in the 1973 International Convention on the Simplification and Harmonization of Customs Procedures (Kyoto Convention), and it has already been long practiced in the EU countries.

The applicant for the AEO status should meet certain criteria and comply with strictly set rules. Specifically, to become an AEO, a firm should: pledge a Euro 1 mln.- orth collateral with regard to payment of customs duties and taxes (for production companies and (or) exporters whose products are exempt from export customs duties, the respective amount is Euro 150,000); have at least 1-year long record of operations in the foreign trade area; have no outstanding liability on customs payments, tax arrears or facts of being brought to responsibility for abusing customs rules (eg. unverified declaring) for 1 year.

Not only did changes affect the conduct of the register of customs business operators, but the one of intellectual property objects. In addition to national registers, the Union member states provided for conduct of a single customs register of intellectual property objects (in addition to national ones).

The adoption of the new, common, customs law does not mean liquidation of the national ones. Thus, on 29 December 2010, the Act 'On customs regulation in Russian Federation' came into force. The Act became a part of the Customs Union law and comprises provisions and requirements of the Union's Customs Code.

The Act 'On customs regulation in Russian Federation' was designed with account of modern trends of development of customs operations, in particular those associated with simplification of export of hi-tech goods and optimization of customs operations. Behind the adoption of the Act lies the fact that the Customs Code of the Customs Union and the Union member states' international agreements comprise over 200 references to the three states' national law, while the Act includes a maximal number of provisions of direct force, while reference provisions are used mostly with regard to technological matters associated with completion of customs operations.

The Act fixes fundamentals of organization of customs agencies' operations, their functions and responsibilities, locations, operating hours, and responsibilities. The document also fixes main principles of moving of goods in the course of their importation in RF and exportation out of the country, transit across RF under customs control, rules of identification of their country of origin, the procedure of application of customs procedures in the conditions of the Customs Union. The Act also establishes requirements to customs transport operators, repre-

sentatives, TSW owners, duty-free stores, and other organizations. The Act also provides for a centralized procedure of payment of customs duties and taxes. To this end, the payer should enter in the respective agreement with Russia's FCS. In this case, the amount of customs duties and taxes payable over the year should account for between Rb. 50 and 100 bln.

The Act also introduces measures aimed at implementation of key tasks on modernization of Russia's economy and support of hi-tech and innovational production. To this effect, it is proposed to simplify procedures under export of hi-tech equipment and import of assembly parts used for its manufacturing. The Act also determines a simplified procedure of international exchange with research and commercial samples, importation of spare parts for maintenance and repair of foreign vehicles.

A major aspect of a specific concern of businesses is minimization of time costs associated with completion of customs operations under the temporary storage of goods, their declaring at the customs, and release of goods. Under customs regulation this can be ensured by means of simplification (reduction in the number of reference provisions) of legal provisions that contain requirements to entities that move goods. In other words, this can be done by regulating critical for business problems right at the level of a federal Act and developing straight and understandable normative dictates. So, the Customs Union should provide for establishment of such a customs control system, which should be efficient for the state and to a minimal extent burdensome for businesses.

Statistics evidence that Russian customs authorities demand far greater a number of documents from participants in foreign economic activities than their peers in the Union member states. For instance, import operations require filling out 22 clearance documents, while export ones – up to 30 documents (according to the RF ministry of Economic Development). By contrast, Kazakh and Belarus customs authorities in such cases request between 4 and 8 documents. The Russian customs strives to reduce the volume of the documents to 14 ones, but it will still be too much a hurdle, nonetheless.

With the Customs Union in place, Russian customs authorities have faced rivals in the other Union member states: should such challenges as delays in the exercise of customs clearance procedures and problems with an excessive amount of necessary paperwork be not replaced by a customer-friendly approach, it will be no sweat for importers and exporters to switch to the same services in Belarus and Kazakhstan.

Now that an agreement on application of the procedure of collection and allocation of import customs duties came into effect on 1 September 2010, the duties in question are channeled to special accounts in each state and automatically allocated between the three state budgets. They first are accrued onto a single account and subsequently are allocated between the said budgets in accordance with pre-set ratio, under which RF is entitled for 87.97% of the overall amount of customs duties, Belarus – 4.7%, Kazakhstan – 7.33%. According to the Commission of the Customs Union, the first month of implementation of the Agreement (September 2010) resulted in Russia collecting USD 2.05 bln. in customs duties, Belarus – USD 109.4 mln., and Kazakhstan – USD 170.9 mln.

The Federal Treasury's statistics of execution of the RF budget evidence that having insisted on its variant of splitting the duties, Russia, as a minimum, has not lost any revenues: prior to the implementation of the new mechanism, in July 2010, Russia had collected Rb. 49 bln. in import customs duties, while in August 2010 – Rb. 55 bln. Meanwhile, the September "split" revenues accounted for Rb. 63 bln. The increase in collection could be ascribed to seasonality. Since October 2010 FCS has started singling out split import customs duties out of

their overall volume and in that month they amounted to Rb. 60 bln. In any case, the amount of import duties is smaller (in 2010 – 4-fold) than export duties that form the major revenue item for FCS, with their amount depending on current prices of Urals.

In compliance with art. 3 of the RF Act “On customs tariff”, in 2010, the RF Government developed and adopted 12 resolutions to approve export duty rates on crude and oil products.

The export customs duty rate on crude and petroleum derivatives produced from bituminous rock exported from Russia to beyond the borders of the Union member states was changed every month in 2010 on the basis monitoring of prices for crude Urals. The prices were subject to monitoring between the 15th day of each calendar month and the 14th day of the next calendar month (*Table 6*).

Table 55

Export Duty Rates on Crude and Oil Products in 2010 r. (USD/T)

	Oil	Oil products	
		light	black
1 January	267.0	192.2	103.5
1 February	270.7	194.7	104.9
1 March	253.7	183.2	98.7
1 April	268.9	193.5	104.2
1 May	284.0	203.7	109.7
1 June	292.1	209.1	112.7
1 July	248.8	179.9	96.9
1 August	263.8	190.0	102.4
1 September	273.5	196.5	105.9
1 October	266.5	191.8	103.3
1 November	290.6	208.1	112.1
1 December	303.8	217.0	116.9

Source: resolutions of the RF Government.

In accordance with the package of agreements on formation of the Common Economic Space signed in December 2010, Russia bound itself to supply exempted from export duty oil to Belarus since 1 January 2011. Meanwhile, Minsk committed itself to refund 100% of export duty on petroleum derivatives produced from the Russian oil, should they be exported to beyond the borders of the Customs Union, while export duties on Belarus’s own oil (some 1.7 mln. tons) will be collected to the country’s budget.

The bilateral agreement on carbohydrates does not concern the oil Belarus can procure from Venezuela and other third countries. Duties on oil products made from such oil will also be collected to Belarus’s budget. Such a scheme will be in place for three years until the moment the three nations develop another mechanism of splitting export customs duties.

As concerns the size of the export duty on oil products Belarus will be transferring to Russia’s budget in 2011, it will make up 67% of the duty on crude for light oil products and 46.7% - for black ones, ie. matching the new formula of calculation of export duty on oil products implemented since February 2011 in compliance with RF Government’s Resolution of 27 December 2010 № 1155. In 2012, the duty on light oil products will account for 64% of the crude duty, while that on black ones – 52.9%. Since 2013 both duties will become even and make up 60% of the oil duty each.

On the level of bilateral agreements Russia and Kazakhstan also agreed, within the framework of the Customs Union, not to change until 2015 the current regime of collection of export duties on oil Russia supplies to Kazakhstan. Presently Russian oil supplies to Kazakhstan have been exempt from export duty.

On 5 November 2010 the Federal Act “On Russia’s joining the International Convention on the Simplification and Harmonization of Customs Procedures of 18 May 1973 as revised in the Protocol on introducing amendments to the International Convention on the Simplification and Harmonization of Customs Procedures of 26 June 1999” was signed.

The International Convention on the Simplification and Harmonization of Customs Procedures (the Kyoto Convention) was adopted on 18 May 1973 in the city of Kyoto and implemented on 25 September 1974. On 26 June 1999, the session of the World Customs Organization approved the revised Convention whose ultimate objective is promoting global trade by simplifying and harmonizing customs rules and procedures. The revised version came into effect in February 2006.

The Convention obligates the signatories to employ uniform international standards in their customs authorities’ operations, simplified and automated customs procedures. As well, it provides for the transition to the use of electronic documents and establishment of an electronic one-stop-shop system. Joining this international treaty constitutes a necessary step in the process of accession to WTO.

As a reminder, Russia, Belarus and Kazakhstan put on hold their negotiations on joining WTO in the frame of respective working groups in the summer of 2009, when they decided to establish the Customs Union and hold negotiations together. The decision was subsequently revised and the then would-be Union states agreed they could conduct negotiations on their own, but proceeding from the common stance.

The multilateral consultations held in Geneva on 25 May 2010 resulted in the Working Group on Russia’s accession to WTO ruling to renew the negotiations. In late 2010, Russia significantly intensified its efforts in that direction and succeeded in completing negotiations with the US and EU.

The Russian delegation and members of the Working Group on Russia’s accession to WTO have to find compromises with regard to the level of agricultural subsidies, the regime of access to Russia’s meat market, state-owned trade enterprises’ operations, the amount of export duties (on timber in particular), transparency of the national law, among other things.

The Russian side keeps amending the draft Report of the Working Group due to the establishment of the Customs Union between Belarus, Kazakhstan and Russian Federation.

The first block of renewed sections was discussed at the multilateral meeting on 21 September 2010, the second one – on 25 October, and the third one – on 8 December 2010. The general reaction of the WG members was positive. A number of WTO member states put some questions, and the Russian side made clarifications in writing and in the course of bilateral meetings.

On 26 October 2010, Russia held multilateral consultations on agriculture with the 4 parties concerned. At the consultations, the Russian side presented revised calculation templates on the state support of the agrarian sector in 2007-08.

In addition to the WG Report, an inseparable part of the Protocol on Russia’s accession to WTO shall become consolidated lists of obligations on granting access to the domestic markets for goods and services. The work on development of the consolidated list of access to the market for goods is still in progress, while the consolidated list with regard to access to the market for services was sent out to the WG members in October 2010. In the event of any discrepancies with regard to any obligation enumerated therein, the Russian side will be compelled to hold additional consultations and negotiations with the WTO member states concerned.

The negotiations on meat import quotas are the toughest challenge, for some WTO member states are keen to retain conditions agreed upon back in 2006. Since then Russia has invested heavily in development of its meat complex and now its domestic producers demand to fence them from import, while the importing countries insist on keeping their quotas unchanged.

Russia is going to hold negotiations on meat supplies with 10-15 WTO member states, including the US. This process should take several months to complete. The Russian negotiators' ultimate task is "to agree on such conditions of importation of meat in the country, which would allow <the government> to implement development and investment plans". What Russia offers seems to be tighter than the 2003-05 conditions (at the time, the Government restricted meat imports).

In 2011, the government is going to substantially slash the poultry import quotas, which are supposed to account for 350,000 t. instead of the earlier planned 600,000 t. The decisions should affect primarily the US suppliers' interests. Their 2010 quota was 600,000 t. out of a total of 780,000 t., but the actual volume of the US poultry import made up just 300,000 t. The fall should be ascribed to the US poultry failing to meet the new Russian sanitary- hygienic standards.

The import quota on pork for 2010 and 2011 was set at the level of 472,100 ton, while for 2012 – 425,000 ton. The annual quota on refrigerated beef for 2010-12 accounts for 30,000 ton, while the one on deep-frozen beef – 530,000 ton.

With its Resolution of 29 December 2010 №1190 the RF Government retained the duty on round timber unchanged – that is, 25% of its customs value, but no less that Euro 15/c.m. The duties on Russian timber supplies to Finland until recently have been a major obstacle to Russia's accession to WTO, as the EU has been demanding for their lowering since 2004. But as the country's accession to WTO was delayed, Russia took a course towards bolstering the national wood-working sector. In February, the RF Government decided to launch a gradual increase of export duties on unprocessed timber. The duties were raised up to 20% of the value of a shipment since 1 July 2007 and subsequently – up to 25% effective since 1 April 2008. It was envisaged to further increase export duties on round timber up to the protective level of 80% since 1 January 2009; however, under the EU pressure and because the domestic wood-working sector was not ready yet, in 2008 Russia imposed a moratorium on increases of the duties and froze them at the level of 25% of the customs value. The moratorium was set to expire on 1 January 2011, after which the duties might have hit 80%. However, at the Russia-EU summit in the early December 2010 the parties agreed to extend the moratorium and to lower duties upon Russia joining WTO. That said, the Russian side does not waive its right to raise the duty rates since 2012, should the nation fail to join WTO.

Russia has chances to join the Organization in 2011, after nearly 17 years of negotiations. Usually, it takes a nation five to seven years to complete negotiations and the accession procedure.

As a reminder, WTO currently unites 153 states, whose overall proportion in the global trade accounts for 95%.

Section 5. Social Sphere

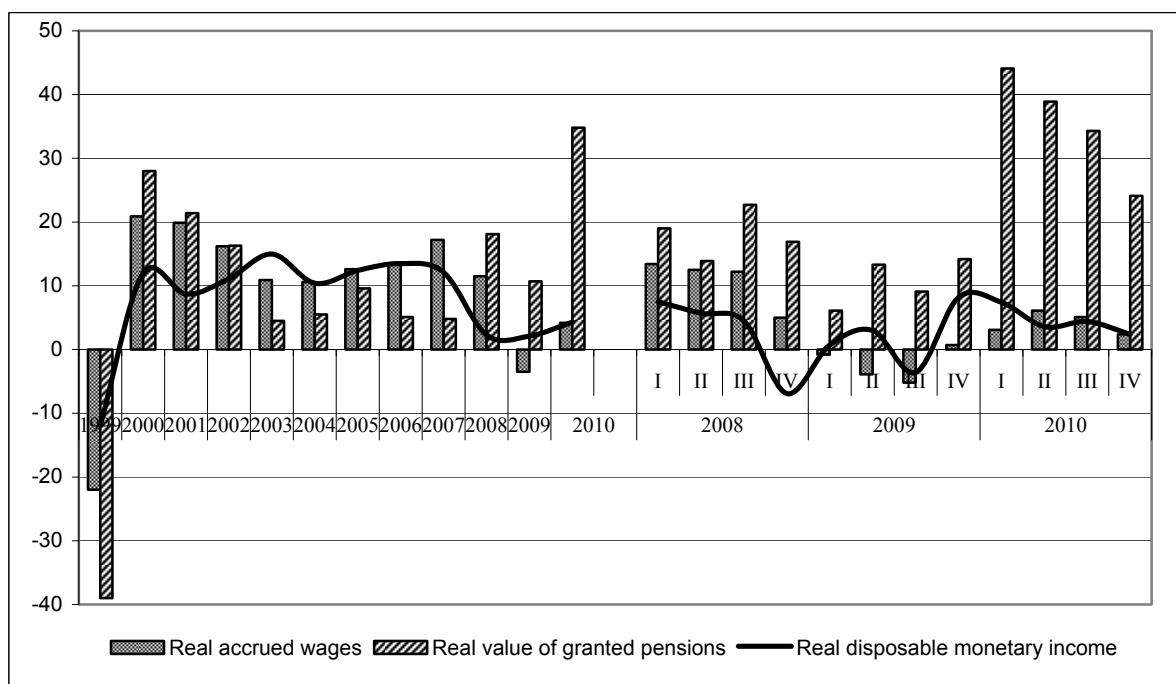
5.1. Social Standard of Living

5.1.1. Monetary Income

The real disposable income of the population dynamics during the period of 2000-2007 on the average was 11.9% per annum. However, during the crisis period (2008–2009) their annual growth rate fell down to 2.2%.

For the first time in the last ten years in 2009 the wages growth rate was in the negative values domain making -4.4% versus the preceding year. Positive real wages dynamics recovery may be observed starting from Q4 2009. 2010 results demonstrated real wages growth by 4.2% bringing the wages back to the level of 2008.

During 2008-2009 in the acute phase of the crisis the RF government increased social support to certain groups of population, mainly – to pensioners. Outstripping growth rates of real pension values versus wages could be observed over the last three years. In 2010 the real granted pensions' growth rate made 34.8% versus the preceding year and reached the 10 years' maximum. As a result, the average value of the granted pensions versus the average wages value increased up to 35.4% versus 27.9% in 2009 and 24.3% in 2008.



Source: Federal State Statistics Service (Rosstat).

Fig. 1. Real disposable income of the population dynamics – by components

In 2010 the real disposable income growth rate increased to 4.2% with simultaneous growth of wages and especially – real pensions' value. The difference in the recovery rates by components defined the specifics of monetary income re-distribution. The most prominent changes in the structure of monetary income of the population in 2010 are associated with de-

creasing shares of property-generated income (down to 4.3% of monetary income) and income from entrepreneurial activity (down to 9.3% of monetary income). Wages account for almost 2/3 of the income of the population and have a dominating impact on social development parameters.

Table 1

Monetary Income of the Population: Structure in 2008–2009, % of the final

	2008		2009				year	2010				
	year	year	quarters					year	quarters			
			I	II	III	IV			I	II	III	IV
Monetary income – total	100	100	100	100	100	100						
income from entrepreneurial activity	10,3	9,7	10,5	9,3	10,2	9,0	9,3	9,7	9,0	9,8	8,9	
remuneration of labor including latent wages	68,3	66,9	67,3	67,2	64,2	68,7	66,4	66,0	65,9	65,1	68,1	
social benefits	13,2	14,9	14,7	14,5	15,3	14,8	18,0	18,0	18,5	18,7	17,1	
property-generated income	6,2	6,5	5,3	6,8	8,4	5,5	4,3	4,4	4,6	4,4	3,9	
other income	2,0	2,0	2,0	2	1,9	2,0	2,0	1,9	2,0	2,0	2,0	

Source: Federal State Statistics Service (Rosstat).

The level of poverty during 9 months of 2010 made 13.5% of the total population if Russia (*Table 2*). The increase of real disposable income of the population in Q4 by 17.1% was to a great extent defined by seasonal factors: paying bonuses and end-of-year allowances in December, etc. It allows for the following assumption: the level of poverty in Q4 decreased so much, that the annual poverty indicator is lower versus 2009 by 0.1–0.5 %.

Table 2

Number of Russian citizens with income below the minimal subsistence level, total in 2009-2010

	Mln. pers.	% to the total population size
2009		
Q1	24.5	17.4
H1	21.1	15.0
January-September	19.7	14.0
Year	18.5	13.2
2010		
Q1	20.6	14.7
H1	19.1	13.6
January-September	18.9	13.5

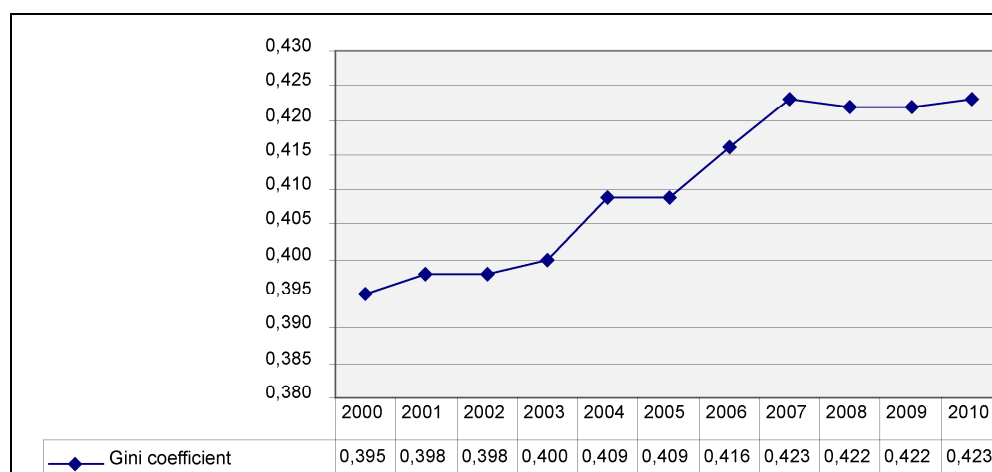
Source: Federal State Statistics Service (Rosstat).

The inequality of income was increasing in the Russian Federation during the entire period of economic growth, but in 2008–2010 it practically stabilized at the level of 2007. Income concentration index (Gini coefficient) decreased in 2009 down to 0.422 and in 2010 was at the level of 0.423; fund factor demonstrated some shrinkage in 2009, then was back to the level of 2007 and in 2010 made 16.7 times (*Fig. 2 and 3*). In 2010 10% of the most well-to-do citizens received for 31.1% of the total monetary income; while 10% of the poorest citizens received 1.9% of the total monetary income.

In 2001–2007 inequality was growing due to redistribution of revenues in favor of the fifth quintile of the population (with the highest income): the share of this group in the total amount of monetary income of Russian population increased by 2.1 percentage points during 2001–2007 (from 45.8 to 47.9%); at the same time the shares of all other groups of citizens

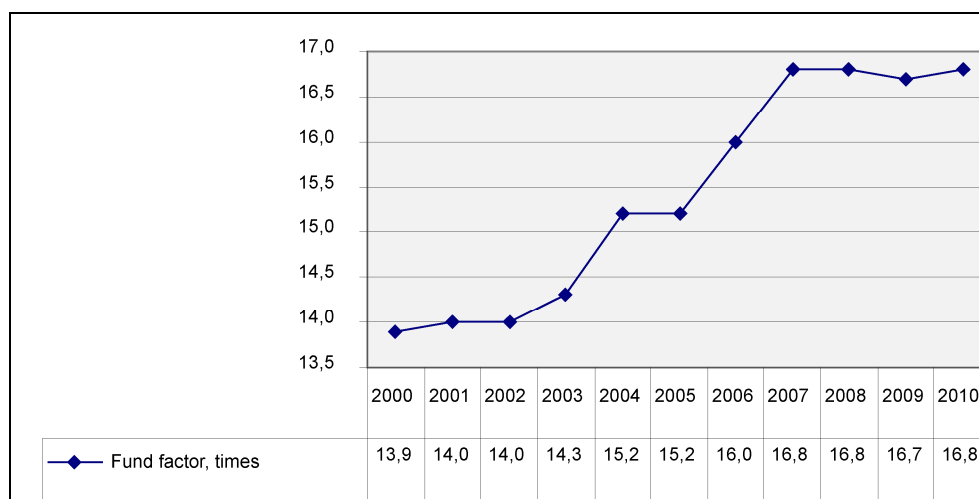
with lower incomes decreased. The first three quintiles of the population demonstrated the biggest shrinkage of their shares in the total monetary income:

- 1st quintile – from 5.6% to 5.1% the total amount of monetary income of the population
- 2nd quintile – from 10.4% to 9.7%;
- 3rd quintile – from 15% to 14.8%.



Source: Federal State Statistics Service (Rosstat).

Fig. 2. Concentration of citizens' income¹ in the RF during 2000–2010



Source: Federal State Statistics Service (Rosstat)

Fig. 3: differentiation of the RF citizens' income² in 2000–2010

¹ Citizens' income concentration index (*Gini coefficient*) characterizes the extent of deviation of the actual distribution of the total income curve from their equal distribution curve. Величина The coefficient value may vary between 0 and 1, the higher one reflecting the increased inequality of income distribution.

² Income spread factor (*fund factor*) is defined as the ratio between average incomes of 10% of the population (employed) with the highest income and 10% of the population (employed) with the lowest income.

RUSSIAN ECONOMY IN 2010

trends and outlooks

5.1.2. Public Expenditure

In 2010 the total monetary income of the RF population made RUR 31,598.6 bln. demonstrating 11.1% growth versus 2009. Citizens spent RUR 22,052.9 bln to buy goods and services which is 11.5% more vs. the preceding year. The amount of savings during this period made RUR 5,785.9 bln, which is 4.0% more than in 2009.

Inflation affected the dynamics and the profile of household expenses significantly. Starting from the beginning of 2010 headline inflation made 108.8% being I line with the preceding year indicators. Due to various factors affecting the dynamics of prices in certain segments of consumer market, the inflation profile was also subject to significant change. Food products prices increased by 12.9% in 2010; at the same time the prices growth rate for non-food products decreased by 5.0% and for services – by 8.1% (Table 3).

Table 3

Consumer Price (Tariff) Index for Goods and Services, December versus December of the preceding year, %

Year	All goods and services	including		
		food products	non-food products	services
2000	120.2	117.9	118.5	133.7
2001	118.6	117.1	112.7	136.9
2002	115.1	111.0	110.9	136.2
2003	112.0	110.2	109.2	122.3
2004	111.7	112.3	107.4	117.7
2005	110.9	109.6	106.4	121.0
2006	109.0	108.7	106.0	113.9
2007	111.9	115.6	106.5	113.3
2008	113.3	116.5	108.0	115.9
2009	108.8	106.1	109.7	111.6
2010	108.8	112.9	105.0	108.1

Source: Federal State Statistics Service (Rosstat).

The share of goods/services expenses in the monetary income profile was practically in the same low level as one year and made 69.8% including 54.4% share of goods expenses versus 53.6% (Table 4).

Table 4

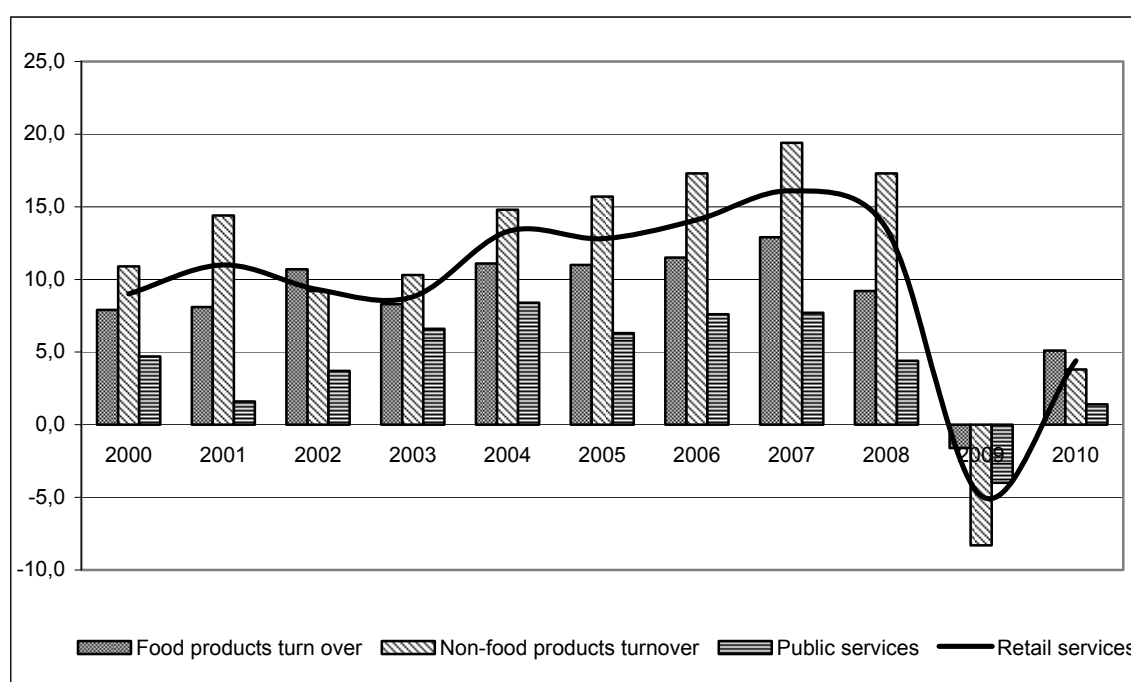
Monetary Income of Population Utilization Structure, %

	Monetary income	including used for:						Increment (+), decrement (-) cash in hand	
		Buying goods, paying for services	including			Savings	including Deposits and Securities		Buying currency
		Buying goods	Paying for services	Making mandatory payments and fees					
2008									
Q1	100	77.1	59.7	17.4	12.1	8.3	+2.7	6.9	-4.4
Q2	100	71.8	55.7	16.1	12.3	7.2	+6.4	4.7	+4.0
Q3	100	74.4	58.1	16.3	12.6	4.6	+1.7	5.7	+2.7
Q4	100	73.6	58.4	15.2	12.0	2.2	-9.2	13.7	-1.5
Year	100	74.1	57.9	16.2	12.3	5.3	0.0	7.9	+0.4
2009									
Q1	100	76.3	58.8	17.5	11.3	8.7	-2.7	10.3	-6.6
Q2	100	66.6	51.3	15.3	10.4	17.1	+6.3	3.5	+2.4
Q3	100	70.2	54.2	16.0	11.4	12.9	+2.4	6.0	-0.5
Q4	100	65.3	51.3	14.0	10.6	16.8	+8.5	3.5	+3.8
Year	100	69.2	53.6	15.6	10.9	14.2	+4.1	5.5	+0.2
2010									
Q1	100	73.0	56.3	16.7	9.6	+15.9	+6.7	3.2	-1.7
Q2	100	68.0	52.6	15.4	10.0	+15.3	+8.8	3.3	+3.4
Q3	100	72.6	56.6	16.0	10.3	+11.7	+4.9	4.3	+1.1
Q4	100	66.6	52.8	13.8	10.3	+15.5	+9.9	4.0	+3.6
Year	100	69.8	54.4	15.4	10.1	+14.6	+7.7	3.7	+1.8

Source: Federal State Statistics Service (Rosstat).

The incomes of the population were growing at a moderate rate; and as for expenditures – the main share fell on buying food and basic necessities. As a result, the share of food products including beverages and tobacco products in the overall retail turnover profile grew up to 48.7% in 2010 and exceeded 2008 figure by 1.8 percentage points with respective shrinkage of non-food products’ share.

In general in 2010 the turnover of food products market increased by 5.1%, and the turnover of non-food products market – by 3.8% (Fig. 4). It resulted in food products market turnover exceeding 2008 turnover by 3.4%. The non-food products market and services market turnover made 95.4% and 97.1% of 2008 turnover respectively.



Source: Federal State Statistics Service (Rosstat).

Fig. 4. Turnover dynamics in retail and services during 2000–2010, % to the preceding year

It should be noted that increasing the citizens’ inclination towards saving is a distinctive feature of 2009–2010 period.

Citizens used different instruments for saving their cash. In 2009 5.5% of the monetary income was used to buy foreign currency, but in 2010 this indicator decreased down to 3.7% while at the same time the share of savings in deposits and securities increased up to 7.7% of monetary income of the population. Total share of savings in monetary income of the population in 2010 made 14.6%.

The following factors had a material effect on the citizens’ savings dynamics: inflation, FOREX change and situation in the real estate market (housing commissioning slowed down). Total citizens’ investment into participatory construction in 2010 made RUR 69.6 bln decreasing by RUR 10.3 bln versus 2009 and making $\frac{3}{4}$ of 2008 amount.

The key areas for citizens to use their savings – same as during two previous years – are acquisition of real property and housing improvements. This underpins the trend towards re-

ducing of arrears in housing loans and mortgages at the expense of citizens' savings, which could be observed starting from Q2 2009. This trend is developing in the environment of tightening credit terms by the banks. The amount of loans issued by credit institutions to individuals in rubles and in foreign currency for buying housing in 2010 made RUR 417.8 and RUR 19.2 bln respectively, versus RUR 170 bln and RUR 11.9 bln in 2009.

Public surveys conducted by Federal State Statistics Service (Rosstat) in Q4 2010 reflect the improvement of consumer expectations.

5.2. Unemployment and New Lines of Inclusion of the Unemployed in Employment in Russia

5.2.1. Review of the Unemployment in 2010.

In 2010, the situation on the labor market started to improve as compared to that in 2009 when the main parameters of the labor market got discernibly worse (*Table 5* and *Fig. 5*):

- The number of the employed in the economy in a situation of a slight decrease in the number of the economically active population increased which factor resulted in growth of 1 % in the share of the employed in the number of the economically active population from 91.7% to 92.6%;
- The number of the unemployed calculated on the basis of ILO methods¹ decreased from 6.3 million to 5.6 million people². As a result the level of unemployment went down from 8.4% to 7.5%;
- The registered unemployment which sharply increased in 2009 started to go down from 2.1 million people to 1.9 million people. In 2010, the level of unemployment in average monthly estimates amounted to 2.5%.

Table 5

Dynamics of the number of the economically active population in 2007–2010 period, million of people, monthly average

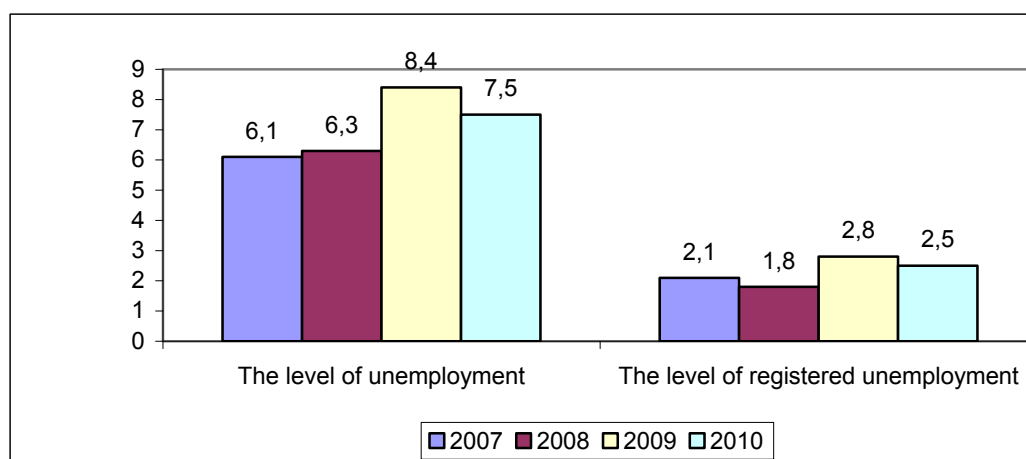
	Economically active population	Including		The registered unemployed
		employed	unemployed	
2007	75.1	70.5	4.6	1.6
2008	75.8	71	4.8	1.4
2009	75.7	69.4	6.3	2.1
2010	75.4	69.8	5.6	1.9

The source: Rosstat.

The value of the ratio of tension on the labor market dramatically increased from 1.3 unemployed persons per a vacant job in October 2008 to 3.1 unemployed persons per a vacant job in January 2010, while in 2010 it began to go down and amounted to 1.8 unemployed persons per a vacant job in December (see *Fig. 6*).

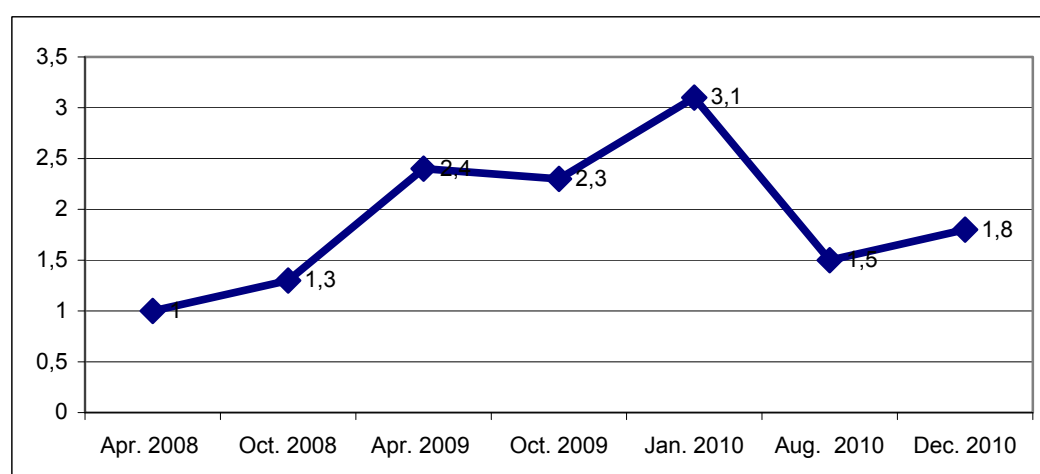
¹ According to the ILO methods, the unemployed are considered those people who have neither job nor gainful employment or those who look for a job and are ready to start working.

² With monthly average of the year.



The source: Rosstat.

Fig. 5. The level of general unemployment and the level of registered unemployment (monthly average, %)



The source: The Ministry of Health and Social Development of Russia.

Fig. 6. Dynamics of the ratio of tension on the labor market (the number of the unemployed per a vacant job)

According to the results of the sample survey of households as regards employment (such a survey is carried out by Rosstat on a regular basis), as of the second week of January 2011:

- the number of the employed population increased by 1.9 million people or 2.8% from the beginning of 2010;
- the number of the unemployed decreased by 1.1 million people or 16.4%;
- the number of the economically active population at the age of 15 to 72 years old amounted to 75.3 million people, including:
 - 69.6 million employed,
 - 5.7 million unemployed according to the ILO methods of calculation.

In the gender structure of the unemployment, men dominate among the unemployed: under the ILO methods, their share among the unemployed amounts to 55%. With the level of gen-

eral unemployment amounting to 7.2% in December 2010, the share of the unemployed among men amounted to 7.7% in December 2010, while that among women, to 6.7% (in January 2001 it was 7.6% and 7.0%, respectively).

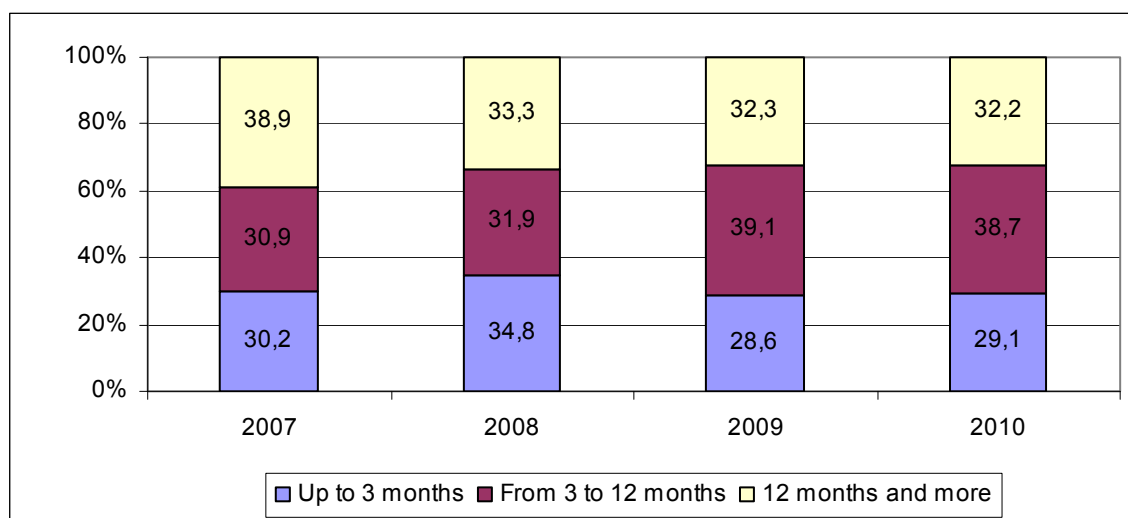
In 2010, city dwellers dominated among the unemployed, while in January 2011 city dwellers accounted for almost two-thirds (63.7%) of the unemployed. As the unit weight of the rural population in the total number of the Russian population is three times lower than that of city dwellers (27% against 73% as of January 1, 2010), the possibility of becoming unemployed in 2010 was 70 % higher in rural areas than in cities; such a situation was related to a greater extent to a more complicated economic situation in rural areas. In January 2011, the level of general unemployment amounted to 6.5% among city dwellers and 10.8% among residents of rural areas with the total level of unemployment amounting to 7.6%.

The growth in unemployment during the crisis years affected both the youth and groups of elder people. However, in 2009 the growth rates of the unemployment among the groups of elder people were 15% higher than those among the youth in the age of 15–24 years old. A drop in the unemployment which began in 2010 was characterized by higher rate of decrease in the unemployment among the youth (10%) as compared to those among the groups of elder people. Such a situation resulted in a decrease in the unit weight of the youth among the unemployed. As compared to 2007, in 2009 the share of the youth in the age of 15–24 among the unemployed fell by 2.8 % to amount to 26.7% of the total number of the unemployed. In 2010, the above trend continued and in January 2011 the unit weight of the youth among the unemployed decreased by another 1.9 % to amount to 24.8% of the total number of the unemployed.

In 2010, the average period of a job search somewhat reduced as compared to that in 2009: in November 2010 the average period of a job search amounted to 7.9 months, while in November, 2010, to 7.7 months.

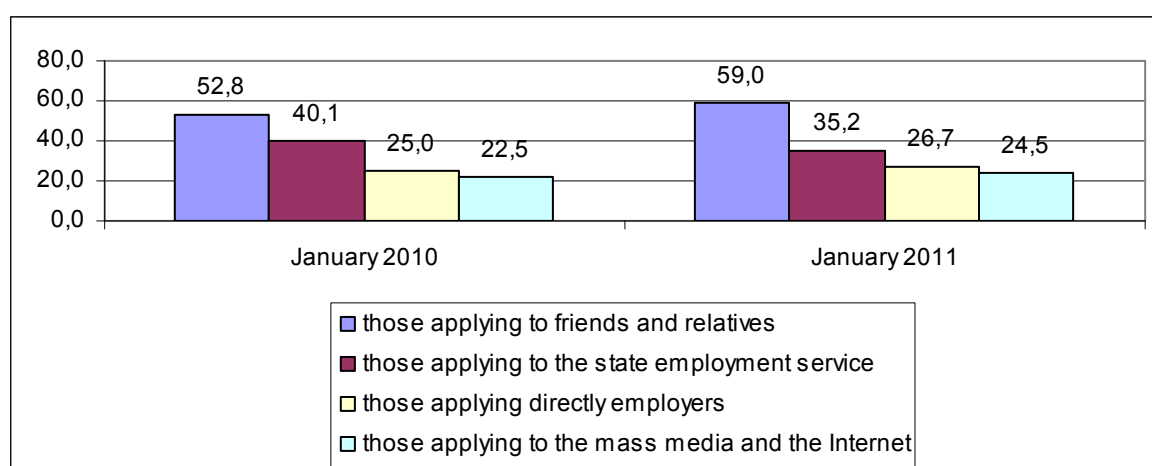
In 2010, the structure of the unemployment as regards the period of a job search discernibly stabilized: if in 2009 a substantial growth of 7.2 percent as compared to 2008 in the mid-term (from 3 to 12 months) unemployment with an insignificant reduction (by 1%) of the long-term (12 months and more) unemployment and discernible reduction (by 6.2 %) of the short-term unemployment was registered, in 2010 changes in the structure of the unemployment as regards the period of a job search were insignificant as compared to those in 2009. (see. *Fig. 7*).

In looking for a job, the unemployed use some of the following main methods: they apply to the state employment service, turn to friends and relatives, look for job openings and place their own CVs in the mass media and contact employers directly. The most widespread practice is turning to friends and relatives and applying to the state employment service. In 2010, it was found that more and more unemployed people look for a job by referring to friends and relatives: in January 2011 the share of the unemployed who used the above method amounted to 59% of the total number of the unemployed, while in January 2010 it was 52.8%. The unit weight of the unemployed who look for a job by turning directly to employers increased by 2%. A similar increase is typical of a job search through the mass media and the Internet. In January 2011, the share of the unemployed who turn to the state employment service for a vacant job was lower than that in January 2010 (35.2% in 2011 as against 40.1% in 2010) (See *Fig. 8*).



The source: Rosstat.

Fig. 7. Distribution of the number of the unemployed by the length of the period of a job search (on the basis of the data of sample surveys regarding the problem of employment in November, %)



The Source: Rosstat

Fig. 8. Methods of a job search used by the unemployed, % of the total number of the unemployed.

Resolution No. 926 of November 14, 2009 of the Government of the Russian Federation fixed the amount of the unemployment benefit in 2010 at the same level as in 2009:

- The minimum amount of the benefit is RUR 850 a month;
- The maximum amount is RUR 4,900 a month.

In 2011, the amount of the minimum unemployment benefit and maximum one remained unchanged¹.

¹ See Resolution No. 812 of October 12, 2010 of the Government of the Russian Federation.

5.2.2. New Lines of Inclusion of the Unemployed in Employment in the Russian Federation in 2010.

From January 2010, an experiment was initiated by the President of the Russian Federation to render assistance to low-income households on the basis social contracts¹. In case of success of the experiment, rendering of assistance to the low-income households on the basis of social contracts is expected to be applied nationwide until 2012². In practical terms, the above experiment is aimed at inclusion of the unemployed able-bodied people in employment (including self-employment) on the basis of provision of social assistance to such people (including that in the form of a monthly benefit or non-recurrent payment) with raising of their responsibility for getting out of a difficult life situation. Such measures have been practiced for long in developed countries.

Approaches to Inclusion of the Unemployed Able-Bodied People in Employment in OECD States.

In OECD countries, system measures aimed at inclusion of the unemployed in employment (the activation policy) were introduced in the practice of dealing with the unemployed in the 1990s and the 2000s. The main guidelines for inclusion of the unemployed in the labor market in OECD countries include: conclusion of agreements and/or contracts with the unemployed on plans of individual actions as regards inclusion of such people into employment and other measures; development and fulfillment of individual plans of actions as regards exit from the existing situation and, primarily, those related to inclusion in employment and, consequently, mandatory participation in employment programs; follow-up by an expert (who is assigned to the beneficiary) of fulfillment of the individual plan of actions; regular monitoring of the progress made by the beneficiary in fulfillment of the individual plan of actions; expansion of the set of programs on inclusion in employment (training, education, subsidized employment, employment assistance, development of foreign language skills, raising of the literacy level, rendering of medical, administrative and social services and other).

A system policy of inclusion of the unemployed in employment is usually accompanied by introduction of both tougher criteria for receipt of benefits and sanctions against the unemployed in case of refusal by the latter to cooperate in order to find a job. Measures may include financial incentives which motivate people to take relatively low-paid jobs (preservation for a certain period of time of a portion of the earlier received benefits in case of employment of the unemployed in order to reduce a possible demotivating effect of a low pay) or subsidies which motivate employers to hire people with a lower level of efficiency.

The source: OECD (2006), Boosting Jobs and Incomes – Policy Lessons from Reassessing the OECD Jobs Strategy, OECD; EC (2006), Concerning a consultation on action at EU level to promote the active inclusion of the people furthest from the labor market, Communication from the European Commission, Brussels.

The data of a number of surveys in OECD countries has shown that provision of generous unemployment benefits and social assistance within a long period of time, on the one hand, undermines labor motivation and results in dependence of beneficiaries on benefits and, on the other hand, involves high public spendings on the social security of low-income households.

¹ Instructions No. Pr-19 of January 27, 2010 of the President of the Russian Federation (2010); the Government Plan of Realization of the Main Anti-Crisis Guidelines and the Policy of Modernization of the Russian Economy in 2010 approved by V. Putin, Chairman of the Government of the Russian Federation on March 2, 2010 (No. 972p).

² News.ru (2010). A system of social contracts will be introduced in Russia until 2012, News.ru, February 2, 2010; D. Nikolayeva (2010), A system of social contracts will be introduced in Russia until 2012, HRMaximum, February 2, 2010.

The Aid to Families with Dependent Children Program¹ in the USA

The Aid to Families with Dependent Children Program was active in the USA in the 1935-1996 period. It often serves as an example of the program which gave rise to dependency sentiments with its beneficiaries.

The Aid to Families with Dependent Children Program was developed in such a way that it included a number of components which could contribute to a decrease in labor motivation with its beneficiaries:

- *the target group of the program was single mothers who were expected to take care of their children. It was understood that in taking care of their babies those mothers would not work at least for a certain period of time;*
- *the program provided for relatively large payments as it was developed as a program of substitution of income; ,*
- *benefits (or a portion thereof) were ceased to be paid after a person was employed.*

As a result, single mothers who received assistance under the Aid to Families with Dependent Children Program reduced by 10% to 50% the intensity of their labor activities, while the number of families -- beneficiaries of the program -- increased to 5.4 million, that is, one out of twelve American families received benefits under the above program; it is to be noted that nearly 50% of the families -- beneficiaries of the program -- received aid within five and more years.

In 1996, the Aid to Families with Dependent Children Program was replaced by the Temporary Assistance to Needy Families Program² which included measures aimed at motivating program beneficiaries to go to work: some states introduced into the program a number of measures which motivated women through use of financial instruments to go to work, while in other states a requirement was made to women to go to work in order to be an eligible beneficiary of the program.

In the USA, activation of the unemployed under the Temporary Assistance to Needy Families Program is recognized as quite a success: the level of employment among single mothers substantially increased: the average level of employment of former beneficiaries of the program amounted to 60% – 75%. Also, it is noteworthy that by setting the requirement to women that they have to go to work new families will be less interested to join the program, while earlier they would have sought to become beneficiaries of it. The number of families – beneficiaries of the program – decreased from 5 million in 1994 to 2.2 million in June 1999.

The source: Moffitt, R. (1992), Incentive Effects of the U.S. Welfare System: A Review, Journal of Economic Literature, American Economic Association, vol. 30(1), March; Moffitt, R. (2002), From Welfare to Work: What the Evidence Shows, Welfare Reform & Beyond Policy Briefs, The Brookings Institution, Policy Brief No. 13, January 2002; OECD (2001–2009), Benefits and Wages: Country specific files, Country chapter for OECD series Benefits and Wage.

In Russia, the size of unemployment benefits and social assistance to families of the unemployed is not large, nor is the period of payment thereof, which factor is not expected to reduce labor motivation with that category of people. However, some surveys show that dependency sentiments do arise with recipients of unemployment benefits, particularly in rural areas. Such conclusions have been made on the basis of the results of both surveys by experts and interviews with unemployed people who admit that they prefer to have the undeclared earnings (in rural areas it is hunting, fishing, picking of wild berries and mushrooms and other) rather than have an unprivileged and low-paid job even if such vacant jobs are available. For such people, importance of registration with the employment service can be explained not only by the fact that the amount of their unemployment benefit depends on such

¹ The Aid to Families with Dependent Children (AFDC) program.

² The Temporary Assistance for Needy Families (TANF) program.

registration, but also by the mandatory requirement to be registered as unemployed in order to be eligible for housing and public utilities subsidies¹.

Russia has experience as regards inclusion of the able bodied unemployed in employment within the frameworks of the *Self-Reliance Program* and *From Benefit to Wages Program*. *Self-Reliance Programs* started to be implemented in the 2000s as municipal and regional programs in such regions as: the Perm Territory, the Tyumen Region, the Rostov Region, the Amur Region, the Samara Region, the Volgograd Region, the Republic of Komi, the Jewish Autonomous Region, Primorsky Krai and some other regions. *From Benefit to Wages Programs* were applied in urban areas where people had an opportunity to find a vacant job². In some regions of the Russian Federation, for instance, in the Republic of Komi *From Benefit to Wages Program* is implemented up till now³. In the 2008–2010 period, regional programs of subsidies for development of the small business and self-employment with financial support from the federal budget (in the sum which does not exceed the 12-fold maximum amount of the unemployment benefit, that is, RUR 58,800) were developed and implemented as anti-crisis measures.

The Self-Reliance Program in Russia in the 2000s

The Self-Reliance Programs were implemented for the purpose of improving the quality of life of low-income families with children in rural areas. Such programs are usually aimed at rendering target assistance in development of subsidiary husbandry or self-employment in rural areas. Apart from rendering assistance to households, the main objective of such programs consists in activation of the labor potential of the household, removal of barriers on the way to labor activities by able-bodied members of the family (rendering of services as regards training and retraining, child care and other) and creation of sustained employment (normally self-employment) of able-bodied members of the family. Families without able-bodied members did not normally receive assistance under such programs.

Rendering of assistance under the programs is carried out on the basis of agreements with beneficiaries of such programs. Under the above agreements, beneficiaries are obligated to fulfill certain conditions as regards, primarily, purpose utilization of the received fund. A specific feature of such programs is a personified approach to beneficiaries (development of a plan of actions for the family as regards movement to self-reliance, determination of the form of the purpose assistance which is required to a specific family and conclusion of an agreement with the family), though the family is not assigned a personal advisor who monitors fulfillment by the family of an individual agreement.

Engagement of local communities in such programs helped select families more efficiently: local communities participated in evaluation of the family's potential, plan of actions towards self-reliance (to what extent such a plan was a realistic one) and other.

The number of families which took part in the above programs was not a large one; it varied from 38 families in one district of the Amur Region in 2007 to over 4,500 families in the Perm Region in 2004. Most families engaged mostly in subsidiary husbandry, while some, in self-employment.

¹ See, for instance, A.N. Demin, I.P. Popova. (2000), Methods of Adjustment of the Unemployed to Difficult Life Situation //Sociological Research.2000. No.5; N.V. Popravko (2009), The Social Aspects of the Unemployment Problem in the Tomsk Region. Bulletin of Tomsk State University . Philosophy. Sociology. Political Science. 2009, No.1 (5).

² In the 2000 – 2001 period, such a program was implemented in the Motovilikhinsky District of Perm. One hundred families took part in that program. Later, the above program was implemented in all the seven districts of Perm (350 households), twelve other cities of the Perm Region (1100 households), as well as in the city of Birobidzhan of the Jewish Autonomous Region (15 households).

³ The Resolution of the Government of the Republic of Komi (2004).

Evaluation of efficiency of such programs, for instance, in the Perm Territory showed that the quality of life of families which received assistance improved and all the families received income (in kind or in a cash form) which was on average higher than the amount of aid granted.

The source: E.E. Grishina, K.G. Chagin (2008), Technology of the Target Social "Self-Reliance" Assistance: The Guidelines for Introduction by Local and Regional Administrations. Moscow.: The Institute of City Economy Fund.

Social contracts (introduced from the year 2010) are the first experiment at the nationwide level (even taking into account the fact that the system of social contracts is not implemented in all the constituent entities of the Russian Federation) as regards provision of social assistance to families which have found themselves in a difficult life situation on the basis of the following principles:

- Conclusion of an agreement between the family and the authority which provides assistance. According to officials who work for authorities which are responsible for implementation of the system of social contracts, the sheer fact that the family has assumed obligations and a representative of the family has signed an agreement on his/her consent to fulfillment by the family of a number of conditions has a positive effect on beneficiaries. Introduction of provisions stipulating purposes which the assistance is rendered for, monitoring of the progress in fulfillment of such purposes and issuing of a warning that the agreement may be terminated in case of a failure by the family to fulfill its obligations properly, while the assistance that was wrongfully received is required to be returned contribute (in the opinion of officials who deal with social contracts) to beneficiaries' higher awareness of their responsibilities.
- Participation of the entire family in the social contract contribute to raising of responsibility of each family member both for fulfillment of the program of social adaptation and provision of the reliable information on the position of the family;
- Introduction of such forward obligations on the part of the family regarding the exit from difficult life situations as include a commitment to engage able-bodied family members in labor activities. In general, social assistance programs include inactive measures of support to families and individuals;
- Within the frameworks of a social contract, the family's progress is followed up by an employee of the system of social contracts who is assigned to that family. No matter how formal such a follow-up may be at the initial stage, the above measure is an important step to utilization of present-day methods of and approaches to rendering of the social assistance and inclusion of the able-bodied people in employment;
- Substantial amounts of the aid (by Russian regions' and municipalities' standards) to low-income families and families which found themselves in difficult life situations may be provided.

Inclusion of the able-bodied family members in the labor market and, the more so, ensuring of sustained employment for them on the basis of social contracts is quite a problem now. As seen from foreign experience, for actual inclusion of the unemployed in the employment market it is required to have and/or create jobs and carry out an in-depth analysis of employment opportunities and barriers which prevent access to it by each able-bodied beneficiary of the program. A program of measures aimed at inclusion of able-bodied family members into employment, personified follow-up of the process of activation of each unemployed person into employment, tough sanctions for a failure to comply with the terms of the contract, as

well as monitoring and evaluation of the efficiency of the activation program should be based on the above analysis.

At present, it appears that a large part of able-bodied beneficiaries of the program of social contracts in the Russian Federation will be engaged in development of individual subsidiary husbandry and, partially, in self-employment. Such a situation is related to a greater extent to a high burden of the unemployed population on one vacant job. Also, regional economic differentiation and smaller employment opportunities in less developed constituent entities of the Russian Federation in a situation where both labor mobility and implementation of the program at the level of a constituent entity are rather low will reduce the extent of employment opportunities.

Ensuring of sustained employment (say, that level of employment which was achieved in the course of fulfillment of the program and prevailed for at least 12 months) is not provided for by the program of social contracts, which fact may have a negative effect on the trend of inclusion of the unemployed in employment under the above program, either.

So far, there is no data available on the outputs of the above program. The program is supposed to have a small coverage due to a lack of budgetary funds for social policy in constituent entities of the Russian Federation. However, efforts to cover with social contracts as many families as possible will result in reduction of the amount of the aid which situation does not help families to solve their problems, either.

The available data points to a small coverage of the program now. For instance, in ten months of 2010 in the Tomsk Region 48 social contracts were concluded (including 35 contracts with families having young children)¹; by October 2010 in the Perm Territory only nine social contracts were concluded².

The amount of the aid under social contracts varies by the region. For instance, in the Primorski Krai the amount of the aid under social contracts amounted to RUR 40,000 to RUR 150,000 (the total amount of aid was about RUR 800,000 which means that the average amount of the aid was at the level of around RUR 89,000 per family). In the Samara Region, in accordance with the regional legislation the amount of the aid under a social contract should not exceed RUR 25,000.

The above amounts of the aid appear substantial as compared to the regular amounts of the social aid³ in regions where it is provided to low-income individuals and families who are not included in the category of federal or regional recipients of privileges. The point is whether those funds are sufficient enough to implement the program of social adaptation of families and raise the quality of their life.

¹ The Social Security Department of the Tomsk Region (2010), *The Social security in the Tomsk Region, Material assistance creates mutual obligations*.

² RIA Novosti (2010), *The first social contracts were concluded in Kamchatka*, 12/10/2010.

³ In 2009, in the Samara Region a non-recurrent cash payment to individuals who found themselves in a difficult life situation amounted to RUR 2,700 per beneficiary, while in the Primorski Krai, to RUR 2,400. In 2009, a non-recurrent cash payment to low-income individuals in the Primorski Krai amounted to RUR 600 per member of the low-income family. The Federal Service of the State Statistics of the Russian Federation (2009), *Implementation of Measures of Social Support of Individual Categories of People in 2009*.

5.3. Migration process

In 2010, one of the most significant events was an All-Russia population census. According to the Regulations on Census, the following persons are subject to census, besides the Russian citizens:

- Russian and foreign citizens and stateless persons who came to Russia from abroad to study or work for 1 year and for a longer period (regardless of how long they have stayed in Russia and how long they intend to stay in Russia);
- Persons whose permanent residence is outside Russia and who stay in the Russian Federation for a short period (up to one year);

Thus, migrants both “residents” (who have come to Russia for a long or permanent residence) and “non-residents” (who have come to Russia to study or to work) had to be counted alongside with the citizens of Russia.

Preliminary census results were as follows: 143.2 million of census forms were filled in for the national residents and 285,000 census forms for the citizens of other countries who have stayed in Russia for less than one year¹. Whatever the final results, it is obvious that this census (as the previous one) was not effective in terms of counting temporary residents. 285,000 is not a large number given that according to the expert estimates, in 2009 the number of employed migrants was about 3.2 – 5.2 million².

Two conclusions can be drawn regarding the undercount of migrants during the census:

- First, Russia as before has no real data on the number of migrants;
- Second, with such undercount of migrants, the population size of the country or some of its regions and/or cities (especially, large cities) can be easily adjusted upwards if desired.

So far, according to the current data, as of November 1, 2010, the number of residents in Russia was 141.8 million having decreased by 82,400 (0.06%) from the year beginning. In the similar period of 2009, a slight increase of the population was recorded (by 12,000 or 0.008%). Thus, the dynamic trend of the population size continues making familiar “leaps”. Changes in the natural loss (growth by 9.1pp vs the previous year) and migration growth (reduction by 36.2 pp) have resulted in no substitution of the loss by migration growth unlike in 2009. The growth compensated 61.9% of the natural loss. It is worth mentioning that we are talking about the “formal” substitution while in reality each year the migration surplus includes those migrants who have moved to Russia much earlier while the natural loss of the population is counted strictly on the actual data basis.

It should be acknowledged that the reduction of the number of able-bodied persons gives more concerns than the reduction of the total size of the population of Russia. Such reduction was observed in 2006 for the first time in the Soviet and Russian history. Since then, a negative growth has been recorded. In 2009, the employable population reduced by 973,000 persons while in 2010 – by another 769,000³. According to a moderate (close to conservative) forecast, the number of the able-bodied individuals will drop by 9.1 million during 2011-

¹ Yu. Khomchenko. We do not know how many people live in the territory of the country// News Time, December 3, 2010.

² Main results of the expert meeting “Consensus – estimates of the number of the migrant workers in Russia” April 3, 2010// Center for Ethno-political and regional research under CEPRI Project “Immigration to Russia: a social parameter” jointly with Project of “New EuroAsia Foundation “A migration barometer in the Russian Federation”// [http: www.indem.ru/Ceprs/Migration/ExSoCoOc.htm](http://www.indem.ru/Ceprs/Migration/ExSoCoOc.htm)

³ Estimated number of population of the Russian Federation of 2010. Rosstat, 2010..

2010, i.e. by 10% vs the number of the able-bodied as of January 1, 2011 (*Fig. 9*). Russia has never been in the economic situation with such drastically reducing labor supply. Only once, in the first half of the 1960's, the rates of natural growth of population reduced almost twice vs 1950, but at that time there was no natural population decline. To help the economy to overcome the demographic gap, a wide range of actions was taken: the military service term was reduced from three to two years, the 11th form (secondary school) was eliminated, the scale of on-campus occupational training was cut short in favor of extra-mural training. As a result, the young labor market increased two-fold. Besides, a lot of services (e.g. office cleaning) became self-maintaining. To release housekeepers and those engaged in personal economies, essential restrictions on keeping livestock in towns were imposed¹.

The demographic forecast suggests that the current situation is much more complicated. "Non-migration" reserves for employment growth or labor productivity improvement are as follows:

- Demographic: a reduced death rate of able-bodied people (primarily connected with alcoholic ethiology and indirectly, with alcoholic consumption, RTI death rate and death rate caused by some other factors) as a result of achievements in the national healthcare sector and due to a self-protective behavior;
- Mobilization of employment: shorter maternity leave², reduced scope of on-site training in Universities and shorter training terms, intensive engagement of pensioners and disabled, active application of part-time employment for on-site students;
- Longer duration of the working day and/or working week at the expense of the weekend;
- Export of jobs, outsourcing;
- Higher labor productivity and reallocation of workers: from low-productive sectors to high productive sectors³, from small towns and/or mono-cities with a high unemployment rate to settlements where a labor shortage is experienced.

Each of the above scenarios may be implemented to a certain extent of desirability (starting primarily with the labor productivity growth) with account of available reserves⁴, political will⁵, cost scale and cost period⁶, and social activity of the community. Imbalances may occur, however. It has been proved, e.g. that the labor productivity growth can be mostly ex-

¹ Zh. A. Zayonchkovskaya. You'd better come to us: What is the threat of a "demographic gap"?// The Russian newspaper. June 30, 2010.

² Contrary to the birth-rate improvement program.

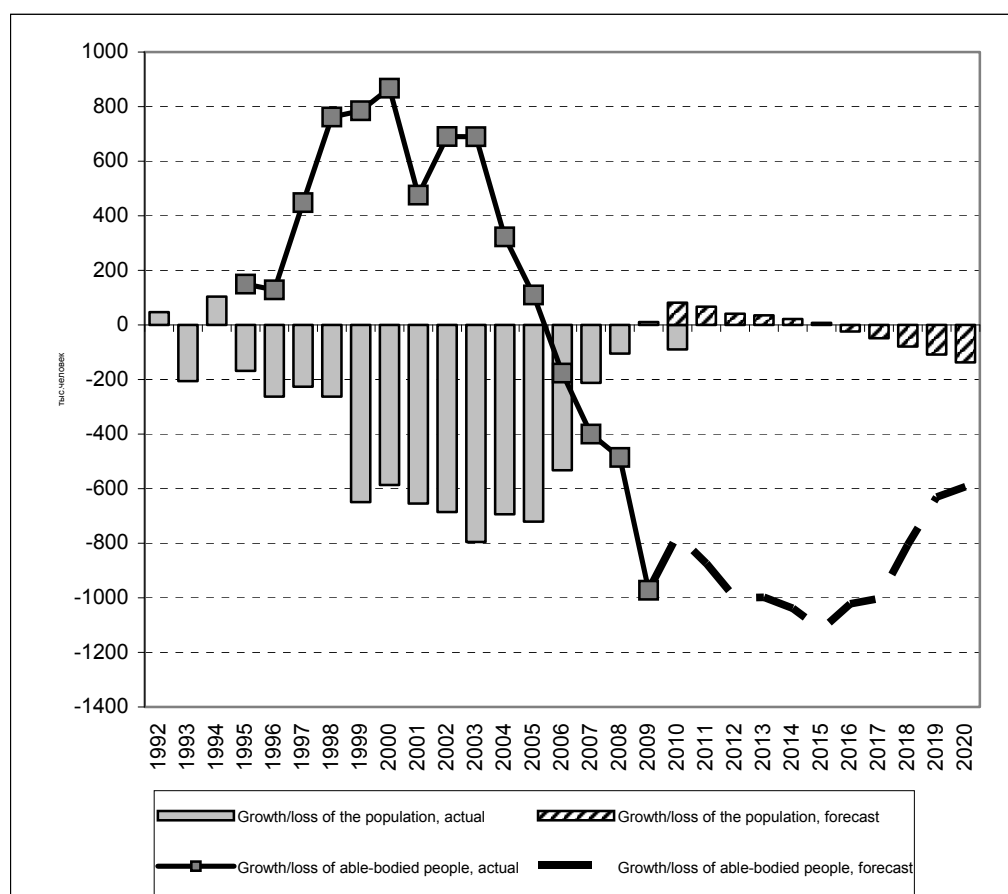
³ For details see V. A. Bessonov, V. E. Gimpelson, Ya. I. Kuzminov, E. G. Yasin. Productivity and factors of long-term development of the Russian economy// E. G. Yasin (ed.) X International Scientific Conference of GUVShE on the problems of development of the economy and the society. 2010. P. 11-61.

⁴ E.g. due to a relatively early retirement in Russia (55 years of age for women and 60 for men) and low pension allowance, the level of employment of pensioners is high. In 2009, the pensioners made 7.7% of the employed in the Russian economy (Economic activity of the population of Russia. Rosstat. 2010). Further growth of pensioners employment can be ensured as a result of longer and sound lifetime or devaluation of pensions vs wages.

⁵ Of late, e.g. it has been announced several times that labor time will not increase in the near future in Russia. See D. Medvedev. Duration of the working week will remain intact// www.ltv.ru/news/economic/167145; V. V. Putin speech at the congress of Independent Trade Unions of Russia <http://www.rian.ru/economy/20110112/320715359.html>

⁶ Any of the above mentioned actions requires considerable costs: e.g. a higher involvement of young mothers in labor activities (which has not been achieved yet) may happen if the market is abundant with preschool institutions or if young mothers are paid comparable wages to hire baby-sitters (this is the case in France). The death rate may be reduced as a result of effective growth of absolute and relative costs for the national healthcare, promotion of and adherence to the sports lifestyle, and self-caring behavior of individuals.

pected at the entities located in agglomerations: the average labor productivity in such entities is by 46% higher than in other settlements¹. While in small and mid-size cities there are considerable reserves of unemployed.



Sources: Demographic yearbook of Russia 2010. Rosstat. M. 2010. Estimated number of the population of the Russian Federation up to 2030. Statistical bulletin. M. 2010.

Fig. 9. Growth/loss of the population and the able-bodied population of Russia (actual and forecasted) in 1992-2020, in thousand persons

Migration can and must become an additional and important support in balancing labor demand and supply. All developed countries of the world even those with more favorable demographic situations as compared to Russia apply the migration reserve. As an officer of the US immigration authorities described, “due to limited economic and demographical factors, the USA will continue to “fly a flag” over the golden door² (Protectionnisme economique et politique d’immigration. Rabat, 1994. P. 49).

¹ The Russian industry at the growth stage: factors of competitiveness. Ed. by K. R. Gonchar, B. V. Kuznetsova.M., Publishing House GU-VShE, 2008, p. 374–381.

² Protectionnisme economique et politique d’immigration. Rabat, 1994. P. 49

5.3.1. On-going migration

In the 2000's, the governments of the world developed countries made a special focus on selective principles of the formation of migration workforce for their countries. The focus was enhanced on the qualifications of the migrated workforce, and intellectual and business migration have become most important. Thus, from 1991 through 2005, the percentage weight of persons who were employed according to preset qualification criteria (together with their family members) increased in Australia from 37 to 64%, in Canada – from 18 to 60%, in the Great Britain from 7 to 62%¹. If Russia could articulate such an objective, the choice would have been complicated. Firstly, it is the scale of the “permanent” migration that prevents making such a choice. In recent years, about 280,000 people come to Russia every year. The majority of the migrants – not less than 93-95% annually – arrive from the CIS countries. This niche created by the common past and modest knowledge of the Russian language is extremely useful to Russia moreover there are no other realistic migration sources². Secondly, a real selection is doubtful in the context of transparent borderlines and common transportation lines.

In 2010, the registered migrations reduced at least by one third (*Fig 10*). All geographic directions of migration, without exception, demonstrated such reduction, but the proportions between them were maintained: as in 2009, 34% of all the migrants came from the Central Asia (13% of them from Uzbekistan), 21% from the Transcaucasia, and 38% from the CIS western countries.

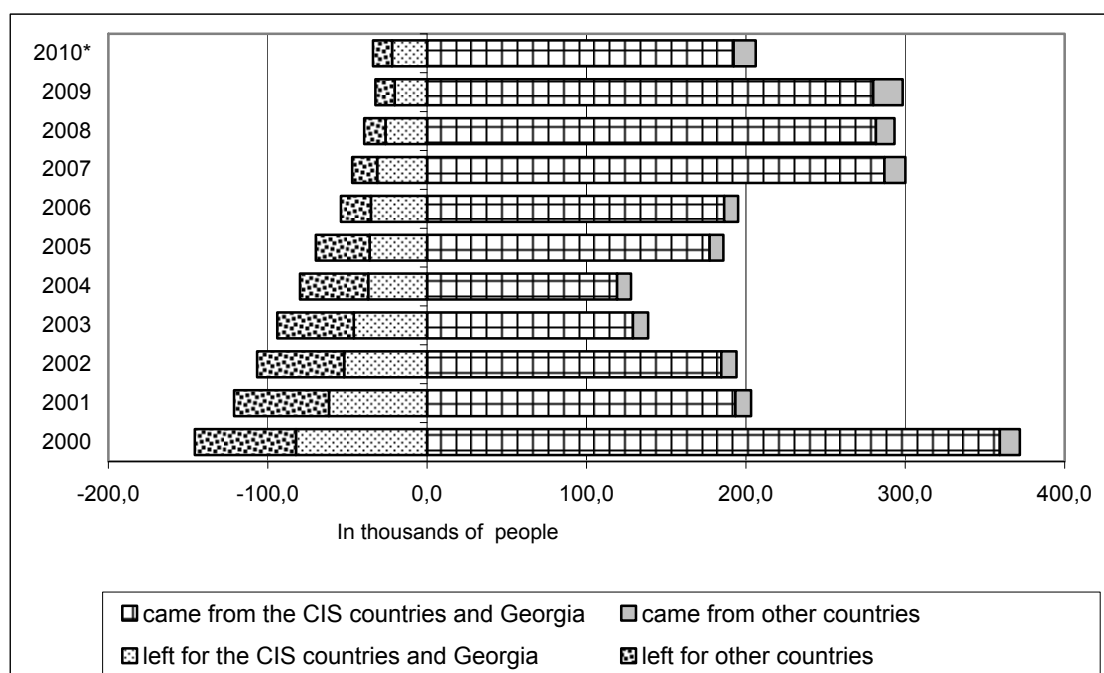
The CIS migration niche is not limitless for Russia. A survey carried out in 2010 by a GALLUP team in the ex-Soviet states (13.2 thousand persons, at least 1,000 in each country) showed that the migration mood of the citizens of the Central Asian republics was mainly associated with temporary migration. Only 9% of the respondents in Tajikistan, 6% in Uzbekistan and 5% in Turkmenia would leave their countries for good. The Armenian and Moldavian respondents demonstrated the highest mobility (39% and 36% respectively would like to immigrate to become residents, 44% and 53% would like to immigrate to become non-residents). 13% of the respondents on the average would leave their countries for ever, 24% of the respondents would prefer being temporary employed abroad³. Russia is not the only country to receive the migration potential from the ex-Soviet states. For Moldavia, e.g., whose citizens have been highly mobile, Ukraine is more attractive than Russia in terms of migration. In 2009, according to official statistics, 38% of all migrants (2,663 persons) moved to Russia to become residents while 46% moved to Ukraine⁴.

¹ I. P. Tsapenko. Attracting economic migrants to the developed countries//Labor abroad, 2008, No 3, p. 25.

² Reduction of the able-bodied population will be observed in the European countries as well in the near future thus enhancing “competition for migrants”.

³ M. Sergeev. Byelorussians destroyed the myth of their prosperity//Independent Gazette, August 6, 2010.

⁴ Population and demographic processes in the Republic of Moldova. 2009. Statistical collection. National Statistics Bureau of the Republic of Moldova.. http://www.statistica.md/public/files/publicatii_electronice/procese_demografice/Procese_demografice_2009.pdf



*Data for 2010 are tentative and estimated on the basis of January – November 2010 data plus December extrapolation of the respective trend.

Sources: Demographic yearbook of Russia 2010. Rostat M., 2010.

Fig. 10. Migration share of Russia in the international migration (for permanent residency or for a period exceeding one year), 2000–2010, in thousand people

The State Program of Assistance to Migration of Fellow-Countrymen to Russia started in 2007 was implemented ineffectively or even failed completely thus demonstrating inability of all the parties concerned to implement migration processes pushed from outside. The time of organizational involvement, relocation of agricultural settlements and other organized migration moves has been over. In 2007 – 2010, 19,535 people (including their family members) participated in the Program instead of 300,000, initially announced. The concept to divide the regions into three groups (depending on their demographic and social-economic situation) and to provide various types of support to the migrants has not been implemented. It was assumed that the fellow-countrymen moving to “worse” regions (as a rule, Far East and Siberia) would get better support. However, 79% of all the migrants settled down in three regions (not in the Far East) that were relatively sound in terms of economic situation and had a high demand for workforce: Kaliningrad, Kaluga and Lipetsk regions. The regional migration programs were developed by 31 subjects of the Russian Federation (60% of the regions refused from participation in the Program) and only 15 regions hosted the migrants. For municipal authorities who actually had been granted the hosting functions and who in non-recession times were engaged in implementation of tactical tasks and patching up, such functions became domineering during recessions, and caring about the countrymen was thought to be redundant ¹.

¹ For other issues of implementation of the Program of Assistance to Migration of Fellow-Countrymen to Russia, see in Sections “Migration processes” in the reviews: Russian economy in 2008. Trends and prospects (Issue 30). M. IEPP, 2009, section 4.2. p 342–359; Russian economy in 2009. Trends and prospects. (Issue 31), M. IEPP, 2010, section 4.2. p. 376–392.

In terms of demography and economics, students of the Russian Institutes of Higher Learning could have become an important component of the permanent migration flow. In 2007/2008 academic year, 36.5 thousand people from the CIS countries studied in the Russian Institutes, another 41.4 thousand people studied in the Russian Institutes of Higher Learning by correspondence and 84.6 thousand were students of international departments of the Russian Institutes¹. Thus, during one academic year, at least 160,000 young specialists got education, according to Russian standards (though with some variations) and therefore potentially were better adapted to the Russian environment as compared to other migrants. However, in 2010, only 1,500 students became citizens of Russia, this being 3.5 times less than in the “non-abundant” 2009.

Almost the same rate of reduction of naturalization in Russia was observed in other categories of the citizens. For 11 months of 2010, 86.4 thousand people (301.8 thousand for the similar period of the previous year) were admitted to citizenship. In 2010, the simplified procedure of admittance to citizenship was cancelled; this can be viewed as a counter-productive measure given the current demographic and economic problems of Russia.

In Russia, there has been no policy of social, cultural and economic integration of the migrants though the Federal Migration Service recently set up an Integration Department, for the first time in the period of the Service functioning.

5.3.2. Temporary migration

In 2006 (the implementation began in 2007), a migration legislative reform began in the country that made a significant impact on external labor migration. The main positive innovation of the legislation was that the migrants from visa-free countries were entitled to self-registration (with the migration authorities) under a “notice-filing” procedure that replaced the earlier authorization-based procedure, to receive a work permit and become free players on the labor market. The employers were granted an opportunity to employ such migrants without receiving a special authorization. To regulate the number of foreign workers, a complex mechanism of quota arrangement, sector shares of foreign employees for certain sectors of economy (retail trade, sports) and some other tools were established.

As always, there were many supporters and opponents of the new legislative package. The supporters believed that liberalization of the migration legislation provided the migrants with an opportunity to compete relatively free for work places with the local workforce, and such completion could eventually improve the labor productivity. They stressed the main issue – a possible removal of at least a portion of migrants from “the shadow”, some guarantees of human rights protection and a larger transparency of the labor market. To a certain extent, all these targets have been achieved: according to the experts, the number of migrants legitimately employed grew from 10–15 to 30–40%². The opponents of the new legislation mentioned damping prices on labor that could emerge in separate segments of the labor market

¹ A. Arefiev. Russian education for export// Demoscope Weekly. 2010. № 441–442. <http://demoscope.ru/weekly/2010/0441/tema05.php>

² E. V. Tyuryukanova, Zh. A. Zayonchkovskaya. Immigration: the way to escape or the Trojan horse?// Russia faces demographic challenges. Report on the development of the human potential in the Russian Federation for 2008. General editor: A. G. Vishnevsky and S. N. Bobylev. M.: 2009. p. 104.

pushing the national workforce out from the labor market, criminality and disease issues, inability of the infrastructure to accept a workforce surplus, increasing conflicts¹.

A review performed by M. Rimmer and P. Dikson for the USA showed that tightening of control and reduction of a flow of low-qualified migrants would make a considerable negative impact on revenues of the US households. A small saving in the government expenditures would be overridden many times by decreasing production volumes and reduction of jobs designed for more qualified US workers. The actions to reduce the number of low-qualified migrants by 28.6% as compared to the “normal” forecasted figures would cut down the aggregate income of the US citizens approximately by 0.5% or by \$80 billion. On the contrary, legalization of such migrants would sufficiently increase incomes of the US workers and their family members. As a result, payments to smugglers and middlemen and other costs of the migrants connected with their illegal entry would be removed. Besides, the migrants’ labor efficiency will improve, and new jobs for highly-qualified Americans will be created. In the context of the legalization and introduction of a visa fee, the US GDP might increase by 1.27% (equal to \$180 billion).

No such estimates have been made for Russia. The financial and economic crisis that formally broke out late 2008 most likely strengthened the position of the “restrictions” lobby. However, the attack on the liberal course began even before the crisis². The liberalization policy has never been accomplished.

For the first turn, this was manifested in the introduction of norms, under efforts of protection of the labor market for the national workforce and unemployment actions during the 2009 crisis, according to which foreign citizens having arrived and registered in Russia were entitled to get a work permit for the period up to 90 days, and only after that, having submitted a draft contract with the employer who could earlier (before July 1st of the previous year) receive a quota for his/her company to employ foreign workforce, to renew the employment term in Russia for the period up to 12 months.

There is a lot of obstacles in this business: employers are not interested and for them it is economically inefficient to hire workers for a short period of time; the procedure of dual execution of contracts takes too much time without any compensation for the efforts; finally, the employer must have a quota on the foreign workforce employment. The application for the quota for 2010 should have been made in summer 2009 (the year of crisis). Even with no recession, it is difficult to assess needs in workforce for the next year, while in the time of crisis to do this is much more complicated. Only major and financially stable business entities were able to estimate their needs realistically. Besides, inter-departmental commissions of the subjects of the Russian Federation refused giving quotas to the employers or made various cuts in the quotas.

In December 2008, when the crisis in Russia formally began, the national government elected to transform like a charm the earlier planned 30% reserve of the quota to a 50% reserve (*Fig. 11*). Practically it meant that the regions would suffer a real cut in their potential employment of foreign workforce. What was developed for 6 months (collection of requests

¹ Ex-mayor of Moscow addressing General Council of the Independent Trade Unions of Russia declared that the “migrants are prostitution of the economic system” // V. Kozlov. Right for hardships. News Time. September 23, 2010.

² See O. Vykhovanets, S. Gradirovsky, Migration policy of Russia for the last years: summary of results (2007 – 2009). // Network project of the Russian World. Russian Archipelago. <http://archipelag.ru/authors/vykhovanets/?library=2766>

from employers) was cut down to 4 weeks¹ – either for the formation of the quota request not so much efforts and time was required (in this case all spring and summer actions had been wrong and ineffective) or the December decision was premature and formalistic.

In spite of the officially announced end of the crisis in 2010, there has been no return to the pre-crisis law enforcement. This situation was reflected in statistical reports on labor migration (Form 1-RD); that year the reports were supplemented with such lines as “work permits for employment of foreign citizens who have come under a visa-free procedure, for the period up to 90 days – issued in total” and the same “..... renewed for up to 1 year”.

There is another example of extra difficulties associated with the quotas” in the Krasnodar Krai, where sports facilities have been built for the Olympics: the employers submitted requests for 70,000 people for 2010, however, “according to the instructions from “above” to make as many cuts as possible, the interdepartmental commission reduced the required number down to 25,000”². O. V. Popova, Deputy Head of Labor Migration Section, FMS Division of the Krasnodar Krai, said that “the commission responds favorably to the needs of Olympic organizations by not cutting their requests by two times: e.g. if you ask for two thousand workers to build an Olympic facility, most likely you will get one and a half thousand”³, which means that the quotas of other employers could be cut by two times – now this has become a common practice. Besides, though the second permit is issued in addition to the established quota, a fee must be paid for the second time (RUR 2,000 instead of RUR1,000).

The “quota fight” is reflected in official statistics: for 8 months of 2010, there were 1,442 cases of refusal to issue work permits for foreign workforce employment while in the similar period of 2009 this figure was 317 only⁴.

Regardless of a post-crisis growth of the economy and therefore a potential increase of the demands for labor force, in 2010 the reduction of the number of issued work permits was officially recorded (almost by 20% vs 2009). It means that we are facing either an unprecedented increase of labor productivity which Rosstat has not informed us about⁵, or the increased use of illegal workforce which strictly speaking should not obligatory include migrants.

¹ Resolution of the RF Government of 07.11.2008, № 835”On the approval for 2009 of the quota for issuance work permits to foreign citizens” (published on 14.11.2008).

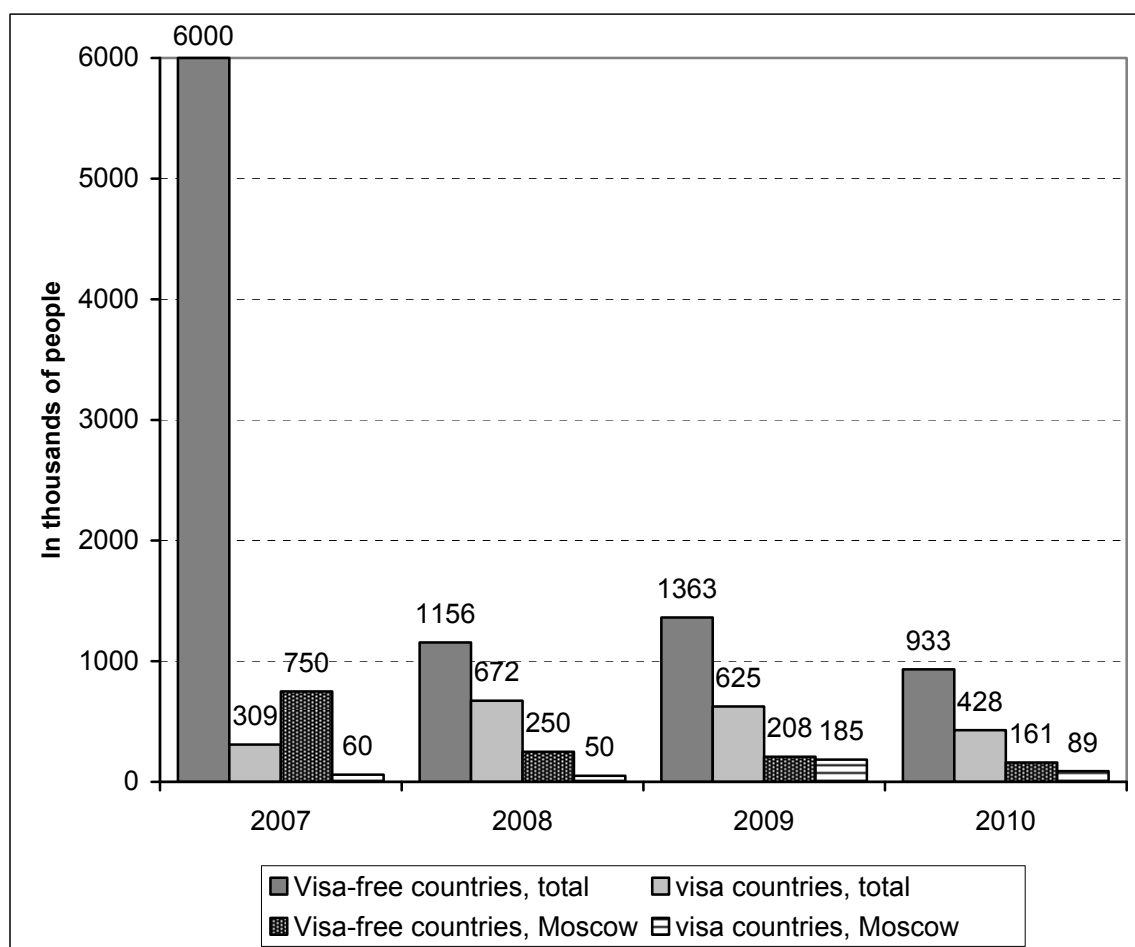
Resolution of the RF Government of 08.12.2008, № 916 “On making amendments in the Rules of determination by the executive government authorities of the demand for employment of foreign workforce and the formation of quotas for labor activities exercised by foreign citizens in the Russian Federation”.

² Quotas is a painful subject. Presentation by O. Popova at the “round table” discussion “Russian migration policy during a demographic decline”// Russian migration: Information and Analytical Journal. № 4–5 (43–44) September–October 2010. p. 28.

³ Same. p. 29.

⁴ For January - August 2010, 460 work permits for foreign workers employment were cancelled against 25 permits for the respective period of the previous year. Though this is not a big number for the entire country, it is the trend that attracts attention.

⁵ According to Rosstat, the labor productivity in the Russian economy from 2005 through 2009 has never increased more than by 7.5%. A greater increase was observed in some sectors. In 2009 vs 2008, the labor productivity in the key sectors with migrants was: in construction – 96.1%, wholesale and retail trade– 92.1%, processing industries – 96.1% and in the agricultural and forestry sectors only – 105%// Social and economic situation in Russia, 2010, Rosstat, 2010.



Source: Resolution of the RF Government on the approval of quotas for issuance of work permits to foreign citizens (2006, 2007, 2008, 2009); Resolution of the RF Government on the approval of quotas for issuance to foreign citizens of entry invitations to exercise labor activity (2006, 2007, 2008, 2009).

Fig. 11. Quotas for issuance to foreign citizens of work permits established by the RF Government and communicated to the subjects of the Russian Federation (no reserve), 2007–2010

For 10 months of 2010, 986.6 thousand of work permit forms were issued against 1,222.7 thousand for the similar period of 2009¹. Almost all indicators characterizing the internal labor migration decreased: the number of issued permits to free-visa migrants dropped by 24.4%; to visa migrants by 20.4%. The level of notices on the engagement of visa-free foreign workers received from the employers remained almost unchanged: 65% in 2010 against 62.6% in 2009. It is the number of issued work permits to foreign citizens who have permits for temporary residence that grew by 65% vs January through October 2009. However, the number of permits for temporary residence reduced by 1/3. The reasons behind such opposite trends are still unclear. Anyway, the share of foreign workers with the temporary residence status makes not more than 3–5% of all types of permits.

¹ FMS of Russia statistical data. <http://www.fms.gov.ru/about/statistics/data/>

If to assume that the number of work permits in November-December 2010 will remain at the level of September – October (mind that in “normal” conditions there must be a reduction in November and especially in December as the labor migrants prefer spending the New Year and the winter months back at home), then for the year the number of the issued work permits will exceed the level of 2006 (1,014 thousand) by 10% - 15% only, being considerably lower vs 2007 (1,717 thousand), the first year when the new migration legislation was effected.

Such comparison is relevant only to a certain extent since the 2010 data refer to the number of issued work permits while the data for the previous period describe “the number of foreign employees engaged in labor activity in the Russian Federation”. Meanwhile, work permit forms can be issued to one and the same migrant one and more than one time during a year. The indicator of “the number of foreign employees engaged in labor activity in the Russian Federation” estimated by the Federal Migration Service and published by Rosstat is incorrect in terms of statistics as it counts both migrants who arrived in Russia during the year and migrants who have stayed in the country as of the given date ¹.

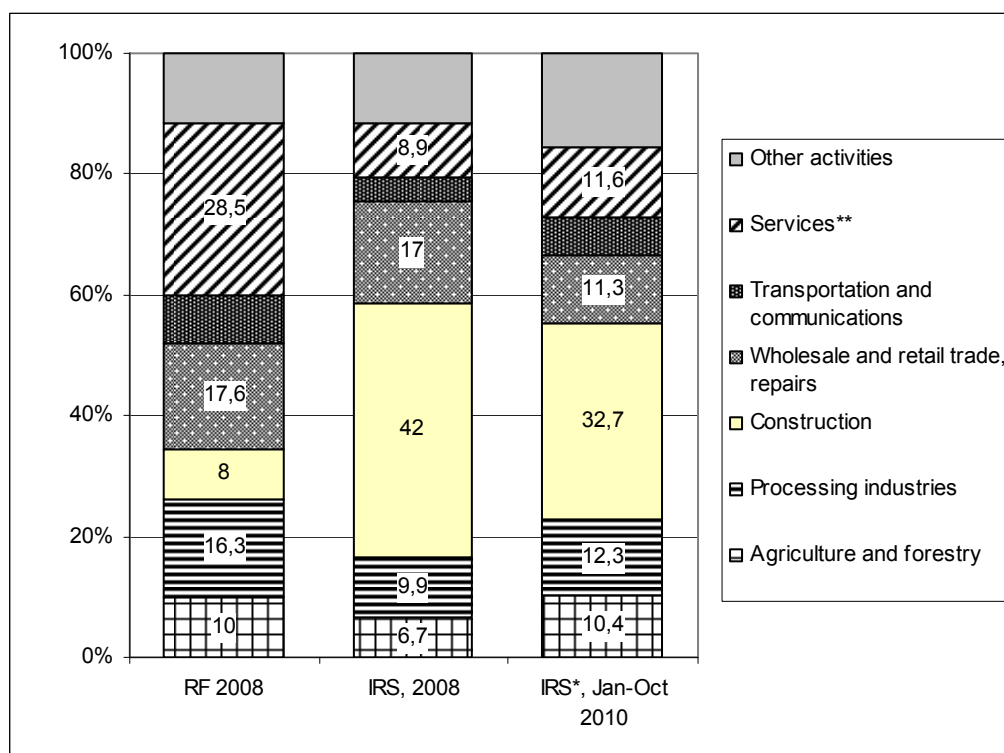
Thus, the data for comparison do not reflect accurately at least the “visible” portion of the external labor migrants, they seem to outline a certain trend which sends us directly to the migration data before the liberalization of the migration legislation i.e. to the period of the “shadow” migration. As for the number of work permits issued to foreign workers (such indicator appeared in the form 1-RD in 2010), this number is lower than the number of issued forms by 25,000.

The quota of 1,944.3 thousand permits approved for 2010 (from them 1,361 thousand were “communicated” down to and distributed among the regions and 583.4 thousand (30%) were reserved) will definitely remain unused. Thus the government authorities were given additional opportunities to sequester the quota of 1,745.6 thousand work permits approved for 2011². The number of invitations to foreign employees from visa countries to enter Russia was also reduced (from 611,000 in 2010 to 499,700 in 2011).

The current distribution of migrants by sectors shown on *Fig. 12* also demonstrates a “shift to shadow” of the Russian economy: for the last years the employment of migrants in the construction sector did not fall lower than 40% (of the entire labor force) while in two other sectors – construction and trade - at least 60% was engaged. In 2010, in line with the notices from the employers on the employment of foreign workers from visa-free countries, the engagement of migrants both in the construction and the trade sector dropped considerably. We believe this is an artifact: firstly, not all the employers comply with the legislation requirements and submit to the FMS their employment notices for workers from the CIS countries. Thus, this year the FMS received only 85% notices vs all issued permits to visa-free employees, and this is the highest figure for the entire period of the action of the new legislation. Secondly, according to the survey data, the employment in the construction and the trade sectors was least subject to documentation even in the best years of the liberalization (*Table. 6*).

¹ For details, see O. S. Chudinovskih. Migration statistics does know everything. Demoscope Weekly 2008. No 335–336. <http://demoscope.ru/weekly/2008/0335/tema04.php>

² Resolution of the RF Government of 12.11.2010 No 895 “ON definition of the demand in attracting foreign employees to the Russian Federation and approval of the respective quotas for 2011”.



* For the notices from the employers on the attraction and engagement of foreign citizens for labor activities who arrive in the Russian Federation under the procedure that do not require visa issue.

** Financial operations, transactions with real property, education, healthcare, other utility-related social and personal services.

Sources: Data of the FMS of Russia. Labor and employment in Russia – 2009, Rosstat, 2010.

Fig 12. Distribution of employees by types of activity in Russia, in %

Table 6

**Certain parameters of the employment of CIS migrants
(the results of the 2008-2009 survey, No 1575) in % of the number
of the respondents in this sector)**

Sector	Work permit available	Written employment contract in place	Salary paid according to payroll
Construction	60,9	51,3	33,4
Trade	56,5	48,4	31,3
Industry	79,7	75,4	59,3
Utilities & housing	58,0	56,0	53,0
Public services	50,6	46,6	30,0
Transportation	80,0	77,4	47,0
Agriculture	71,2	53,8	40,4
Services for household (nurses, babysitters, housemaids, etc.)	51,4	51,4	17,1

Source: Survey of labor migrants from the CIS countries carried out by the Center for Migration Surveys (Leader – E. V. Tyuryukanova) in Moscow, St-Petersburg, Astrakhan, Voronezh, Kazan and Krasnodar.

Thus a general statement can be made that the “crisis standards” continued to be used in the migration even after the crisis was officially over. To be more accurate, there was another “victory” of the forces interested in “shadow” employment of the foreign labor force.

With account of the approximate scale of the migrant employment in Russia, the geography of their “entry” and “exit” can be defined but only roughly. Unlike early 2000’s, when the far-abroad countries officially domineered on the Russian labor market and Ukraine was leading among other CIS countries, now it is the countries of the Middle-Asia region that play a leading role on the market. These countries in total account for more than a half of all the registered migrants. (*Table. 7*).

The geography of the migrants on the labor market did not change: according to the 1H 2010 data, 29.2% of all the registered migrants have been employed in Moscow and the Moscow region. In this context, all other regions including St.-Petersburg (6.3%) and the Krasnodar Krai (2.4%) seem not to be covered with employment of the foreign workforce.

In 2009 – 2010, the official migrants accounted for about 3.1% of the total number of the employed in Russia. This is a lower number as compared to the majority of OECD countries. Given the expert estimates of the illegal migration (in 2009 – 3.2–5.2 million people¹), the total scope of the foreign workforce employment on the Russian market will be within the range of 4.7–7.7% of the total number of the employed. For comparison: in the USA, illegal migrants make up to 5.2% of the total number of the employed².

Table 7

The number of foreign employees engaged in labor activity in Russia, 2000–2009

	in thousands people				in % of the total number			
	2000	2005	2008	2009	2000	2005	2008	2009
Total	213,3	702,5	2425,9	2223,6	100	100	100	100
including:								
<i>CIS countries</i>	<i>106,4</i>	<i>343,7</i>	<i>1780,0</i>	<i>1645,1**</i>	<i>49,9</i>	<i>48,9</i>	<i>73,4</i>	<i>74,0</i>
out of them:								
Azerbaijan	3,3	17,3	76,3	60,7	1,5	2,5	3,1	2,7
Armenia	5,5	26,2	100,1	82,0	2,6	3,7	4,1	3,7
Georgia	5,2	4,3	4,2	...	2,4	0,6	0,2	...
Kazakhstan	2,9	4,1	10,4	11,2	1,4	0,6	0,4	0,5
Kirgizia	0,9	16,2	184,6	156,1	0,4	2,3	7,6	7,0
Moldavia	11,9	30,6	122,0	101,9	5,6	4,4	5,0	4,6
Tajikistan	6,2	52,6	391,4	359,2	2,9	7,5	16,1	16,2
Turkmenia	0,2	1,5	3,1	2,4	0,1	0,2	0,1	0,1
Uzbekistan	6,1	49,0	642,7	666,3	2,9	7,0	26,5	30,0
Ukraine	64,1	141,8	245,3	205,3	30,1	20,2	10,1	9,2
<i>far-abroad countries</i>	<i>106,9</i>	<i>358,7</i>	<i>645,0</i>	<i>577,3***</i>	<i>50,1</i>	<i>51,1</i>	<i>26,6</i>	<i>26,0</i>
out of then:								
Vietnam	13,3	55,6	95,2	97,5	6,2	7,9	3,9	4,4
China	26,2	160,6	281,7	269,9	12,3	22,9	11,6	12,1
USA	1,8	2,9	5,0	5,0	0,9	0,4	0,2	0,2
Turkey	17,8	73,7	130,5	77,2	8,4	10,5	5,4	3,5

* including the citizens of Byelorussia – 11.1 thousand people.

** without Georgia.

*** With Georgia.

Source: Russia in figures of 2010. Rosstat, 2010.

¹ Main conclusions of the expert meeting “Consensus-assessment of the number of labor migrants in Russia”, April 9, 2010/ Center for Ethnic, Political and Regional Studies within the CEPRI Project “immigration to Russia” a social parameter” jointly with the project of the Foundation “New Euroasia” “Migration Barometer in the Russian Federation” // <http://www.indem.ru/Ceprs/Migration/ExSoCoOc.htm>

² Jeffrey S. Passel, Pew Hispanic Center – Washington, DC «U.S. Immigration: Numbers, Trends & Outlook».

The process of legislative regulation of the external labor migration has continued. The legislative innovations of 2010 set up norms for engagement of visa-free migrants according to the “migration patents” established by the government on top of the established quotas. After July 1 2010, Federal Law of 25.07.2002, No115-FZ “On the legal status of foreign citizens” was amended accordingly.

The introduction of such patents has been discussed at length. According to the law, migrants from visa-free countries are entitled to use such patents to be employed privately. According to the FMS, annually about 3-4 million of migrants are engaged in repairs of apartments of the Russian citizens, work at their subsidiary plots, employed as nurses, baby-sitters, etc. However, even those who moved to Russia and registered legally could not be employed legally as it was actually impossible to count those working for households. According to the new provisions, a migrant can receive a patent after he/she is registered, under a self-declaring procedure, after he/she undergoes the procedure of dactyloscopy and photography and pays a monthly fee of RUR1,000. After the entire period of the migrant’s work under the patent expires (not more than 12 months) the migrant will pay a total tax (including prepayments). The total tax amount, however, subject to payment to the respective budget shall be calculated on the actually received income (at 13% rate). Thus, if a migrant gets monthly a sum exceeding RUR7,692, the migrant will have to pay an additional tax after his/her employment is finished. The mechanism of implementation of such rules is not totally clear.

According to the new provisions, the employers will have to report to the FMS on the conclusion/termination of the employment contracts with foreigners and on unpaid vacation leaves (for a period exceeding one month).

The patents introduced for migrants were called to withdraw from the «shadow” a part of the migrants who work for individuals, to ensure surplus revenues to the national and local budgets (some of the revenues from the imputed tax equal to RUR1,000 will be remitted to local budgets).

So far it is unclear how these rules will be applied practically. There is an opinion that the migrants who may fail to use the quota but who wish to work in Russia on legal terms will try to receive patents. According to the FMS estimates, in 2011 at least 1 million expatriats will use their right to patents¹. By November 1, 2010, patents for 100,120 people were issued.

Another innovation effected by the amendments in Federal Law No115-FZ of July 1, 2010, was designed to alleviate a work mode and accommodation terms for high-qualified specialists. The quotas for them were abolished; such specialist and his/her family was entitled to get a residence permit for more than 5 years; to do this, such specialist should not live in Russia for one year (this was the earlier requirement established by the legislation for all, without exception, applicants for naturalization in Russia). According to the law, the high-qualified workforce include those specialists whose labor is worth two and more than two million rubles for the period under one year, i.e. who legally earn over RUR166,000 per month. For 4 months (since the date of the amendment being effective), 1,456 migrants were issued work permits (under a high-qualified specialist option), and 93% of them are migrants from the “classical” abroad². Apparently, the majority of such migrants lives and works in Moscow. This novelty will hardly affect the regions.

¹ M. Moshkin. Migrants have been patented//Time for News. May 21, 2010.

² The FMS of Russia official web-site – <http://www.fms.gov.ru>

Besides, there is a strong competition to receive the status of a high-qualified specialist. Good specialists even from the CIS countries prefer other countries to Russia¹. Finally, it is worth noting that though the migration novelty is aligned with the strategy of innovative development and modernization, present-day realities of the labor market are more pragmatic and create a niche of low-qualified workers.

To summarize, the official end of the crisis has not brought about a visible normalization in the labor market and migration. The quotas are still an acute problem of the entire system. The mechanism of providing quotas is exposed for bribes and difficult for implementation in all the sectors – be it education, healthcare or migration. It is inefficient in the context of protection of the national labor market; neither it reflects the demands of the economy in the workforce. Other significant barriers on the way of legalization of the migrants are shadow economic relations in Russia. Such relations occur to a greater extent in the sectors where migrants are employed. Thus, e.g., a share of illegal migrants in the Russia' agriculture is as high as 58.1%, in the wholesale and retail trade sector - 37.7%, in the construction sector – 23.2%, in utilities and personal services sector – 21.1%².

5.3.3. Internal migration

The internal mobility of the population is primarily related to the housing market, due to a number of reasons, and is insignificant. The difference in the unit price of one square meter of housing in a standard building located in a capital and even in a regional center and other towns and settlements is so high that makes any move, especially for a large family with many children quite unrealistic. For reference: the average price of 1 sq. m in a one-room apartment of the secondary housing stock in Kaluga (with population of 327.7 thousand residents) is in the range of RUR 49–62 thousand, in Kirov (which occupies the fourth place in the Kaluga region in terms of size and has 38.6 thousand residents as of January 1, 2010) - RUR20–25 thousand. Similar parameters are demonstrated in Yaroslavl (706.9 thousand) – RUR40–57 thousand, in Rybinsk (second largest city of the Yaroslavl region, 206.7 thousand people) – RUR24–30 thousand, in Yekaterinburg (1,343.8 thousand) – RUR50–60 thousand, in Nizhny Tagil (second largest city in the Sverdlovsk region, 373 thousand residents) – RUR20–28 thousand³. Thus, even inter-regionally, a family moving from a district center to a regional center will have to overcome at least two-fold housing price barrier while a move from countryside to a city cannot be made without reliable support of the kinship. There are just a few hostels through which the majority of village inhabitants moved through on their way to cities in the 1970 – 1980'es. The housing rent is high, besides, the stock of rented housing is quite large in Moscow (15% of apartments are rented out, as estimated) but insignificant.

¹ Addressing the conference “Development of proposals for inter-government regulation of labor migration of Russia and Byelorussia” Deputy Head of Social Policy Department, Standing Committee of the Union state, O. Vinogradova noticed: “Russia says it needs qualified labor hands. But we need them too! We take care of them and create good conditions. Moreover – Poland, France and Italy compete for them offering more favorable options than Moscow. Therefore, not the best HR arrive here//A. Druzhinina. Fight for love. New updates. September 23, 2010.

² Data of the Population survey on the employment issues, 2009, Rosstat, 2010.

³ Calculations made using the data from the sites” Real estate in Kaluga and the Kaluga region” <http://www.kalugahouse.ru/>, ”Real estate in the Yaroslavl region» <http://nedvizhimost.yar.slando.ru/>, “Real estate in the Sverdlovsk region” <http://nedvizhimost.slando.e-burg.ru/>

nificant across the country (5%)¹. Only a few employers are ready to provide a temporary residence together with a job place (not more than 5% of vacancies).

The survey of the internal mobility of the unemployed and those seeking for job carried out in all regions of Russia under a Rostrud order² in two “waves” – before the crisis (October 2008) and during the crisis (December 2009) demonstrated that the willingness to work in a different region was not connected with the unemployment growth (4.2% before and 4.4% during the crisis survey). To make a move realistic, the proposed wage was to be larger by 3.8 times (before the crisis) – 3.1 times (during the crisis) vs the average wage paid at the last job of a migrant, i.e. be within the range of RUR 36.5–39.7 thousand; while RUR66 thousand were required to relocate to Siberia and Far East (from other regions)³

There are no realistic grounds for increasing the current low internal mobility of the population: the countryside resources are exhausted, the age structure of the population corresponds to “a high level of demographic aging”⁴, the attained involvement of women into labor relations is an additional “anchor” to keep a household away from mobility; uniformity of socialization channels that occurred in the 1900-2000’s (with the help of relatives and acquaintances only) has become another obstacle for development of internal mobility. 57-60% of the Russians while looking for a job in the 2000’s named their friends, relatives or acquaintances as the main source of the job search. In some of the Russian regions (besides Chechnya, where this indicator was as high as 90.5% in 2009) – Oryol, Tambov, Lipetsk regions, Kalmykia, Chuvashia, Tatarstan, etc. the indicator exceeds 70%. It means that “free agents” cannot fit in into a local labor market. In addition, the search for a job using “close relatives channels” enhances the informal aspect of the labor market. The farther to the East we move, the higher becomes an opportunity to find a job by using other, more “market-like” channels; but the main migration flow during the 1990-2000’s moved to the opposite direction called “Western drift”.

Thus, two key factors - labor and housing – tend to become constrains of the mobility in the present-day Russia.

According to the official statistical data, the scale of the internal migration in Russia since early 1990’s reduced by 2.2 times: from 4.2 million of relocations in 1990 to 1.88 million in 2011. (*Fig. 13*). In 2010, a slight increase of the number of internal relocations was recorded. It should be noted that the analyzed data describe the migration that is accompanied by the change of registration at the place of residence without due account for numerous temporary relocations in the process of registration at the place of residence or without any registration at all. According to the Center of Migration Studies, based on the results of the surveys in various types of settlements in 2000-2001, 3 million of people⁵ participated in the internal

¹ A. Zyuzyaev. It is time to cancel registration (an interview with V. I. Mukomel)//Komsomolskaya Pravda, June 16, 2010.

² State contract “Development of a model of organization of employment in other locations of citizens looking for jobs, by the government authorities”, Leader M. B. Denisenko

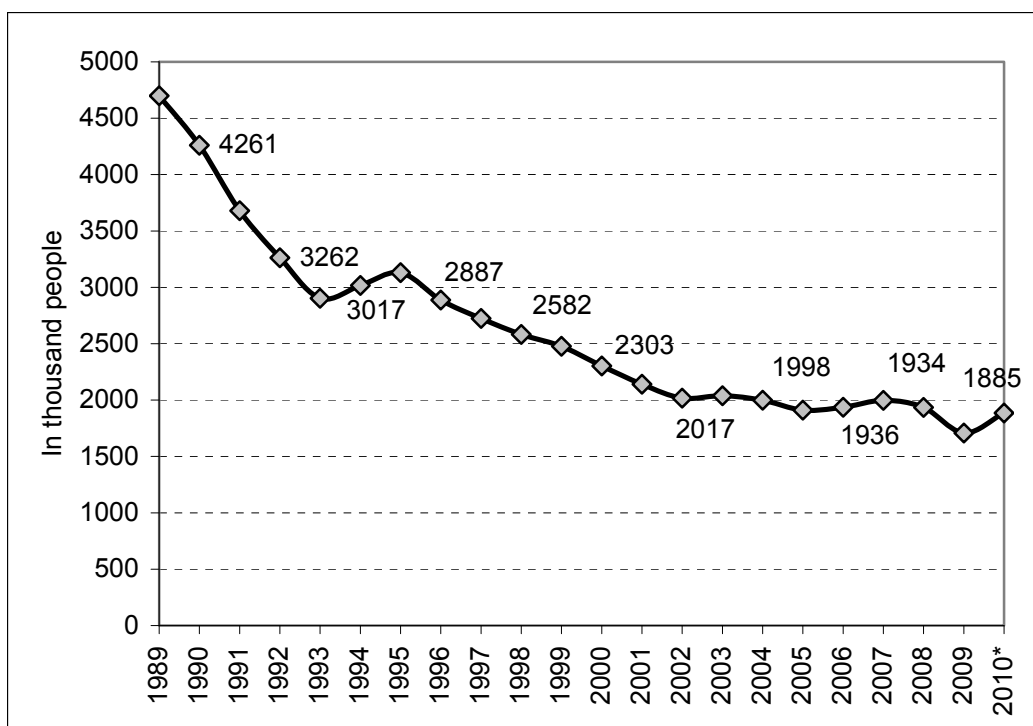
³ M. B. Denisenko, L. B. Karachurina, N. V. Mkrtychyan. Are Russian unemployed ready to move to find a job? // Demoscope Weekly. 2010. No 445-446. <http://demoscope.ru/weekly/2010/0445/index.php>

⁴ According to the generally accepted Garnie-Rosset, classification, countries/regions with 16th-18th share of population in the age of 60 and older are referred to the high level of demographic aging. In 2009, in Russia this indicator was 17.8%. // Demographic yearbook of Russia 2010. Rosstat, 2010.

⁵ Migration of population. Issue 2: Labor migration in Russia. Supplement to Journal “Migration in Russia” M., 2001, p.21.

temporary labor migration; this figure is comparable to the scale of labor migration to Russia from the CIS countries.

Internal migration in the developed countries is an important regulator of regional and local labor markets; as a rule, the larger is the territory of a country, the more significant is internal migration. Thus, in the USA, according to the current survey data in 2008-2009, 21 inhabitants per 1,000 made inter-district moves in the same state, and 19 inhabitants out of each thousand moved to another state. For the same period in Australia, 17 thousand of people were involved in inter-regional migration, while in Canada – 9.5 thousand.



2010 .* – preliminary data.

Source: Demographic yearbook of Russia 2010. Rosstat, 2010.

Fig 13. Migration across Russia in 1989–2010, in thousands of people

Similar estimates for Russia suggest 12,000 – 13,000 persons for each thousand (including 6.6–7.2 thousand – in intra-regional relocations and another 5.4–5.8 – between the regions) which may be compared with intensity of internal migration in such European countries as Spain (comparable in terms of the area to Khanty-Mansysk Autonomous District), Italy (Tomsk region), Czechia (Krasnodar Krai or Nizhny Novgorod region) ¹.

When the crisis broke out, efforts were made to migrate citizens from the so-called mono-cities more actively, e.g. from Togliatti to Tikhvin ². Agency for Restructuring of Mortgage and Housing Loans (ARIZhK) is a developer of the program of relocation of residents of the mono-cities to other regions. The relocation scheme is as follows: a person agrees his/her

¹ . B. Denisenko, L. B. Karachurina, N. V. Mkrtychyan. Are Russian unemployed ready to move to find a job? // Demoscope Weekly. 2010. No 445–446. <http://demoscope.ru/weekly/2010/0445/index.php>

² Relocation of AutoVAZ//Vedomosti, January 28, 2010.

move with the Agency, then moves to a new city and is granted a hostel for a time being; he/she finds a job and looks for a new housing. ARIZhK evaluates and pledges his/her previous housing space, and against this collateral issues a two-year loan at 2/3 of the Central Bank refinancing rate. The loan amount will be equal to the cost of the housing less the interest accrued for the two years. The migrant using the loan is expected to buy a new housing, and if the loan sum is not enough, a bank will give a mortgage loan to the migrant. Within the two years the migrant can sell his previous housing or assign the right thereto to the Agency. How this scheme works practically and whether it will be efficient, is unclear yet. The very idea of administrative regulation of internal relocations seems doubtful. In case of Togliatti and Tikhvin, the scheme does not seem to be workable: the change of a large (in the Russian perspective) city of Togliatti (hit by the crisis) located on the south (720,000 residents) for a small (about 60,000 people) city of Tikhvin that has a lot of problems in terms of development of industrial sectors, unemployment and some social issues will hardly be attractive to a large number of people.

Another idea of internal migrations in Russia is to relocate from problematic (in terms of unemployment) regions of the Northern Caucasus about 30,000 – 40,000 people annually to other regions of the country via Agency for Labor Migration; this idea was outlined in the approved Strategy for Social and Economic Development of the Northern-Caucases Federal District till 2025¹ and looks doubtful in terms of its possible implementation.

5.4. Russian Education – Basic Development Trends in 2000 – 2010

5.4.1. Russian Education within a Global Context

The Russian Federation is regarded as a country whose population has a formally high level of education.

In 2009, the population with higher (including postgraduate) and secondary vocational education accounted for 28.2% and 27.1% of the total employed population, respectively. Hence a share of the population with higher and secondary vocational education reached 55.3% of the total employed population. Russia is ranked number four worldwide in this indicator after Norway, USA and the Netherlands².

Having 523 higher education students per 10,000 persons of the population, Russia is ranked number two worldwide after the United States. By adding students of SVE institutions (tertiary education according to the international classification) to this figure, Russia would have 673 students per 10,000 persons of the population and world lead in this indicator.

However, Russia was ranked number 65 worldwide in the list of 169 countries in 2010³ under the Human Development Index⁴ (HDI) which is estimated as part of the UNDP. *Table 8* shows four countries with the highest Human Development Index, namely Norway, Australia,

¹ Order of the RF Government of September 6, 2010, No 1485-r “On the approval of the Strategy for Social and Economic Development of the Northern-Caucases Federal District till 2025”.

² Educational Indices. Statistic Year Book. M.: HSE-NRI (Higher School of Economics of the National Research University).

³ Report on Human Development – 2010. <http://hdr.undp.org/en/reports/global/ru/>.

⁴ The Human Development Index (HDI) is an integral indicator which is estimated annually to make cross-country comparison and measure living standards, literacy, level of education and life expectancy as the key features of human development in the surveyed area. HDI is a tool which is used to making a general comparison of living standards at different countries and regions.

New Zealand and the United States of America, as well as the BRIC countries, which included most dynamically developed countries prior to the global economic recession in 2008. Furthermore, the Table includes the Russia's nearest HDI neighbor-countries ranked numbers 60 to 70, including Kazakhstan, one of the former republics of the Soviet Union, which carried out radical reforms in its educational system and was ranked number 66 in HDI in the UNDP rating.

Table 8

Human development index in specific countries in 2010

Country	HDI rating of the countries	Human development index	Estimated life expectancy at birth (years)	Average duration of education for adult population (years)	Estimated duration of education (years)	Gross national income (GNI) per capita (PPP in USD, 2008)
Norway	1	0,938	81,0	12,6	17,3	58 810
Australia	2	0,937	81,9	12,0	20,5	38 692
New Zealand	3	0,907	80,6	12,5	19,7	25 438
USA	4	0,902	79,6	12,4	15,7	47 094
Serbia	60	0,735	74,4	9,5	13,5	10 449
Belarus	61	0,732	69,6	9,3	14,6	12 926
Costa Rica	62	0,725	79,1	8,3	11,7	10 870
Peru	63	0,723	73,7	9,6	13,8	8 424
Albania	64	0,719	76,9	10,4	11,3	7 976
Russian Federation	65	0,719	67,2	8,8	14,1	15 258
Kazakhstan	66	0,714	65,4	10,3	15,1	10 234
Azerbaijan	67	0,713	70,8	10,2	13,0	8 747
Bosnia and Herzegovina	68	0,710	75,5	8,7	13,0	8 222
Ukraine	69	0,710	68,6	11,3	14,6	6 535
Iran (Islamic Republic)	70	0,702	71,9	7,2	14,0	11 764
Brazil	73	0,699	72,9	7,2	13,8	10 607
China	89	0,663	73,5	7,5	11,4	7 258
India	119	0,519	64,4	4,4	10,3	3 337

Source : UNDP. Human Development Report – 2010.

With regard to education, Russia fall far behind the leading countries in average duration of education for adult population as well as estimated duration of education. Had it not been for a lower GNP per capita, Kazakhstan would have left Russia behind in this rating, though it fall behind Russia in terms of life expectancy. The leading countries comprise not only countries with economically high living standards (per capita GNP), but also those with long terms of education of the working population, which in many ways makes their development dynamic.

With regard to Brazil, China and India, though these countries fall behind Russia in terms of educational and per capita GNP, they leave Russia behind in public health indicators expressed in estimated life expectancy at birth (save for India, where this indicator is lower than in Russia). This conclusion is true for the Russia's HDI neighbor-countries, most of which leave Russia behind in public health indicators and average duration of education for adult population, because most of them transited to the 12-year school education.

Russia was ranked number 41 (for reference, Kazakhstan is ranked number 22) in the composite index of education estimated as part of the UNDP, and 122 in the healthcare composite index in 2010. In 2007, Russia was ranked number 118 in the healthcare index, which means that situation in this field has been aggravating globally. In the meantime, the public health status in Russia, in particular high death rate of the working population, is, generally speaking, referred to the issues of quality of education.

5.4.2. Russian Education Financing Policy

Dynamics in General Expenditures on Education

In the period between 2000 and 2010, expenditures on education increased from both public and private sources. Between 2000 and 2003, a share of budgetary expenditures on education in GDP increased from 2.9% to 3.8% and then gradually stabilized as absolute volumes increased. In 2009, consolidated budgetary expenditures increased by 7.1% against 2008, whereas GDP reduced by 7.9%. This resulted in growth in a share of budgetary expenditures on education in GDP up to 4.6%. In 2010, this share decreased a bit (*Table 9*).

In Russian statistics, private expenditures on education are referred to as “The scope of paid services in the educational system” with due account for hidden and informal activities. Dynamics of the scope of paid services in the educational system tend to grow steadily, with growth rates having been comparable with growth rates of budgetary expenditures on education to date (*Table 10*).

Table 9

Budgetary expenditures on education in 2004 – 2010

	2004	2005	2006	2007	2008	2009	2010
Consolidated budget for education, bln RUB, including	593,2	801,8	1033,3	1342,3	1664,2	1783,5	1893,9
• federal budget for education	121,6	162,1	201,6	278,5	354,9	418,0	442,8
• consolidated budgets for education of the constituent territories of the Russian Federation	471,6	628,6	831,7	1063,8	1309,3	1365,5	1450,9
Expenditures of the consolidated budget for education as % of GDP, including:	3,5	3,7	3,9	4,1	4,1	4,6	4,4
• of the federal budget for education	0,7	0,8	0,8	0,8	0,8	1,1	1,0
• consolidated budgets for education of the constituent territories of the Russian Federation	2,8	2,9	3,1	3,3	3,3	3,5	3,5
A share of expenditures on education in the consolidated budget of the Russian Federation, %	12,7	11,8	12,3	11,9	11,8	11,1	11,2
A share of federal budgetary expenditures on education in the expenditures of the consolidated budget of the Russian Federation, %	2,6	2,4	2,4	2,5	2,5	2,6	2,6
A share of consolidated budgetary expenditures on education of the constituent territories of the Russian Federation in the expenditures of the consolidated budget of the Russian Federation, %	10,1	9,4	9,9	9,4	9,3	8,5	8,6

Source : Rosstat (Federal State Statistics Service), Russia in Figures, the Federal Treasury.

Table 10

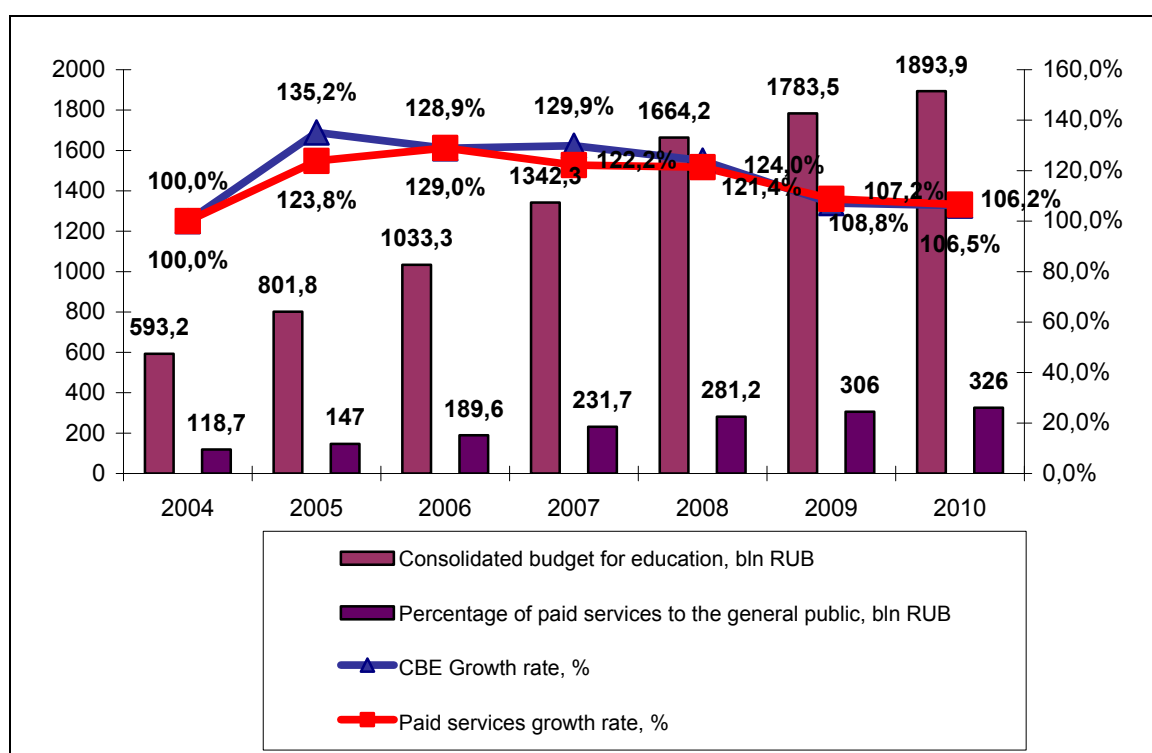
Percentage of paid services in the educational system in 2000 – 2010

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010*
Percentage of paid services in the educational system, bln RUB	41,5	56	72,9	95,4	118,7	147	189,6	231,7	281,2	306,0	326
as % of GDP	0,6	0,6	0,7	0,7	0,7	0,7	0,7	0,7	0,7	0,8	0,76

* tentative data published by Rosstat.

Source : Rosstat, Russia in Figures.

Comparative dynamics of growth in budgetary expenditures on education and paid services in this field is presented in Fig. 14.



Source : Rosstat, Russia in Figures, the Federal Treasury.

Fig. 14. Dynamics of budgetary expenditures and paid services for education in 2004–2010

Dynamics of changes in budget financing for education and scope of paid services adjusted for inflation is shown in (Fig. 15).

As shown in Fig. 15, consolidated budget for education in real terms began to decrease since 2008, a scope of paid services since 2010 (in 2009 it was equal to that in 2008).

The school education system, including extended education of school-aged children, accounted for about 12.5 – 13% of total scope of paid services. Hence according to preliminary estimates, in 2010 the population paid nearly RUB 40,2 – 41,8 bln for paid school services and extended education of schoolers.

According to preliminary estimates, in 2010 the population paid nearly RUB 65 bln for paid services in the system of secondary vocational education, and more than RUB 160 bln for higher and postgraduate vocational education.

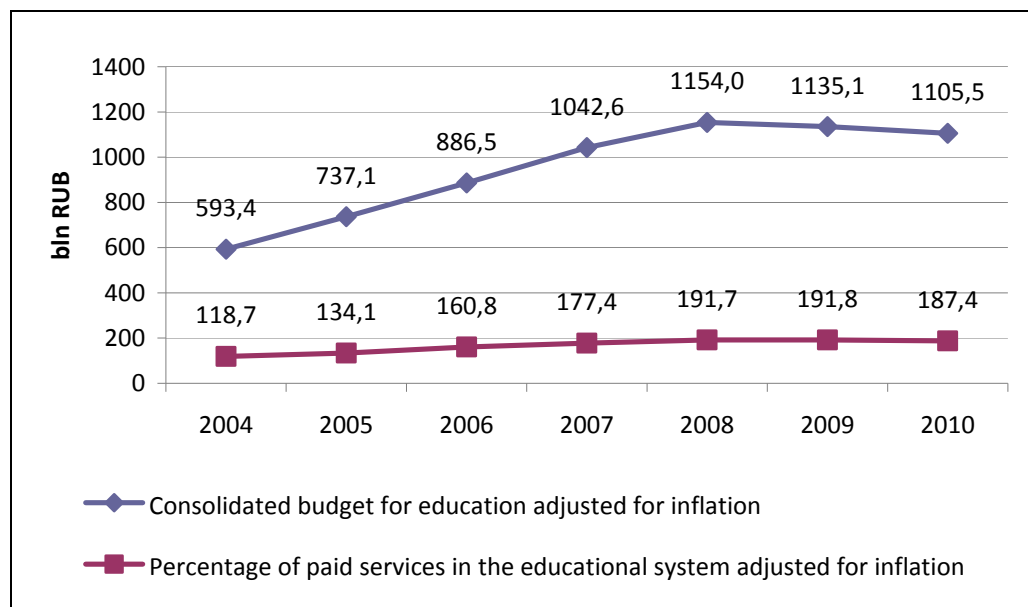


Fig. 15. Dynamics of budgetary expenditures and paid services for education B 2004–2010 adjusted for inflation.

Dynamics of budgetary expenditures on education

To get a better picture, let us compare budgetary expenditures by level of educational system. The size and structure of such expenditures in 2004 – 2010 are shown in *Table 11*.

Table 11

Size and structure of expenditures of the consolidated budget for education by level of the educational system in 2004 – 2010

	2004	2005	2006	2007	2008	2009	2010
1	2	3	4	5	6	7	8
Consolidated budget for education, bln RUB	593,4	801,8	1036,4	1342,3	1664,2	1783,5	1893,9
Preschool education (PE), bln RUB	91,7	113	145,3	189,7	254,5	287,5	321,3
A share of expenditures on PE in the consolidated budget for education, %	15.5	14.1	14.0	14.1	15.3	16.1	17.0
A share of expenditures on PE as % of GDP	0.54	0.52	0.54	0.57	0.61	0.74	0.75
Growth rates of budgetary expenditures on PE, %	–	123.2	128.6	130.6	134.2	113.0	111.8
General education (GE), bln RUB	298,1	356	475,9	599	737,1	795,7	827,4
A share of expenditures on GE in the consolidated budget for education, %	50.2	44.4	45.9	44.6	44.3	44.6	44.5
A share of expenditures on GE as % of GDP	1.75	1.65	1.77	1.80	1.78	2.04	1.93
Growth rates of budgetary expenditures on GE, %	–	119.4	133.7	125.9	123.1	108.0	104.0
Elementary vocational education (EVE), bln RUB	35,6	39,4	47,4	57,6	65,5	66,8	61,7
A share of expenditures on EVE in the consolidated budget for education, %	6.0	4.9	4.6	4.3	3.9	3.7	3.3
A share of expenditures on EVE as % of GDP	0.20	0.18	0.17	0.17	0.16	0.17	0.14
Growth rates of budgetary expenditures on EVE, %	–	110.7	120.3	121.5	113.7	102.0	92.4

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(continued) table 11

1	2	3	4	5	6	7	8
Secondary vocational education (SVE), bln RUB	30,5	43,3	55,3	70,4	93,9	102,2	102,1
A share of expenditures on SVE in the consolidated budget for education, %	5.1	5.4	5.3	5.2	5.6	5.7	5.4
A share of expenditures on SVE as % of GDP	0.18	0.20	0.21	0.21	0.23	0.26	0.24
Growth rates of budgetary expenditures on SVE, %	–	142.0	127.7	127.3	133.4	108.8	99.9
Higher and postgraduate vocational education (HVE), bln RUB	76,9	125,9	169,9	240,2	294,6	347,2	377,8
A share of expenditures on HVE in the consolidated budget for education, %	13.0	15.7	16.4	17.9	17.7	19.5	19.9
A share of expenditures on HVE as % of GDP	0.45	0.58	0.63	0.72	0.71	0.89	0.88
Growth rates of budgetary expenditures on HVE, %	–	163.7	134.9	141.4	122.6	117.9	108.8

Source : Federal Treasury.

As illustrated in *Table 11*, a share of budgetary expenditures on general education in GDP increased until 2009 and slightly decreased in 2010. A share of budgetary expenditures on preschool education in GDP increased almost by one third over the period under review. However, basic growth in this indicator was reported in 2009, when the Russian GDP decreased considerably.

A share of budgetary expenditures on elementary and secondary vocational education in GDP remained stable in the period between 2004 and 2010, whereas a share of expenditures on higher and postgraduate vocational education in GDP grew steadily throughout the entire period, from 0.45% in 2004 to 0.88% in 2010, which means that they doubled.

In the period between 2004 and 2010, a share of expenditures on preschool education in the consolidated budget for education increased (likewise in GDP), whereas a share of expenditures on general education decreased in 2005 and then remained stable.

At the same period, a share of expenditures on EVE in the consolidated budget for education gradually decreased, which can be explained by integration of a part of EVE and SVE institutions which were transferred under the jurisdiction of the constituent territories of the Russian Federation.

A share of expenditures on secondary vocational education in the consolidated budget for education remained stable throughout the entire period, and even tended to slightly increase over the recent years.

A share of expenditures on higher and postgraduate vocational education in the consolidated budget for education increased visibly from 13.0% to 17.9% in the period between 2004 and 2007, slightly decreased in 2008, and then resumed to grow, reaching a growth rate of 19.9% in 2010.

In general, one may infer that budgetary expenditures on higher education relatively increased as expenditures on school education remained stable, and expenditures on non-higher vocational education decreased.

It should be noted that growth rates in general education (like at the other levels of education) were considerable in 2004–2008, whereas decreased dramatically in 2009–2010, which can be explained by the global recession. However, these growth rates are expected to keep falling in the short term, according to the budget for 2011 and the planning period of 2012–2013.

In 2010, expenditures on general education totaled RUB 827,4 bln or 44.5% of the consolidated budgetary expenditures for education in the Russian Federation. Consequently, an average of RUB 62,4 K were spent per public and municipal secondary schooler in Russia in 2010.

An average of RUB 132,6 K was spent per state-financed student in higher education.

Wages of Education Employees

Wages of the education employees should have been raised *against the average in the economy* through a new labor remuneration system as a tool designed to attract skilled workforce to the system of education. Unfortunately, it was not the case, which can be seen by comparing the dynamics of wages of education employees in 2004 – 2008 and early in 2010.

Dynamics of monthly average accrued wages by Federal District in 2004 – 2008 is presented in *Table 12*.

Table 12

Dynamics of monthly average accrued wages in the educational system in 2004–2008 by Federal District (RUB)

	2004	2005	2006	2007	2008	For reference:2008 as % of the wages in the Russian economy and federal districts
Russian Federation	4203,4	5429,7	6983,3	8778,3	11316,8	65,5
Central Federal District	4735,1	6258,6	8230,3	10867,3	14493,2	70,1
Northwestern Federal District	5028,0	6628,7	8446,3	10402,9	13210,2	68,1
Southern Federal District	2991,8	3757,3	4842,5	6036,5	7773,6	66,2
Volga Federal District	3210,4	4076,3	5226,8	6478,8	8359,2	63,3
Urals Federal District	5233,6	6788,4	8763,3	11022,9	13660,6	62,6
Siberian Federal District	4222,8	5390,2	6872,8	8414,2	10523,1	68,4
Far Eastern Federal District	5887,8	7268,5	9082,2	10938,8	13891,4	66,9

Source : data published by Rosstat.

In 2009 monthly average wage in education totaled RUB 13312, or 65.8% of the monthly average wage in the Russian economy, which means that it remained the same against the average in the economy against 2008.

Monthly average accrued wage by level of education and federal district in the period between January and May 2010 is presented in *Table 13*.

However, in 2010¹ wages of education employees accounted for 62% of the monthly average wage in the Russian economy, which means that in 2010 wages in the field of education increased at a slower rate than wages in the Russian economy.

The data published by Rosstat (*Table 13*) shows that all of the recently made efforts in general and basic vocational education failed to bring any visible results: in 2005, the monthly average wage of the teachers at the elementary and senior high schools accounted for 61% of the monthly average wage in the economy, whereas in H1 2010, in five years, the percentage slightly increased up to 61.6% (in terms of the Russian average figures). Wages in basic vocational education was found to be ever lower than in general education, save for the Northern Caucasus Federal District.

¹ Most recent data published by Rosstat.

Table 13

Monthly average accrued wage of education employees at the federal districts by level of vocational education in January – May 2010 , RUB

Name	Total in the economy	Education – total	of which:						Wages in education against the average wage in the economy, %	Wages in PE against the average wage in the economy, %	Wages in elementary general education against the average wage in the economy, %	Wages in Basic general and general secondary education against the average wage in the economy, %	Wages in EVE against the average wage in the economy, %	Wages in SVE against the average wage in the economy, %	Wages in HVE against the average wage in the economy, %
			preschool education (preceding elementary general education)	elementary general education	Basic general and general (senior) secondary education	EVE	SVE	HVE							
Russian Federation	21144	13363	9948	10089	13029	11810	15663	19351	63,2	47,0	47,7	61,6	55,9	74,1	91,5
Central Federal District	26459	17527	14273	10280	17405	11508	20657	22395	66,2	53,9	38,9	65,8	43,5	78,1	84,6
Northwestern Federal District	24056	15574	11140	13454	15472	14912	17048	21592	64,7	46,3	55,9	64,3	62,0	70,9	89,8
Southern Federal District	15343	10630	7110	9567	10849	10438	12291	14962	69,3	46,3	62,4	70,7	68,0	80,1	97,5
Northern Caucasus Federal District	12097	8372	6131	7963	8157	9115	10859	11642	69,2	50,7	65,8	67,4	75,3	89,8	96,2
Urals Federal District	25349	14658	10689	14081	15468	13405	16399	21189	57,8	42,2	55,5	61,0	52,9	64,7	83,6
Siberian Federal District	18744	12011	8271	9678	11587	11199	14051	19341	64,1	44,1	51,6	61,8	59,7	75,0	103,2
Far Eastern Federal District	26445	16363	11351	14731	16800	16407	19606	22294	61,9	42,9	55,7	63,5	62,0	74,1	84,3

Source: data published by Rosstat, which was provided during preparation of the materials for the meeting of the State Council for vocational education which was on 31.08.2010

5.4.3. Institutional Reforms in Education

Universal State Exam

In 2009, the Universal State Exam (USE) was for the first time introduced in full into the educational system, and higher educational institutions admitted applicants on the basis of the USE results.

The following rules of entitlement to the secondary school diploma were established after the introduction of the USE. Where a school graduate fails to pass one of the two compulsory USE subjects, which means that he/she is assigned a grade below the established minimum, he/she may repeat the exam. If a school graduate fails to collect the required minimum of points immediately following the two compulsory exams (the Russian language and mathematics), he/she is not entitled to repeat the exams until next year, in which case he/she is entitled a secondary school attendance certificate rather than a USE pass certificate.

Where a school graduate, taking an exam on a subject of his/her choice (exclusive of the Russian language and mathematics), is assigned a grade below the minimum, he/she is not entitled to repeat the exam until next year.

Where a school graduate collects the number of points above the established minimum threshold for two compulsory subjects whereas collects the number of points below the minimum threshold for a subject(s) of his/her choice, he/she will be entitled to a secondary school diploma.

Hence the rules for passing the USE fail to be explicit in that the entitlement to the secondary school diploma in the Russian secondary school is only linked to passing the threshold imposed on the two compulsory subjects – the Russian language and mathematics¹. From now on, the secondary school may not be liable for the knowledge of other subjects. Furthermore, the rules fail to define when and how secondary school graduates who fail to pass exams in Russian and mathematics must get the knowledge they failed to get due to various reasons, including neglecting their schoolwork. It is unclear how to distinguish between neglect schoolwork and poor work of teachers. Neither is it clear about optional subjects: is it not specified when and how a school graduate has to complete his/her studies to be able to pass exams on these subjects. It should be noted, however, that the Federal Law No. 194-FZ “On the Amendments to Specific Legal Acts of the Russian Federation in Connection with the Establishment of Compulsory General Education” which, generally speaking, holds the state, which is represented by public or municipal general educational institutions, liable for the full-fledged knowledge of secondary schoolers, was adopted as early as 2007. It is the kids from lower-income households, which cannot afford additional knowledge required for passing the USE, who are exposed most by shifting this problem onto the schoolers and their families. Consequently, no further development in terms of education and vocational education was defined. More specifically, to be able to enter secondary vocational education institutions, one has to have a secondary school diploma, which means that those who fail to pass exams on the compulsory subjects only may enter EVE institutions. Those who have a secondary school diploma but fail to collect the required number of points for optional subjects are likely to enter SVE institutions.

In 2008, the final year of the USE experiment, the USE results shocked the society: grades of “2” in Russian and mathematics accounted for 11.2% and 23.5%, respectively, which meant that more than one third of the secondary school graduates would not be entitled to a secondary school diploma (fail to graduate) and enter a higher educational institution, which became a social norm for 11-grade secondary schoolers. The USE, a symbol of better access to higher education, instantly became an obstacle to entering higher educational institutions. In 2009, when the USE was introduced in full, the economic recession in Russia was in full swing, and public authorities got very concerned about the inflow of unskilled secondary school graduates to the labor market.

A solution was found in drastic reduction of the previously imposed requirements. The USE results in 2009 – 2010 can be regarded as a severe defeat, not so obvious though, of the USE concept. A total of 2.76 – 2.1 and 3.0 – 3.5% grades of “2” in Russian and mathematics school graduate o in 2009 and 2010, respectively, is an evidence of a drastic reduction of the requirements to the examined rather than improved situation in the secondary education, in particular, when these figures are compared with the dynamics of those who were assigned a grade of “2” for the above mentioned subjects at the USE (under the traditional 5-point grading scale) in 2006–2008 (*Table 14*).

¹ In addition, the rules fail to show how the secondary school diploma and USE grades are linked with the results which school graduates showed throughout the entire period of secondary education.

Table 14

Secondary school graduates who were assigned a grade of “2” for USE compulsory subjects under the 5-point grading scale in 2006 – 2010, %

Subject	a grade of “2” (under the 5-point grading scale)				
	2006	2007	2008	2009	2010
The Russian language	7,91	8,81	11,21	2,76	2,1
Mathematics	19,99	21,14	23,48	3,04	3,5

However, the USE should not be criticized indiscriminately. This appraising tool for secondary school graduates meets the modern development stage of higher education in the Russian Federation – transition to a more accessible higher education, when nearly 70% of the age cohort enter higher institutions. However, this tool needs to be developed so that the society feel confidence in it. Too bad that many of its inherited weaknesses were detected or neglected at the USE experimental stage.

Autonomous, “new” state-financed and public institutions

Federal Law “On Autonomous Institutions” (FZ No. 74) was adopted on November 3, 2006. It was recognized that introduction of a new form of incorporation would allow public and municipal educational institutions to be more independent and transparent.

However, the adoption of the Federal Law “On Autonomous Institutions” failed to result in any significant transition of public (municipal) educational institutions to AI. For instance, none of the federal educational institutions transitioned to AI in 2009. In this context, Federal Law No. 83-FZ “On the Amendments to Specific Legal Acts of the Russian Federation in Connection with the Enhancement of the Legal Status of Public (Municipal) Institutions” was developed and adopted in May 8, 2010.

The adoption of the new federal law created a conceptually new situation, because it allowed public and municipal educational institutions to operate as public, state-financed, and autonomous institutions, in which case “new” state-financed institutions became closer to autonomous ones in terms of their organizational and economic status (*Table 15*)¹.

No effects or risks that may arise from the Federal Law No. 83-FZ in the educational system have been explored to date. At the federal level, public educational institutions may operate as state-financed and autonomous (save for special-purpose) institutions, while at the level of constituent territories of the Russian Federation and municipalities, transition of a part of educational institutions to public ones (e.g., low-numbered and ungraded rural schools will become public in many regions).

A variety of public and municipal institutions brings up a question of the criteria under which a public assignment – and, consequently, budgetary funds – will be distributed among the same. The answers that have been given to date – it is the founder (an agency acting as the founder), knowing well its institutions, who will decide, or the public assignment will be distributed according to the quality of educational services – fail to satisfy anyone. Before that, the founder distributed budgetary funds among institutions with the same status, and its main participants understood its choice given some transparency of procedures. Today, if the procedures and principles remain the same, it would be totally unclear why such a large-scale

¹ See also Tipenko N.G. Transition to the Arrangement of Provision of Services and Financial Support of Public Assignments. http://www.cmprog.org/docfiles/Tipenko_poryadok_perehoda.doc

changes took place. If the procedures begin to change, it would be necessary to make clear the reasons behind such changes.

Table 15

**Basic differences between public (municipal), state-financed
and autonomous institutions**

	Public institutions	State-financed institutions	Autonomous institutions
Status	Non-profit organization	Non-profit organization	Non-profit organization
Financing procedure	Based on budget estimates	As subsidies for execution of public (municipal) assignment (assignments)	As subsidies for execution of public (municipal) assignment (assignments)
Property	To be assigned on the basis of operational management (article 296 of the Civil Code)	To be assigned on the basis of operational management (article 296 of the Civil Code)	To be assigned on the basis of operational management (article 296 of the Civil Code)
Money transaction procedure	Through personal accounts opened with sub-branches of the Federal Treasury .	Through personal accounts opened with sub-branches of the Federal Treasury.	AI in compliance with the set procedure may open accounts in credit organizations
Owner's liability	The owner of the institution's property shall bear subsidiary liability for the liabilities assumed by the institution	The owner shall bear subsidiary liability for the liabilities assumed by the institution	The owner shall bear subsidiary liability for the liabilities assumed by the institution
State procurement	Under the Federal Law No. 94-FZ	Under the Federal Law No. 94-FZ	Not governed by the Federal Law No. 94-FZ
Entitlement to establish other legal entities (participation in joint-stock capital)	Not entitled to establish	May establish subject to approval by the founder	May establish subject to control by the Supervisory Board
Entitlement to obtain loans	Not entitled to obtain loans	Not entitled to obtain loans	Entitled to obtain loans

New Draft Law “On Education in the Russian Federation”

There is another problem – a new draft law “On Education in the Russian Federation”, which was submitted for nationwide discussion. The law must replace the Federal Law “On Education” of 1992 which was made patchwork by multiple amendments thereto. Experts and the general public, however, were perplexed, to say the least of it, by the original decision on developing a new law – collect all of the provisions existing in the legislation on education, add all of the documents regulating educational institutions, and then somehow streamline and name all that a law. The initial version of the law could be named law materials rather than a draft law. Their trend was of concern: it was the provision of support to educational institutions rather than satisfaction of the Russian citizens’ needs for education that became the pivotal motive in the new draft law.

Following numerous comments, the draft law was refined and posted on the website for discussion which ended on February 1, 2011. It is obvious, that the new version was found to be much better than the previous one, but the draft law retained its general intention – regulate educational institutions in the first place rather than protect interests of the Russian citizens in the field of education. In general, the draft law is still raw and indistinct: its general idea is obscured by numerous details. Unlike the Federal Law “On Education” of 1992, the draft law fails to give a clear signal to the general public as to which way and how education should develop in Russia.

5.5. The State of the Research and Innovation Sphere

Last year, the subject of innovation development formed one of the top public policy priorities. That manifested itself in the rise of new initiatives on support of university research, development of interaction between science and business, and encouragement of the latter's innovation activities. The focus shifted onto huge projects, with Skolkovo being atop the list. But from the perspective of earmarked resources, there also are other large-scale measures: a project on engaging leading researchers in forming new laboratories at Russian universities and an initiative on establishment of state-sponsored cooperation between universities and industrial corporations on hi-tech production projects.

5.5.1. The State of the Research

Despite the government increasingly centering on innovation development, there were no notable changes in the research sphere. Reform of the public research sector has not kicked off, the general ageing of the cadres was still under way, while a more vigorous support of university research has so far failed to yield visible results, because the processes of its transformation have been nascent.

The state budget remained a major source of funding of research, but the share of businesses in the support of R&D rose slightly. The specific weight of spending on fundamental research was on the upsurge, which can be ascribed to growth in budget appropriations on respective activities by leading universities and research centers.

Overall, within next three years the public spending on science should be substantially lower than public expenditures on innovation development¹. (*Table 16*).

Table 16

Funding of Main Socio-Economic Policy Priorities, as % of GDP

Priority	Estimated		
	2011	2012	2013
INNOVATION DEVELOPMENT	0.9–1.1	0.9–1.1	0.9–1.0
including:			
Development of fundamental and applied research	0.2–0.4	0.2–0.3	0.2

Source: Consolidated background reference paper to bill № 433091-5 «On the 2011 federal budget and the planned period of 2012 and 2013 ». P.5.

In 2011, the budget spending on fundamental research should increase by 9% and the one on applied research - by 50%, with a 32% overall increase in budget appropriations compared with the 2010 figures. So, the government's sharp turn towards applied research is evident, and, from the perspective of the task to encourage innovation development in the longer run, this trend may prove an ambiguous one.

The tender-based funding of research, including projects run in tandem with businesses, forms an officially announced government priority. However, it has been consistently shrinking over the past three years. More specifically, the volume of budget allocations on imple-

¹ According to the RF Ministry of Economic Development's definition, **public spending** on innovation development is formed by types of expenditures that help develop (create, introduce) new products, services, technologies, form competencies in priority spheres of economic development, advancement of the knowledge-based economy. Innovation expenditures comprise both direct expenditures on support of innovations and those exerting an indirect influence through private demand, intensification of motivation, and other factors. (Source: Strategiya innovatsionnogo razvitiya Rossiyskoy Federatsii na period do 2020 goda. Proekt. M.: MER, 2010. Wording of 31.12.2010.

mentation of federal target programs slid from Rb. 903.8 bln. in 2009 to 730.9 bln. in 2010¹. Tender mechanisms and procedures became target for the academic community's criticism, because of their opacity and problems with application of Federal Act № 94-FZ², in compliance with which it is the bid price, rather than the applicant's qualifications and quality of the project, that forms a main projects assessment criterion.

The other kind of tender-based funding is formed by grants awarded by public research foundations. It de facto appears stagnant, as originally cash-strapped, such foundations see their public funding contract. In 2011, their budget should increase by meager 5.7%, while it should have increased at the same rate as the overall appropriations on civil research - that is, by 32%. According to the budget plan for 2011-2013, the Russian Foundation for Fundamental Research should receive Rb. 6.0, 4.3 and 4.3 bln., respectively. For reference: MSU and SPSU should receive far greater volumes of funds on research: MSU – Rb. 10.6 bln. in 2011, 10.7 bln. in 2012 and 9.9 bln. in 2013, while SPSU – 5.4 bln., 8 bln. and 8 bln., respectively³.

Notwithstanding the above challenges, the financial standing of the research sector has lately relatively stabilized. This, however, is not true, as far as the state of research cadres is concerned. They have constantly decayed. The outflow of the cadres engaged in R&D activities was on the upsurge, while all their structural indicators were aggravating. More specifically, the researchers' average age was on the rise, as was the bust bay of the middle-aged (35-55 years) researchers; the young practice a "quick call" on science, while auxiliary and technical personnel are washed away at a rate greater than researchers'.

A critical aspect of the research complex's functioning also is the state of its material and equipment base. A poor material provision of research affects the state of its human capacity and effectiveness of research activities. Quantitative characteristics of the material base of research in value equivalent collected by the official statistics fail to provide an adequate idea of its state, so much for problems associated with renewal of the equipment stock and its use by research organizations and universities.

The year of 2010 saw completion of the inventory check of unique scientific equipment placed with research organizations and universities of the public sector for science. The data collected across nearly 400 objects of the research infrastructure allow a series of qualitative conclusions. The main finding is that the material base of research is basically obsolete; a radical renewal of equipment takes place chiefly at individual universities, while the average equipment effectiveness rate is fairly low. Meanwhile, academic institutions tend to use equipment more efficiently than universities and other scientific organizations.

Academic research organizations have on average more outdated equipment than universities, particularly with account of unique equipment renewal rates. Starting from 2007, academic institutions saw placement in operation of 26% of research equipment of the overall number of machines a given organization has vis-à-vis the universities' 37%. In leading universities, unique equipment is located chiefly at research institutes under universities, which have a relatively autonomous status (this situation is characteristic of MSU, SPSU, Tomsk polytechnic university, the Southern federal university). That said, academic organizations have recently been more active than universities in modernizing of their unique equipment.

¹ Berdaskevich A.P., Safaraliev S.G. Ob effektivnosti byudzhetykh investitsiy v rossiyskuyu nauku//Innovatsii. 2010. №1. p.33.

² Federal Act of 21 July 2005 № 94-FZ "On placing orders on supplies of goods.

³ Gorbatova A. Zashli v tupik?//Nauka i tehnologii Rossii. 21 October 2010. - URL: http://strf.ru/material.aspx?CatalogId=221&d_no=34423 Date of access: 07.02.2011.

The equipment load rate was higher at academic institutions than at universities, which can be explained by the former's more intense research activities vis-à-vis the universities'. At academic institutions, 40% of equipment is loaded at 91-100% relative to the nameplate full load, while the universities' respective rate is 15%. Meanwhile, as much as 20% of unique equipment placed with academic institutions and 31% of unique equipment at universities is loaded at 50% and less (vs. the nameplate full load).

It is academic institutions and universities that remained major outsider users of unique equipment (accounting in total for 54% of all users). Meanwhile, the proportion of small-sized start-ups in the total number of users of unique equipment accounts for just 11%, which proves loose relations between science and business.

It is academic institutions that boast the highest average and absolute unique equipment effectiveness rates measured by the number of publications, conference presentations, patenting and licensing. However, the aggregate indicators are low. Thus, research findings resulted in granting licenses only at 0.05% of examined objects, while findings obtained using less than a half of the overall equipment stock were protected with patents.

In all, the research sector's performance mirrors its state and ongoing processes therein. Accordingly, Russia's specific weight in the global flow of publications registered in Scopus database plunged from 2.22% in 2005 to 1.8% in 2009. By the level of citation rate Russia ranks 16th worldwide. When compared with the BRIC nations, Russia outpaces only Brazil (the 20th place worldwide), while trailing behind India (the 16th one) and hopelessly falling behind China (the 7th place). Russia's publication policy, especially in the regions, is very poor. By contrast, facing a profound challenge of mastering the English language, Chinese researchers nonetheless literally bombard journals with their articles, thus bolstering changes for their publication. By contrast, Russian researchers often do not even dare try to prepare an article for a foreign journal. Plus, there is no training on the art of drafting a research paper in Russia, albeit there are strict rules in this regard.

To bolster the scientific sector, in 2010 the government promoted three main directions: (1) assistance with furthering interaction with the Russian-language research expat community; (2) development of an organizational reform mechanism for the public research sector; (3) support of university research and its promotion of its cooperation with business community.

5.5.2. Measures on Promotion of Interaction with Representatives of the Expat Community

Support of research spearheaded by the Russian expat community

The project "Conduct of research by teams headed by visiting researchers" is implemented in the frame of the Federal target program (FTP) "Scientific and scientific-pedagogical human resources of the innovation Russia" for 2009- 2013 (hereinafter referred to as Measure 1.5 (as enumerated in the list of measures under GTP). The federal budget funding is granted to research projects spearheaded by expat researchers, with a maximum volume of support of a 2- year long project making up no more than Rb. 2 mln. a year. During the project implementation period, the expat researcher's physical contribution in research activities in Russia's territory should make up no less than two months a year.

The first competition was held in 2009 and resulted in funding of 110 projects. The second competition was run in 2010 and by its results funding was made available for 125 projects. The intensity of the competition proved fairly even – 3.4 applications per project in 2009 and 3.2 ones- in 2010¹. The selection resulted in 60% -plus of the winning entries being carried out at universities.

The competition was run on the basis of provisions stipulated in the law on public procurements, which is why the core selection criteria were price and project implementation timelines. As a result, instead of the ultimate Rb. 4 mln., the average value of a contract (for 2 years) was Rb. 3.0 mln. in 2009 and 2.6 mln. in 2010. These are fairly moderate figures of reduction in the contract value when compared with other FTP's measures. The requirement to have an expat project leader to some extent proved a quality criterion, and it partly cut off brazenly low-balling organizations.

Generalized data on expat project leaders failed to produce a clear understanding of whom research organizations had managed to sign up. Country-wise, the expat pattern proved insignificantly different from data of other competitions (including the geographic pattern of joint publications). In 2009, as much as 64% of researchers came from the US, Germany and France, while in 2010 the proportion of these countries was 57%. As much as 52% of project leaders hold a second (Russian) passport², thus facing no problems with obtaining Russian entry visa. Expat researchers basically tend to hold fairly prestigious positions- 49.6% of participants in Measure 1.5 are professors, 19.2% - heads of departments, chairs and laboratories, and 24% - research fellows; however, the visiting researchers' scientific profile remained practically unknown. No citation index data was collected. There exists only information³ on expat project leaders' publications in journals with the impact factor⁴, which showed that 89.6% of them have such publications. As for the other performance indicator- that is, patenting, it proved to be pretty low, with 67% of the total number of visiting researchers not ever authoring a patent.

So, the data collected with regard to Measure 1.5 failed to give a comprehensive answer to the question as to whom Russian research organizations have managed to sign up. Meanwhile, as objectives of Measure 1.5 were formulated fairly murky right from the beginning, there is no answer to the question as to whom specifically, and for what purpose, they would like to sign up. The Measure is currently losing its momentum – at least, the plans for 2011 no longer feature it. It has been replaced by a far more ambitious project on attraction the most renowned researchers.

Creation of new university laboratories led by prominent researchers

Measures on attraction of leading researchers into Russian institutions of higher professional education were approved in 2010 by a special Government Resolution (of 09 April

¹ Here and below the source of qualitative data on measure 1. 5 is the national foundation for cadres training, which is the operator of this program Measure.

² Only the 2009 data.

³ The data was collected only in 2010.

⁴ The impact factor, often abbreviated IF, is a measure reflecting the average number of citations to articles published in science and social science journals. It is frequently used as a proxy for the relative importance of a journal within its field, with journals with higher impact factors deemed to be more important than those with lower ones. Accordingly, a publication in the journal with a higher impact factor is considered to be more prestigious, as it gives a broad audience an opportunity to know the author's paper.

2010, № 220). The ultimate objective of creation of research laboratories run by the best researchers from overseas is most likely to shape competition environment, boost the quality of research and the university research on the whole. Theoretically, this might give an extra fillip to the best academics' migration to universities.

If successful, universities are entitled to Rb. 12 bln. in subsidies in 2010-2012. The plans comprise establishment of 80 laboratories, each entitled to up to Rb. 150 mln. (some USD 5mln.) in subsidies for three years – the amount unprecedented even by developed nations' standards. The funds can be spent on purchases of new equipment, reagents, and other needs. The only restriction is that labor compensations payable to the team and its leader may not exceed 60% of the grant's amount. The most substantial condition is that the competition is open for the best researchers, regardless of their residence or job location, which means these can be both domestic researchers, expats, and foreign scientists alike. Their expertise is assessed by past achievements, including such formal indicators as the h-index¹. Meanwhile, under the terms of the competition, a leading researcher is bound to work in the newly created laboratory for no less than 4 months a year starting from 2011.

The competition in question displayed a number of problematic aspects that had been evident yet prior to its start, which is why they appear particularly perilous from the perspective of the possibility to ensure an adequate return on the budget investments.

The main problems associated with the ideology of the competition are as follows:

1. Building a world-class laboratory is a daunting challenge, given a poor general university infrastructure (from the perspective of efficiency of equipment use, problems with human resources, including the shortage of auxiliary and other staff).
2. The requirement to be present *in personae* at the university laboratory for no less than 4 months a year precluded a substantial number of leading foreign researchers from bidding, for they are not in a position to spare so much time on their work in Russia. The condition in question de facto constitutes a “pendulum migration” option, which back in the 1990s had been the way Russian researchers sought to increase their material level. This approach does not appear efficient enough from the perspective of attraction “crème of the crème”, and to some extent it is less appealing than the other two options – namely, a long-term contract implying a complete relocation to Russia for the lifetime of a respective contract or a flexible schedule of visits to the country coordinated with a university head, with no compulsory timeframe. That is why the best option might become creation of laboratories with “Western participation”, rather than establishment of the ones run by a visiting researcher.
3. Requirements to research outputs seem overly lax when compared with an extensive and fairly strict set of project and staff selection criteria and planned sizeable financial infu-

¹ The h-index is an index that attempts to measure both the productivity and impact of the published work of a scientist or scholar. The index is based on the set of the scientist's most cited papers and the number of citations that they have received in other people's publications. The index can also be applied to the productivity and impact of a group of scientists, such as a department or university or country. The index was suggested by Jorge E. Hirsch, a physicist at UCSD, as a tool for determining researchers' relative quality and is sometimes called the Hirsch index or Hirsch number. The index displays a proper accuracy only under comparison of researchers of the same field of science, as citation traditions differ across different branches of science. Like other bibliometric characteristics, the h-index is not strictly correlated with the researcher's profile and performance, because of string of parameters that bias its value, including for example time that has elapsed from the moment the article was published (this is why young authors cannot enjoy a very high h-index).

sions in creation of laboratories (the researcher is required to publish at least one article or obtain at least one patent upon 18 months of his work). Meeting these requirements is no sweat working anywhere, too. For reference: in the US, researchers of national laboratories are bound to publish annually no less than three articles in peer-reviewed journals.

4. Uncertainty of prospects and a short time horizon of the budget support: the government has no plans (or they have not been made public) with regard to a further support of laboratories upon expiration of the three-year grant. Meanwhile, the term of financing effectively is two year (the year of 2010 cannot be considered a full-fledged year of funding, as the competition results were reckoned up only on 29 October 2010), which is not enough for launching and fine-tuning a research laboratory's efficient operations. Worldwide, the respective timeline is in the region of 5 years (eg the "standard" practiced by the National Institutes of Health in the US).

Huge funding proved very attractive to prospective applicants – shortly after the RF Ministry of Education and Science voiced the intent to award 80 grants, the competition level became 6 applications per grant, i.e. twice as many "average nationwide" Russian foundations' grant competitions and ministries' tenders. However, having assessed the applications, the decision was made to award only 40 grants and to hold another competition in early 2011¹.

Researchers from overseas were more responsive to the call for competition than Russian-speaking expats – 35%² and 22% of the total number of applications, respectively (*Table 17*), with Russian researchers clearly dominating the list of applicants (43% of applications in total). The structure of grant recipients, however, proved to be nearly an opposite one, as the competition winners chiefly became projects spearheaded by expat community representatives (52.5% of all the awarded grants). The proportion of overseas researchers that did not belong into the expat community in the overall number of grants remained unchanged, while the number of Russian permanent residents amid victors was a meager 12.5% (5 people).

Table 17

**Distribution of Megagrant Applications and Awarded Grants
due to the Project Leader's Residence**

The project leader's residence	Applications, as % to their total number (N = 507)	Grants, s % to their total number (N = 40)
Russian researcher	43	12.5
Foreign researcher	35	35
Foreign researcher- the Russian expat community representative	22	52.5

Source: calculated on the basis of data of the RF Ministry of Education and Science. <http://mon.gov.ru/press/news/7876/>

Speciality-wise, the pattern of victorious projects appears fairly balanced and mirrors both the current balance of forces across areas of research (with projects in the field of physics, mathematics and mechanics being traditionally strong) and the government's new priorities (an unusually great number of grants on biology, biotechnologies, medicine –11 grants combined of 40 ones). Such fields as astronomy, nuclear power and technologies, machine sci-

¹ Minobrnauki provedet vtoroy otkrytyi konkurs dlya uchenykh na polycheniye grantov dlya nauchnykh issledovaniy//29.10.2010 г. - URL: <http://www.rbc.ru/rbcfreenews/20101029212303.shtml>. Date of access: 07.02.2011.

² Including 2% of researchers from across the CIS.

ence, chemistry, energy production and conservation, as well as the direction of “economics, international studies and sociology”, were awarded one grant each.

University-wise, the grant pattern shows that alongside a relatively big number of grants allocated to several leading universities, the competition organizers also supported a string of projects on creation of laboratories at regional universities that do not hold such status, such as Puschino State University, Udmurt State University, Bashkir State university. The group of leading universities comprised nine universities, each enjoying a certain status (an especially valuable object; research or federal university): MSU, SPSU, MFTU, SU-HSE, Sibir Federal University, Novosibirsk State University, Nizhegorodsky State University, LITMO, and Tomsk Polytechnic University.

After the competition results were made public, the research community found themselves engaged in a heated debate on to what extent the choice was fair. The evaluation process was arranged well - for the first time ever some 2/3 of experts engaged in the primary assessment of projects was represented by researchers from overseas¹. The evaluation stage resulted in picking 114 finalist projects, of which it was supposed to select 80 winners. That the Council for Grants under the RF Government, which has the final say on the matter, singled out only 40 winners and did not care to publicly substantiate the move sparked the most acid comments. In a situation when 13 applications rival for a grant (the actual level of the competition), indeed, the choice no longer can be made solely on the basis of assessment results –it already becomes political and in favor of projects that will be led by expat community representatives.

Legislative Changes Aimed at Attraction of Highly Qualified Specialists into Russia

Grant programs aside, the Government undertook other measures aimed at promotion of interaction with the expat community. More specifically, the Government introduced measures to facilitate foreign specialists' employment conditions in Russia.

The legal ground of the move became Federal Act of 19 May 2010 № 86-FZ “On introducing amendments to the Federal Act “On legal status of foreign citizens in Russian Federation promulgated on July 1 2010. The Act reads that work permits are now granted to foreign citizens who are highly qualified specialists for the term of up to 3 years, with a possibility of their repetitious extension. The said foreign citizens shall also be granted the RF resident tax regime, with their personal income tax rate being 13% (regardless of length of their stay in Russia). Meanwhile, the highly qualified specialist is construed by the law as a foreign citizen who has a professional background, operational skills or achievements in a given field of activity, should conditions of his attraction to labor activity in RF provide for his receiving a salary (labor compensation) in an amount of Rb. 2 mln. more over the period not exceeding one year. No doubt the new Act will be instrumental in the first place to those foreign citizens who will be awarded grants for creation of laboratories with universities, as well as to those who are planned to be attracted for contribution to the Skolkovo project. However, like a number of recently promulgated legislative acts, this one does not appear fully consistent with the already effective law and Codes in particular, either. Furthermore, it comprises equivocal formulations that engender legal collisions. Problems of this kind have already arisen, with the most obvious of them being the following ones:

¹ According to the RF Ministry of Education and Science, there were 600 foreign experts out of the total of 1,000 experts engaged in the evaluation process.

1. The amount of salary forms the only imperative criterion of identification of the invited specialist's qualification. In a number of other countries that likewise regulate attraction of qualified human resources, their national legislation emphasizes imperativeness of the presence of at least yet another criterion – namely, the period of service in the speciality, or a diploma on the speciality by whose profile the specialist is hired. Introduction of qualificatory characteristics of a highly qualified specialist increases prestige of a given category and forms a “filter” on the way of hiring those who in reality are not qualified employees.
2. The preferential employment and visa regimes do not concern highly-qualified specialists' family members of an able-bodied age. Russia cannot boast a great variety of kinds of visas, which is why employers of highly qualified specialists have to journey through all circles of bureaucratic hell in an attempt to obtain a visa and employment permit for a foreign citizen who is the highly qualified specialist's family member.
3. The 2m ruble-worth labor compensation is not linked to the calendar year, which might provoke an employer to abuse the contract (an early termination of the contract without paying the amount due in total). The monthly labor compensation would form a more efficient criterion than the “period not in excess of one year”.
4. The preferential tax regulation with respect to highly qualified specialists does appear vain in the event they are classified as non-residents, for tax treaties read they are bound to pay back taxes in the country of residence, notwithstanding their tax contributions in Russia. So, for a prospective specialist the tax benefit is not that important, and it per se results in the migration of funds from the RF budget to foreign countries' ones.

The above list is not exhaustive, as there exist a whole string of local and detailed challenges facing both employers and employees eager to benefit from the status of highly qualified specialist.

The government reacted to the challenges with a laudable speed by promulgating already on 23 December 2010 Federal Act №385-FZ “On introducing amendments to individual legislative acts of the Russian Federation”. The Act is aimed at remedying a number of the above problems.

First, the Act introduced the variative definition of the concept of highly qualified specialist, which is now recognized as a foreign citizen with a professional background, skills or achievements in a specific field of activity, should conditions of his attraction to labor activity in Russian Federation provide for his receiving a salary (labor compensation):

- 1) In an amount of no less than one million rubles a year on the basis of one year (365 calendar days) payable to highly qualified specialists who are researchers or faculty members in the event they are invited to carry out research or tuition activities by publicly accredited higher educational institutions, state academies of sciences or their regional subsidiaries, national research centers or public research centers;
- 2) Without regard to the amount of a salary – to foreign citizens participating in implementation of Skolkovo project, per the Federal Act “On innovation center “Skolkovo”;
- 3) In an amount of no less than two million rubles on the basis of one year (365 calendar days) – to other foreign citizens.

So, the Act classified Skolkovo and the research sphere into separate categories, which, fundamentally, is correct.

Second, the Federal Act establishes a more liberal and simpler procedure of issuance and a subsequent extension of working visas for the highly qualified specialist's family members.

In all likelihood, such a prompt fine-tuning of the normative and legal regulation can be explained by the government's keenness to complete the model projects – that is, the innovation town of Skolkovo and the megagrant program designated for inviting world's leading researchers to Russia.

5.5.3. Plans on Reforming the Public Scientific Sector

The principles and methodologies of the organizational reforming of scientific organizations under the federal agencies of executive power and state academies of science have been developed since 2008. In April 2009, the RF Government issued its Resolution of 08 April 2009 № 312 “On assessment of performance of research organizations conducting civic research, pilot-plans and technological works”. In compliance with the Resolution, the assessment should result in optimization of the research organizations network with a subsequent reallocation of volumes of budget appropriations for R&D for departmental research institutions.

Upon an inventory check, all such organizations should be classified into three categories: leaders, stable organizations, and institutions that have lost their research profile and development prospects. After that, there should be designed plans on solidification of leading positions of organizations of the 1st category, building of institutional development programs for organizations of the 2nd category, and design of proposals on reorganization or liquidation, and – in individual cases - on replacement of their heads – for organizations of the 3rd category.

Despite the standardized methodology approved by the RF Ministry of Education and Science, principal budget funds managers (ministries and the RAS) had the right to modify the standardized version of assessment criteria with account of the departmental organizations' profile. As a result, through 2010 agencies have been designing their own performance assessment methodologies¹, and the inventory check should kick off only in 2011. According to the RF Government's plans, conduct of a comprehensive research audit on public organizations should be implemented no later than in 2012². It was only institutions under Rosatom that were able to avoid the comprehensive inventory check, as from the perspective of its legal status, Rosatom is an incorporated entity, rather than a public agency, and as such, it defended the right to deal with subordinated institutions on its own.

In all likelihood, the conduct of the above audit would procrastinate the reform process in a given sector, for, as proved by the past record, no post-Soviet interdepartmental reform attempts have ever yielded serious positive consequences.

Methodologies designed by different agencies practically replicate the standardized one and, accordingly, bear the legacy of all its problem criteria and indicators. Thus, a great attention is paid to the performance assessment on the basis of citation indexes and impact factors. Meanwhile, it is suggested to employ both the Russian Research Citation Index (RRCI), which is still under development and object of harsh criticism, and the Web of Science database. The excessive pursuit of citation indices is dangerous, as their main mission is to assess

¹ Thus, the RF Ministry of Education and Science approved the standardized methodology with Executive Order of 14.10.2009 № 406, while, for example, Rosobrnadzor approved its own methodology with Executive Order of 25.06. 2010 №1756, and the RF Ministry of Health Care and Social Development did that with Executive Order of 26.08. 2010 № 738n.

² Porjekt strategii innovatsionnogo razvitiya RF na period do 2020 g. materials of the RF ministry of Economic Development. Section VI “Efficient science” (September 2010).

ongoing changes across various directions of research on the basis of mapping the science's development trends, rather than to evaluate research teams and institutions' performance. While assessing smaller objects, such as institutions, along a short time interval (according to the aforementioned Resolution, reports should cover the preceding five years), there appear numerous biases. An article is cited not only because it is important and instrumental, but because a certain theory or direction of research might have grown fashionable at the moment. There also exist such problems as self-citation, negative citation, citing colleagues and seniors. There exist statistical methods that allow cleaning databases from such "inaccuracies", but it is highly unlikely there will be anyone in each reporting institution to take care of that. The methodology also features a clear predominance of quantitative indicators (machinery and equipment in value equivalent, the number of established start-ups, the number and proportion of researchers).

The issue of reform has garnered attention particularly because of a long-standing conflict between the RF Ministry of Education and Science and RAS. Meanwhile, the critical outcome of the exercise should become reform of the survived (albeit rapidly shrinking in terms of the number of both institutions and researchers) departmental science. Public departmental research institutions, including the MIC ones, employ 2/3 of all the domestic researchers.

5.5.4. Businesses' Innovation Activity

According to Goskomstat, over the past 6–7 years the group of innovatively active corporations comprised 9–11% of industrial corporations included in a sample of research into the state of innovation activities. According to the 2009 data of the Center for science research and statistics, the proportion of the said corporations declined to 7.7%. Meanwhile, against this background, their spending on innovation activities, including the proportion of R&D expenses, rose slightly (*Table 18*).

Table 18

Main Indicators of Innovation Activities by Organizations of the Industrial Sector and the Services Sphere

Year	The number of innovatively active organizations	Spending on technological innovations, as Rb. mln	Of which, as % to the aggregate volume of costs:	
			On R&D	On purchases of equipment and machinery
2006	2830	211392.7	17.8	55.4
2007	2828	234057.7	16.5	58.5
2008	2908	307186.9	14.1	59.0
2009	n/a	399122.0	24.9	51.0

Sources: Nauka Rossii v tsifrakh: 2009. Statistichesky sbornik. M.: TSISN, 2009, Table. 8.1; Nauka Rossii v tsifrakh: 2010. Statistichesky sbornik. M.: TSISN, 2010, Table 8.1 (in press).

At the same time, various surveys on innovation activity in the industrial sector post far more optimistic figures, including corporate spending on R&D.

More specifically, a May 2010 survey on 100 large Russian corporations¹ showed that a half of them spend on R&D between 3 and 10% of earnings, while another one-third – less than 3% of earnings. At the same time, there were 4 times as many private innovatively active

¹ Understood as corporations with no less than USD 100m in annual earnings (Source: Innovation by Large Companies in Russia. Mechanisms, Barriers, Perspectives. M.: RUSNANO, Russian venture Company, New Economic School, PriceWaterhouseCoopers, 2010).

companies as public ones. For reference: according to OECD data, the large companies' average volume of spending on R&D accounts for 5% of earnings¹. However, around one-third of Russian respondents noted that their innovations were groundbreaking only to their companies.

Another survey the "Expert" media holding ran on 33 large corporations in 2010 complemented the picture and showed that practically all the large companies' innovative projects focused on the domestic market. Quite notably, while implementing R&D projects, many of them continue using resources of the former departmental research institutions, rather than centering on bolstering cooperation with small-sized start-ups².

So, the major challenge is corporations' insufficient innovation activity from the perspective of both volumes and quality of R&D they implement or commission. The bulk of innovations appear imitations, with genuinely pathbreaking ones being noted on the local level. One of main causes behind such a situation is an insufficient level of competition and monopolistic position of many Russian corporations. Besides, the so-called administrative resource is still very strong and its use allows some companies, particularly large public ones, to take various economic advantages (lower tariffs, preferential interest rates, etc.).

At the same time, there is no demand for innovations, either. It is the middle class that forms their major consumer, but it is small in Russia. Some other economic reasons, albeit of a more specific nature, matter too. These are: an insufficient level of intellectual property protection, customs barriers, certification and technical regulation problems, among others. Finally, a whole set of challenges lie in the human resources field (the poor corporate "culture of innovation", a small number of staff focused on development of innovations and an insufficient number of managers capable of efficiently implementing innovative projects).

A specific segment of the business sector is formed by small-sized start-ups. Their qualitative growth dynamic has long been negative. While in 2004 there were 22,500 start-ups in Russia, by 2009 the figure plummeted to 12,900, with their employees combined accounting for a meager 0.65% of the employed in the SME sector³. Small-sized start-ups are loosely connected to medium-sized and large firms. Many of them are research organizations and universities' spin-offs, but their ties to the mother organizations in many instances are unstable.

The rise of development institutions limelighted the catastrophic scarcity of small-sized companies at the "seeding" stage whose projects could be backed by venture financing. Mr. I.M. Bortnik, Chairman of the Board of the Foundation for support of development of small forms of enterprises in the scientific –technical sphere, holds that in order to hit the level of 1,000 venture deals a year, Russia "should support at least 10,000 start-ups to energize the venture industry"⁴, while today the country sees only some 2,000 start-ups emerge annually.

¹ Innovation in Firms. Microeconomic perspective. OECD, 2009.

² Krupnyi biznes: kak stimulirovat innovatsionnyu aktivnost. Analiticheskiye materialy. M.: Media-holding "Expert", 2010, p. 7.

³ Tormysheva T.A. Osnovnye problem, prepyatatstvuyuschiye sozdaniyu malykh innovatsionnykh kompaniy v vyzakh//Innovatsii i investitsii dlya modernizatsii i tekhnologicheskogo perevooruzheniya ekonomiki Rossii. Sb. Materialov. FGU NII RINKTSE, NP "Innovatika", 2010. P.61.

⁴ Ne poseesh- nepozhnesht//Nauka i tekhnologii Rossii. 02.11.2010. – URL: [http://strf.ru/material.aspx? CatalogId=223&d_no=34744](http://strf.ru/material.aspx?CatalogId=223&d_no=34744) Date of access: 07.02.2011.

5.5.5. Government Taking on Encouragement of Corporate Innovation Activity

To give fillip to public companies' innovation activities, in 2010 the Government decided to impose two "compelling" measures:

- The obligation to form corporate innovation development programs following requirements approved by the Government; such programs should be adopted together, rather than within, investment programs;
- A "standard" proportion of spending on R&D to be set individually for each company, proceeding from its sectoral specialization and its comparison with peers overseas.

The Government compiled a list of 55 largest public companies (including RZHD, Gazprom, FSK "UES", OAK, Rostekhnologii)¹, which were suggested to design innovation development plans. It is planned to consider development plans by some 30 such companies in early 2011. The purpose of the exercise is to give boost to their innovative activities, bolster demand for innovations particularly by means of a significant "extension of introduction by companies of findings of outsider R&D carried out in the domestic sector for generation of knowledge and higher education, as well as the use of cutting-edge technologies, products and services developed by small- and medium-sized innovative enterprises"². So, as far as public corporations are concerned, an attempt is made to link them with scientific organizations and to increase outsourcing, which, in contrast to worldwide practices, so far has been very moderate.

As in many other recent governmental projects, a particular emphasis is likewise made on cooperation between corporations and universities. It is envisaged that corporations would select *backbone universities and research organizations* to run joint research and technological works, form, in tandem with *universities*, research programs, mechanisms of exchange with research and technical, and marketing information, and the composition of works on forecasting research and technical development. Lastly, corporations should team up with *universities* to kick off implementation of programs on increase of the quality of education and staff training for hi-tech sectors.

As concerns private companies, which are harder to "force" to develop and use innovations, the Government provides for other measures, a fraction of which appears important for encouraging innovation in the business sector as a whole, nonetheless, regardless of corporations' property forms.

Private companies may bid for budget funding on R&D carried out in cooperation with universities; new tax incentive measures are going to be introduced for them; as well, it is planned to intensify the work on introduction of technical regulations and standards. At present the technical regulations and standards establish mandatory requirements only to 36.7% of products subject to the mandatory certification in the RF territory³. Meanwhile, penalties for breaching the said technical regulations and standards prove to be lenient and pose no challenge even to robust small-sized firms, let alone large corporations. The work on revision

¹ WebGround. Poyekt monitoring Runeta. – URL: <http://webground.su/topic/2010/08/03/t375/>. Date of access: 07.02.2011.

² Klepach A.N. O razrabotke program innovatsionnogo razvitiya kompaniy s gosudarstvennym uchastiyem. Presentation of 03.08.2010 г. www.economy.gov.ru. Date of access: 07.02.2011.

³ Krupny biznes: kak stimulirovat innovatsionnyu aktivnost. Analiticheskiye materialy. M.: media-holding "Expert", 2010. P. 14.

of the technical regulations and standards in 2010 was given a posh name of “creation of ‘technological corridors’” wherein technical regulation forms an element of a complex of measures, which comprises both stimulating and restricting ones. More specifically, along with harmonization of the regulations and standards according to international standards (the EU’s ones in the first place), which should make enterprises take more vigorously upon innovations, the Government will be funding their innovative projects. According to data as of the late 2011, the selection of projects has begun, and its main criterion is to make sure that upon implementation of the projects in question by 2015, enterprises will have been able to hit the sales volume of Rb. 15 bln.

Finally, the RF Ministry of Economic Development provides for private companies the possibility of introduction of the so-called “contract with the state”. Under such a contract, the state assumes obligations to back corporations’ interests on external markets (eg to lobby raising of customs duties on importation of rival equipment) in exchange for intensification of their innovative activities¹.

Support and encouragement of innovative activities were also delivered through development institutions – Rosnano and the Russian venture company (RVC), in particular. So far these institutions to a certain degree have duplicated each other’s operations by developing and introducing similar concepts and arrangements, albeit in different sectoral segments. If improved, their coordination might ensure a new quality of the development of the national innovation support system. So far the “innovation lift” cited in various official documents and presentations has been practically idle, while new high-risk projects have spontaneously found support amid various structures operating in Russia.

As of 12 January 2011, Rosnano had approved 92 production projects and 7 infrastructural ones. Plus, the corporation funds another 31 educational projects and co-funds a number of projects on creation of investment funds (including Skolkovo). It is too premature to judge Rosnano’s performance, as the projects are at an early stage of implementation. Experts voice contrast opinions on the prospective viability of the selected production projects, and many of them criticize them. That said, Rosnano actually became the first institution that introduced a mandatory procedure of international project evaluation and experts selection procedures with account of their past record.

Rosnano’s project on establishment of nanotechnological centers seems promising, for such centers should radically differ from what used to emerge in the form of techno parks, innovation-technological centers and other suchlike infrastructural objects. The peculiarity of nanotechnological centers lies in concentration in the same spot of technological equipment and competencies on incubation of small-sized start ups (marketing, administrative, and information support). Substantial funding will be made available for creation of such centers, including earmarking for equipment purchases. The support will be extended over next 3-5 years. So, the concept for nanocenters has taken into account past mistakes (short-term funding, its small volumes, an absence of such expenditure items as costs of infrastructure and new equipment). It is planned that by 2015 there will have been as many as 12-15 such centers in Russia. By early 2011 seven centers had already been selected on the basis of competition. RVC establishes analogous structures, too. Thus, the Biopharmaceutical Cluster Fund

¹ Presentation by O. Fomichev, Director of the Department of Strategic Management and Budgeting of the RF Ministry of Economic Development, as the plenary session “Large business and innovation” at the “Russian innovations” forum. Moscow. 27.05.2010.

created in 2010 under RVC will not only invest in biotechnological start-ups, but in the cluster's service companies as well. Given that there are just a handful of service and intermediary companies in Russia, such an approach seems very promising.

RVC's mission is two-fold: the company runs a contest-based selection of venture managing companies and acquires shares in venture funds these companies establish in the form of closed-end mutual investment funds. The initial expectations of RVC's performance were fairly high - it was envisaged that already in 2007 RVC would contribute to establishment of 8-12 new venture funds with the aggregate capital of some Rb. 30 bln. Those venture fund were supposed to be investing in companies at their early stage of development. According to the data as of early 2011, as many as 10 venture funds with the aggregate capital of a. Rb. 22 bln. had de facto been created. For reference: venture funds located in Silicon Valley outnumbered 300¹.

A major challenge, however, does not lie with the fact that the number of operating funds have failed to match the initially planned figure, but with their performance – the existing venture funds so far have funded only 35 innovation companies. By late 2010 the Seed Investment Fund had approved 20 projects², of which 8 ones fall under medicine and pharmaceuticals. This is an encouraging indicator, as until recently expenditures associated with improvement of the population's health and quality of life were relatively modest (and substantially inferior to traditional technocratic and production priorities).

Behind low operational performance indicators of the venture funds created by RVC were the same causes as those underpinning problems associated with development of small-sized innovation entrepreneurship. These are: an absence of potentially commercialized projects, the lack of qualified managers, a practical absence of business angels and, finally, problems associated with projects appraisal. While Russia has experts capable of running an adequate scientific and technological evaluation, the situation with business experts is catastrophic.

In the light of this, international aspects of the RVC's operations deserve a particular attention. In 2010, RVC established two funds in foreign jurisdictions, which implies access to the international market for technologies and new venture business practices, which domestic managers needs to master.

In 2010, the Government embarked upon yet another new direction of improvement of the development institutions' performance and, at the same time, of bolstering the interaction between all the participants in the innovation system – that is, formation of technological platforms. Originally, they were understood as forums for discussions on critical projects and shaping of demand for them. Consequently, however, the concept evolved to imply a group of technologies which should advance with account of those sectors upon which the developed technologies will exert their influence. That said, creation of technological platforms should bolster hi-tech exports, an influx of private investment, and give rise to new hi-tech companies. Accordingly, businesses are to play practically a pivotal role in such platforms; the Government assumes that they should form no less than a half of their participants. In the meantime the Government also forges approaches to bundling the technological platform instrument with measures on “forcing” businesses to innovations (that concerns, primarily,

¹ Shekhovtsov M. *Venchurnye fondy Rossii – pervye shagi i pervye itogi*//Novaya ekonomika. Innovatsionny portret Rossii. M.: Tsent strategicheskogo partnerstva, 2009. P. 195.

² Investitsionny portfel Fonda posevnykh investitsiy RVK//Rossiyskaya venchurnaya kompaniya. The data as of 17 January 2011. –URL: <http://www.rusventure.ru/ru/investments/fpi/portfolio.php> Date of access: 07.02.2011.

large public companies – through the compulsory practice of their designing innovation development plans). Private businesses so far have treated the new initiative with caution – a typical record of their contribution to projects initiated by the Government proved negative; plus, they fear disclosures of confidential information in the process of coordination in the frame of technological platforms¹.

The RF Ministry of Economic Development in tandem with the RF Ministry of Education and Science collected 140 applications for projects on implementation of technological platforms. By February 2011 a list of 10-20 state-sponsored platforms will have been built. One of the problems is that there is no vision as to which directions of development of technologies should form priorities for building such platforms: whether they should lie exclusively in the frame of the five “technological breakthrough” directions, or one should not limit himself with the officially set governmental priorities.

6.5.6. Support of Small-Sized Start-ups

Regulation of establishment of small-sized start-ups

The unfolding of development institutions, Rosnano and RVC among them, compelled the Government to focus more on problems in the area of support of small-sized start-ups. At the end of the day, it became obvious there were very few projects qualifying for the seed and venture financing, the old R&D potential practically exhausted, while a new one was emerging in an insufficient volume. Accordingly, ensuring emergence of new projects to be implemented by small-sized firms necessitates new incentives.

In August 2009, new Federal Act of 02 August 2009 № 217-FZ “On introducing amendments to individual legislative acts of Russian Federation on matters of establishment by budget scientific and educational institutions of economic companies for the purposes of practical implementation (introduction) of results of intellectual activity” came into effect. In compliance with the Act, budget research institutions, including the ones in the system of public academies of science, as well as universities that constitute budget institutions, may become, on a notification basis, founders of economic companies established for the sake of commercialization of intellectual activity results. The Act reads that the said institutions can transfer *rights* to their intellectual property objects as a contribution to the small-sized firms’ authorized capital.

One year after the promulgation of the Act in question, it is clear the small-sized entrepreneurship has displayed a certain progress; however, there are notable challenges associated with the Act per se, its interpretation by bureaucrats, research organizations and universities, as well as with objective limitations to its enforcement.

The main legal challenges are as follows: first, it is just rights to use intellectual property objects, rather than exclusive rights to them, that are transferred to newly founded small-sized start-ups’ authorized capital. Where budget institutions contribute with one and the same non-exclusive license to several new small-sized start-ups, such firms have low chances to survive.

¹ Tekhnologichskiye platformy kak instrument modernizatsii ekonomiki//Nauka i tekhnologii Rossii. 16.11.2010. – URL: http://www.strf.ru/material.aspx?d_no=34973&CatalogId=34910&print=1. Date of access: 07.02.2011.

Second, in compliance with the Act, the budget institutions' share should make up no less than 25% in a joint-stock company and at least one-third in a limited liability company. This constrains advancement of partnerships between research institutes and universities with regard to establishment of a small-sized start-up, as at such a juncture each investor's share would plunge under 50% - the development any investor is unlikely to hail. Plus, this provision forms a serious hurdle to the small-sized start-up's development, for in the course of the second and subsequent rounds of funding, the budget institution's share shall not diminish (and that would block investment). Meanwhile, there is no mechanism of reassessment of already transferred by budget institutions and universities licenses. That is why to implement investment-intensive projects a small-sized start-up is left with a sole option at hand – that is, to resort to loans, which is a real albatross for a company of this size.

Third, the Act reads that research organizations and universities may contribute to the authorized capital with the right to use intellectual property results without the property owner's consent. However, in compliance with the Budget Code, budget institutions (bar autonomous ones) may not control property on their own and without the property owner's consent. The collision is set to be eliminated in 2011, after coming into effect of Federal Act of 08 May 2010 № 83-FZ "On introducing amendments to individual legislative acts of Russian Federation due to improvement of the legal status of public (and municipal) budget institutions".

Fourth, the budget institution may not sell its stock (shares) without its owner's consent. Enacted since 1 January 2011, Federal Act № 83-FZ grants budget institutions the right to exercise profit-making activities according to their statutory documents, while incomes resulting from such activities and assets acquired at the expense of the said incomes are subject to the budget institution's control.

Fifth, incomes research institutions and universities derive from their participation in a newly established small-sized company's operations can be spent not only on operations associated with commercialization of intellectual activity results, but on any of research institution or university's statutory activity. In other words, such incomes can be spent on purposes other than innovation development, which forms an incentive for management of such organizations to create small-sized companies, rather than to develop incentives for the rise of small-sized start-ups.

There also exists string of other challenges that are not associated with the legislation. More specifically, the acute cadres hunger is still there, so far as technology transfer procedures are concerned: not just specialists in this field, but even respective divisions at research institutes and universities appear missing. Meanwhile, it is critical that the law with regard to creation and improvement of operational environment for small-sized start-ups is making a pretty dynamic progress.

That said, a serious complication is that the objective of enactment of Federal Act № 217 has undergone a certain transformation. Originally, the Act was supposed to boost the process of commercialization of intellectual activity results; however, it was consequently construed as a necessity for universities to establish small-sized companies and report on their performance. In this regard, all credit should go to the Ministry of Education and Science which started measuring the budget institutions' research and educational performance by using the number of newly created small-sized start-ups as a key indicator. That many such companies are founded for the sake of reporting, rather than for an actual realization of intellectual activity results can be proved by data on the value of intellectual property introduced as a contribution to the small-sized firm's authorized capital. As of November 2010, it accounted for under

Rb. 20,000 at 72.2% of such firms¹, which makes it impossible to launch commercialization, but pretty easy to find and attract, as per the law, an external investor that has the right to introduce his share into the statutory capital solely in the cash form.

Having construed the Act in this vein, universities began to fairly vigorously found small-sized forms, with their contributions to such companies' authorized capital largely being data bases and software. Meanwhile, companies established at the expense of the transfer of a patent and instrumental models account for just a. 10%².

As of early-January 2010, out of 364 universities under the Rosobrazovaniye, 33 ones founded 116 economic companies with 881 jobs³. As of 4 November 2010, there already were 591 such companies, which is way below the planned indicators set by the RF Ministry of Education and Science, which had suggested that as of late-2009 there should have been 121 universities engaged in operations of 929 small-sized firms with 11,485 employees⁴. According to the Ministry, as many as 70-80% of small-sized firms established under research institutes and universities functions actively⁵, ie the Ministry's estimates appear more optimistic than the expert community's ones.

New measures of support of small-sized firms created under universities

Encouraged by the enactment of Federal Act № 217, creation of small-sized firms formed just the first step – to grow and develop, small-sized forms need to have an access to funding. That is why the Government designed and implemented mechanisms of support of small-sized firms created by universities and measures aimed at intensification of ties between the university research and business on the whole.

The first measure implies a competition-based allocation of subsidies to universities on creation of innovation infrastructure. As many as 56 universities became winners of the 2010 competition, including 5 federal, and 20 national research universities⁶. They launched projects on support of three-year long programs of support of incubators, techno parks, legal protection of intellectual property objects, and advanced training programs on innovation activities for their staff.

Such a program is very timely, indeed. In practice, when it comes to even Basic innovation activity 101, the staff of technology transfer centers under Russian universities appear new kids on the block. Thus, for example, a 2010 evaluation of results of trainings in the field of technical entrepreneurship held by the US-based CRDF Global Foundation, showed that 90% of technology transfer centers staff who took part in the workshop found 90% of inputs fundamentally new to them, while the courses taught were basic ones and covered such issues as

¹ Data of JSC "Tsentri aktsionirovaniya innovatsionnykh razrabotok".

² Muravyeva M. Bez otkrytoy vuzovskoy statistiki uvazhaemykh reytingov u nas ne budet// Nauka i tekhnologii Rossii. 20 January 2011. - URL: http://strf.ru/material.aspx?CatalogId=221&d_no=36411. Date of access: 07.02.2011.

³ Innovatsii v vuzakh: vyalotekuschiy rezhim// Nauka i tekhnologii Rossii. 18 January 2010. – URL: http://www.strf.ru/material.aspx?d_no=26759&CatalogId=223&print=1. Date of access: 07.02.2011.

⁴ Source: Dyachenko O.G. O prakticheskoy realizatsii Federalnogo zakona ot 02.08.2009 r. № 217-ФЗ. A presentation delivered at a workshop on technological entrepreneurship. SFU, 15 October 2010.

⁵ Rekomendatsii "kruglogo stola" na temu "Zakonodatelnoye obespecheniye protsessu inegratsii obrazovaniya, nauki i naukoemkogo proizvodstva kak klyuchevogo faktora innovatsionnogo razvitiya Rossiyskoy Federatsii". M.: Sovet Federatsii, 23.11.2010. P. 6.

⁶ 26 milliardov raspredelili po vuzam I kompaniyam// Nauka i tekhnologii Rossii. - URL: http://strf.ru/organizatsion.aspx?CatalogId=221&d_no=34073. Date of access: 07.02.2011

appraisal of intellectual property, the concept of venture capital, drafting business plans, development of network interactions, market entry technique and strategies, and interaction with investors and business angels. After the workshops, 73% of participants contemplated the imperative of developing a market entry strategy, 68% - perused where potential sources of financing could be found, and 64% - meditated over the need to develop new market entry strategies¹. All this is yet another proof of the fact that prior to participation in the workshops the staff at the technology transfer centers had not ever tried such activities, not had they given a thought to the need for running some kinds of operations in relation to commercialization of R&D outputs.

The focus of the second governmental measure was on supporting universities partnerships with economic companies through allocation to the latter of subsidies. That was supposed to encourage universities to carry out R&D for the corporate sector. To this end, up to Rb. 100 mln. in federal grants is allocated annually on the competition basis to corporations that team up with universities, provided 100% corporate co-funding. As many as 112 projects submitted by 107 corporations and 99 universities became victors in the competition, with practically all the research universities (25 out of the total of 29) and the federal universities (6 out of 7) being among them. The group of leading universities that were granted the biggest volume of funding comprised MSU, MFTI, the Siberian Federal University, and LETI. Considering a university's size, small universities (MFTI and LETI) deserve a particular praise.

While the initiative is very green, it quickly became evident it was not thought through well enough. The participant corporations faced tax challenges, as they found themselves bound to pay the corporate profit tax on the grants they had received from the budget and transferred to universities to carry out R&D works. Meanwhile, the universities, in their turn, notwithstanding the funds were allocated from partner corporations and not from the budget, had to follow provisions of Federal Act №94-FZ on public procurements, nonetheless. As a result, a number of corporate winners in the competition refused to partake in the project.

5.5.7. The Skolkovo Project as a Mini Model of the Innovation System

A new Government's project known as Skolkovo can be considered a future local model of a "perfect" innovation system. The RF President announced the start of its implementation in February 2010, and since then the work on the project has gained an unprecedented momentum. From its very onset the project was a state-run one, and this manifests itself in many aspects - from approaches to selection of its location to highest public officials monitoring constantly and closely progress in project implementation.

Originally, it was announced that the location for the innovation city would be selected using such criteria as developed infrastructure and its accessibility². That is why centers qualifying for the criteria (Tomsk, Novosibirsk, St. Petersburg, Obninsk, Dubna, Zelenograd, among others) were ready to compete for the status of "innocity". But later at the level of the RF Government Skolkovo was picked, and it is a location that does not quite fit the criteria.

Apparently, there were two alternative approaches to the problem. The first approach implied building the innocity from scratch, so that it would bear no signs of legacy of the past

¹ CRDF Technology Commercialization Practicum. Vladivostok, RF, May 25-27, 2010. End-of-Practicum Evaluation. CRDF Global, June 2010. P. 12.

² Dmitry Medvedev provel soveschaniye po voprosu sozdaniya sovremennogo tsentra issledovaniy//The Administration of the RF President. – URL: <http://news.kremlin.ru/news/7061> . Date of access: 07.02.2011.

whatsoever. The other approach was to erect it on the basis of one of the already existing technopolises or science campuses wherein investments had already been made in development of the innovation infrastructure and just a minimum additional construction was required. In the former case, the main reasoning is that in Russia, it is simpler to build something anew, rather than to change the mentality that was shaped for decades. In the alternative case, it was regions that have recently witnessed a substantial influx of investment in their innovation infrastructure, such as technical and engineering zones (Zelenograd, Dubna, St. Petersburg, Tomsk), that should have looked more attractive. Plus, the said complexes appear most akin conceptually to the innovation city concept.

That the ultimate choice was made in favor of a new spot casts doubt upon effectiveness of all previous governmental initiatives in the area of building innovation infrastructure. It is common knowledge that in the early 2000s the Government emphasized development of technopolises, with respective concepts and methodologies being developed with attraction of EU experts in particular. Then the funding was axed, and technopolises no longer were a priority. In 2006, the Government announced the start of a new infrastructural project – namely, building special economic zones (SEZ), including technical-engineering ones (TEZ). Presently, as many as four SEZ-TEZ have been established, albeit their performance has been low. Some other SEZ-TEZ have just begun developing, because of substantial delays with land development and infrastructure construction processes. What is known today of such zones is just the dynamic of the number of their residents, their investment and production volumes, and the number of jobs created therein. At the same time, residents do not have to physically reside in the zones – their residents are corporations that were registered in a zone and assumed obligations to invest in construction and implementation of science-intensive projects.

Over the 9 months of 2010 SEZ-TEZ became home to 26 new residents, but not so many of them started implementing investment projects. The TEZs' most general parameters as of 1 October 2010 are presented in *Table 19*. The data therein allows assertion that it is the Zelenograd zone that posts the record-breaking growth rates from the perspective of production volumes and the number of created jobs. Meanwhile, Dubna and Tomsk run neck-by-neck in terms of characteristics of the output volume per resident, and they both fall behind Zelenograd in this respect. As for the St. Petersburg zone, it is likely to have not started operating at a full capacity as yet. But it is hard to realize what lies behind the figures, what an actual situation in the TEZs is, what challenges they face and how they cope with them, for there is no information even on such generalized parameters as the nature of their output, the level of its novelty, main sales markets, etc.

Table 19

Comparative Characteristics of Technical-Engineering Zones

Location	Area, as hectares	Number of residents	Residents' investment record through the whole zone's life, as Rb. mln.	Volume of residents' output, as Rb. mln.	Jobs created
St. Petersburg	129.4	36	148.0	–	–
Moscow (Zelenograd)	147.0	35	557.0	3 206.0	789
Moscow oblast (Dubna))	188.0	65	693.0	464.0	380
Tomsk	207.0	50	2 559.0	396.56	517

Source: Data of the RF ministry of Economic Development. Information as of 01.12.2010.

Skolkovo de facto emerged as substitute for the SEZ project, though in the event a SEZ could be considered one of vehicles for commercialization of Skolkovo's projects, both infrastructural projects might be considered interlaced. Skolkovo has already proved it made up a far more successful project compared with any SEZ. Thus, coordination of matters of land allocation, construction, selection of operational avenues has been completed at an incomparably greater speed. The financial resources that shall be allocated from the federal budget should also be unprecedentedly huge for an innovation infrastructure project: between 2010-2014 they should amount to Rb. 85.5 bln., including 9.5 bln. in 2010 alone¹.

Already in the late-September 2010, Federal Act of 28.09.2010 № 244-FZ "On innovation center "Skolkovo" was enacted. It comprises a number of measures aimed at generation of favorable conditions of life and work in the new innovative city. More specifically, Skolkovo will be granted the following benefits and preferences:

- 1) Tax breaks for companies operating in Skolkovo: ten-year holidays with regard to the corporate profit tax, land and property taxes, a beneficial rate on mandatory insurance contributions (14% instead of 34%); the right of choice with regard to VAT payments for companies carrying out innovative activities in the territory of the zone, customs benefits;
- 2) Simplified technical regulation procedures;
- 3) Simplified procedures of the transfer of land from one category into another;
- 4) Special sanitary procedures and fire safety rules;
- 5) Relaxed conditions of interaction with authorities, particularly thanks to formation of special divisions of the federal authorities, such as the Ministry of Interior, the Federal Immigration Service, the Federal Tax Service, the Federal Customs Service, among others.

Skolkovo is an open project, i.e. it is supposed to be expanding in the course of its implementation. Furthermore, even its objectives and parameters should transform, too². The project, indeed, has been evolving rapidly even in its conceptual part. The today's information suggests Skolkovo should be formed by four components:

- A backbone university;
- Research centers;
- Large companies' representative offices, which will tie up business and science, and start-ups;
- Infrastructural environment.

It is planned to organize research centers across five "technological breakthrough", or cluster, avenues to have, at least, two centers for each avenue³, with their major objective being support of commercialization of R&D outputs.

One of Skolkovo's cornerstone should become a technical university. It is planned to build it on the model of (and with contribution by) MIT. At this point, the developments appear controversial. According to the Russian project executives, the signing of the contract with MIT is to take place in the spring of 2011. The contract provides for establishment of a new

¹ Innograd oboydetsya gosudarstvu v 85,5 milliarda rubley// Nauka i tekhnologii Rossii. 15 October 2010. http://strf.ru/organization.aspx?CatalogId=221&d_no=34294 . Date of access: 07.02.2011.

² As asserted by the project executives. See, for instance: Yakubovich V. Sovety konsultanta: Bez prava na oshibku//Vedomosti. №210, 09.11.2010; Vaganov A. Izobretat nelzya zaimsnvovat//Nezavisimaya gazeta. 10.11. 2010. P. 11.

³ The RF President's meeting with Viktor Vekselberg//Administration of the RF President. 13.05.2010 - URL: <http://news.kremlin.ru/news/7743> . Date of access: 07.02.2011.

technological university with no BA training, but MA and postgraduate ones only¹. The Government's plans suggest that the first enrollment should take place in 2014.

Meanwhile, the MIT staff believe that the problem of the degree of their engagement in Skolkovo has not been finally sorted out as yet. The US side argues that the RF Government's refusal to establish a full-fledged university is a mistake and the concept for the new university is reminiscent of the Russian/Soviet-style research institutes. That suggests that tuition of future BAs would be carried out using the old "templates", and they would consequently be re-trained to earn a modern MA. As well, such cooperation cannot be fruitful, unless the MIT faculty and leading researchers succeed in finding Russian counterparts to develop joint scientific projects. So far such an intermutual process has been spotted on the peer-to-peer level, ie between researchers and faculty members, rather than on the executive one².

This is particularly alarming, as the cornerstone of the concept of innocity is getting stake of the overseas expertise in practically all the project's components. The Government admitted the nation was incapable to create a fundamentally new innovation city on its own, which is why an intense process of attraction of foreign organizations and individual experts is underway. Whilst the use of foreign expertise is a pivotal condition, it is important to bear in mind that it takes decades for a harmonious innovation ecosystem to unfold. In this respect, it is worth referencing to MIT as a model vehicle for arranging ties between science and industry: it took the Institute some 25 years to master the art of nurturing start-ups.

The main hopes associated with implanting overseas experiences lie with Skolkovo emerging as a center of expanding networks and horizontal ties, including social networks, and giving rise to a new culture of scientific, production and innovative activities. Meanwhile, one of the gravest concerns is that Skolkovo may mutate into an intellectual outsourcing center: in such circumstances Russia once again would be selling R&D outputs, with Western companies marketing them overseas, as the innovation environment and the domestic market for innovative products in the country have remained nascent.

It is envisaged that the project should start paying off no later than in 2015. Indeed, building a whole city from scratch takes quite a time. Hence, a logical question as to a possibility for the kick-off of implementation of innovation projects before the infrastructure is complete, ie. in the "virtual" mode. Pres. Medvedev first rejected the approach as he was afraid that under the Center's signage "there will be functioning a whole lot of structures not at all associated with it"³. Later, however, it was decided that it would make sense to start funding projects (with all the benefits due) located beyond the future city's boundaries. The process of selection of recipient projects started after adoption of the Skolkovo's Mandate⁴.

¹ Innovatsii i chastno-gosudarstvennoye partnerstvo. A presentation by O. Alexeev, Vice President and Chief Managing Director for education and research of the Skolkovo Foundation at the workshop "Developing higher education and research in Russia and the Netherlands". Moscow, the Mission of the European Commission to Russia. 24 November 2010.

² Source: the author's private correspondence with the MIT participants in the discussion on Skolkovo. The data as of 25 November 2010.

³ The RF President's meeting with Viktor Vekselberg//Administration of the RF President. 13.05.2010 - URL: <http://news.kremlin.ru/news/7743> . Date of access: 07.02.2011

⁴ The Mandate of the Foundation for the Development of the Center of Development and Commercialization of High Technologies (Skolkovo Foundation) "as approved at the meeting of the Council of the Foundation for the Development of the Center of Development and Commercialization of High Technologies (Skolkovo Foundation)" and enacted on 28 October 2010. – URL: <http://www.i-gorod.com/en/newslit/201011001-mand/>. Exraction date: 07.02.2011.

Accordingly, leading Russian universities, research centers and foundations expressed their interest in contribution to projects under the Skolkovo's aegis and started signing bilateral memoranda on cooperation with the Foundation for the Development of the Center of Development and Commercialization of High Technologies (Skolkovo Foundation). The list of university signatories comprises MSU, SPSU, Novosibirsk and Kazan state universities, the Bauman MGTU, MFTI, and SU-HSE¹. It is planned that since 2011 the leading Russian universities will be entering into joint projects with their foreign counterparts on building laboratories whose operations will be funded by Skolkovo Foundation's grants. Presently, as many as 20 such grants are envisaged to be awarded. The initiative appears to a certain extent similar to the RF Ministry of Education and Science's megagrant project.

As concerns research organizations, it is Russian Research Center "Kurchatov Institute" that became a major partner to Skolkovo. The RRC should contribute with its research and technological base located in the only national center for nano-, bio-, information and cognitive sciences and technologies².

As of early 2011, the Skolkovo Foundation had registered 16 research centers and institutes that became participants in the project. It is suggested that most projects should be oriented towards technology export³. That, on the one hand, proves some experts' concerns that an absence of the domestic market for innovative products would entail an outflow of new technologies. On the other hand, export of technologies means an increase of competitiveness of Russian hi-tech developments and, to a certain extent, a turn to a "positive" trend, for so far Russian technological imports are far greater than exports.

Despite great expectations, the process of development of the innocity once again exposed problematic aspects of the governmental innovation policy. Those are, first, the selected approaches falling behind the global trends of innovation systems' development. Thus, the concept of building a "closed", in many respects, city and a clearly visible in the Skolkovo's Mandate linear model of innovation process (from R&D towards development) is at odds with the contemporary logic of innovation-based development. Nowadays, it is increasingly seldom a case of innovations advancing in isolation⁴, as networks expand and so do stakeholders, institutions and end-users' networks. The trend implies abandonment from closeness in all its senses and transition to "open innovations" and global innovation networks, and revaluation of significance of various kinds of "zones".

Second, one can notice some idealization of foreign experiences coupled with the use of a combination of different Western approaches: the Skolkovo's fathers have opted for a few models at once, rather than for a single model, for instance, Silicon Valley (though it is much referenced to in the context of the building of Skolkovo). They consider and partially adopt elements of techno parks, technopolises, and one can trace some analogy with the UAE's Masdar City. An attempt to integrate elements of different models is a very challenging task, as it is not easy to ensure their synergy.

¹ Skolkovo razdvigayet granitsy//Rossiyskaya gazeta. 21.09. 2010. - URL: <http://www.i-gorod.com/press/20100921003/>. Date of access: 07.02.2011.

² Penkina O. Priyutili. Kurchatovsky institut stanet vremennym domom dlya skolkovtsev//Poisk. №34-35. 27.08.2010. P 3.

³ Fedorov E. Transformatsia zakonodatelstva v 2011 godu//Nauka i tekhnologii Rossii. 12.01. 2011. URL: http://strf.ru/material.aspx?d_no=36176&CatalogId=223&print=1 . Date of access: 07.02.2011.

⁴ Draft Ministerial Report on the OECD Innovation Strategy: Innovation to Strengthen Growth and Address Global and Social Challenges. Key Findings. Paris: OECD, February 26, 2010. P. 6.

Third, as before, the Government failed to run a hindsight evaluation of initiatives implemented to date. If completed, it would have enabled one to advance more efficiently, particularly with a due account of past failures. With the record of building science cities and research campuses at hand and being aware of a subsequent evolution of “closed” cities, one needs to think through additional measures to cope with phenomena, particularly social ones, which might emerge in the course of the city’s “ageing”. Thus, sooner or later, a limited number of land sites at Skolkovo will ultimately hurdle its expansion. The planned approach, which provides for leasing the housing, rather than selling it to the residents¹, does not help overcome potential constraints facing Skolkovo’s growth.

So far Russian corporations and the national research community have remained moderately optimistic regarding Skolkovo’s prospects. According to a sociological survey Corus Consulting ran on high- and medium-level Russian corporate executives, 27% of respondents believe the project is going to be a success, another 23% holds the opposite view, while another 48% considers the idea to be a good one in principle, but doubts the possibility for its actual implementation².

5.5.8. The Government’s Plans on Shaping Efficient Science

In the nearest future, the Government is going to bolster initiatives aimed at increase of the research sphere’s efficiency. The initiatives in question are laid down in the draft Strategy of innovation development of Russian Federation through 2020 the RF Ministry of Economic Development unveiled on 31 December 2010. The Strategy specifies the following development priorities for the national research complex:

The first priority, whose implementation has already been underway, is formed by a set of measures on boosting the university science. That said, the text of the Strategy implicitly holds that over time universities should substitute for RAS as core centers of the national fundamental science. Specifically, the document reads that research universities “should form a nucleus of the new integrated research-educational complex that will ensure ...conduct of a significant proportion of the fundamental and applied research”.

The second priority concerns the sphere of applied research and implies establishment of national research centers, particularly on the model of NRS “Kurchatov Institute”. Whether the latter’s performance is adequate and, accordingly, whether it is worth replicating this model sparked animated discussions in the research community. Their opinions, as a rule, appear not that positive. Meanwhile, it is not easy to understand how the RIS has advanced, as there are no objective data in this respect. But there are concerns that the model results in monopolizing a given sphere of research, which hardly can form an incentive to boost efficiency.

The third priority is the human resources policy. The Strategy enumerates quite a number of measures in this respect, including a few brand new ones, such as introducing a status of the “federal research fellow” or implementing a pilot program on attraction onto executive positions at federal and research universities of specialists with the respective record with leading foreign universities.

¹ Minutes of the meeting of the Commission on modernization and technological development of Russia’s economy. The Administration of the RF President. 29.04. 2010. – URL: <http://news.kremlin.ru/transcripts/7585>. Date of access: 07.02.2011.

² Predprinimateli ne veryat v uspehnost Skolkovo// Nauka i tekhnologii Rossii. 01.10. 2010. – URL: http://strf.ru/science.aspx?CatalogId=222&d_no=33960 . Date of access: 07.02.2011.

The fourth priority is improvement of financial mechanisms, focus on priority scientific and technological development avenues, optimization of grantor organizations' performance. The work in this direction is currently underway, too.

So, the clearly manifested themselves over 2010 scientific and innovation policy priorities may further unfold as long-term ones, which, in principle, should help enhance the quality of the public regulation.

The year of 2010 the current controversial state of the national science. On the one hand, judging a string of indicators, its disruption continued, particularly as far as cadres are concerned. On the other hand, its significance is propped up by certain selected organizations (the status universities) and territories (Skolkovo) wherein a sizeable budget funding has poured in.

From the perspective of innovation activities, the business sector appeared very heterogeneous, with large corporations no longer being overly passive, albeit not so much in anticipation of research organizations, universities and start-ups' produce.

The Government attempted to establish linkages between science and businesses and boost development of small-sized start-ups, but the policy was poorly coordinated at the interdepartmental level. That said, the Government's presence in the national research and technological complex still is excessive and it tends to dictate, rather than regulate.

The Government's active engagement has produced an adverse impact on the development of network interactions, the rise of new grass-root initiatives and their natural spread. That is why horizontal ties, the institution of intermediaries, small innovative entrepreneurship, flexibility and diversity of interactions between science and business – all the components underpinning an innovation system's sustainability- have so far remained at their nascent state.

Section 6. Institutional Problems

6.1. Public Sector and New Privatization Policy

6.1.1. Public Sector Scope

General Dynamics in the Scope of Public Sector in 2008–2010

The currently available *official*, quantitative data on federal property allows one to infer that the Russian Government kept reducing its direct involvement in the national economy late in the first decade of the 21st century (*Table 1*).

Table 1

Dynamics of the number of organizations using federal property, and property assets registered in the federal property register in 2008 – 2010 (as units)

Date	Federally-owned unitary enterprises (FOUSs)	Joint-stock companies, in which the Russian Federation holds an interest as a shareholder	Movable and immovable assets	Land plots
as of January 1, 2008	5709 ^a	3674 ^a	...	...
as of January 1, 2009	3765 ^a	3337 ^a /3500 ^b /3047 ^c	1293788 ^d	67000 ^e
as of January 1, 2010.	3517 ^a	2950 ^a /2646 ^f	1276572 ^g	126761 ^g
May 2010. ^h	...	3124 ⁱ	1704958	570 956 808 ha

^a – according to the data included into privatization programs for the next year;

^b – according to the data published by the Federal Agency for State Property Management with reference to the federal property register as of mid-January 2009 ;

^c – the number of blocks of shares (interest, stakes) in business companies held by the federal government, according to the data reported in the Progress Report for 2008 issued by the Federal Agency for State Property Management (net of 136 joint-stock companies which are subject to a special right – “Golden Share” – in participation in their management) ;

^d – according to the data published by the Federal Agency for State Property Management with reference to the federal property register as of mid-January 2009 ;

^e – according to the data published by the Federal Agency for State Property Management with reference to the federal property register as of mid-January 2009, whereas the Progress Report for 2008 of the Federal Agency for State Property Management specifies that as of January 1, 2009 the immovable assets registered in the registry include 33,955 land plots, with a total of more than 150 land plots for which the Russian Federation has a registered land title ;

^f – the number of blocks of shares in joint-stock companies owned by the Russian Federation, based on the federal property register according to the data of the Federal Agency for State Property Management ;

^g – according to the data of the Federal Agency for State Property Management with reference to the federal property register ;

^h – according to the data The Federal Agency for State Property Management with reference to the federal property register ;

ⁱ – the number of joint-stock companies which are managed by the federal government through the Federal Agency for State Property Management.

Source: The Forecast Plan (Program) of Federal Property for 2009 and the Guidelines for Privatization of Federal Property for 2010 and 2011 ; The Forecast Plan (Program) of Federal Property for 2010 and the Guidelines for Privatization of Federal Property for 2011 and 2012, the Progress Report for 2008 issued by the Federal Agency for State Property Management, M., 2009, The Forecast Plan (Program) of Federal Property and the Guidelines for Privatization of Federal Property for 2011 – 2013, www.rosim.ru, www.economy.gov.ru.

This is mostly referred to business economic agents who perform the state business function, which is basically supported by the Rosstat’s (The Federal State Statistics Service) data

which reflect the composition of the public sector of the economy and its contribution in final figures of business activity (*Table 2 и 3*).

According to the data obtained through a Rosstat's monitoring of the public sector, the number of the economic agents monitored between mid-2008 and mid-2010 changed as follows (*Table 2*).

Table 2

The number of public sector organizations registered with territorial offices of the Federal Agency for State Property Management and agencies for federal property management of the constituent territories of the Russian Federation in 2008–2010 .

Date	Total*	SUEs, including state-owned enterprises	Public agencies	Business companies in which more than 50% of equity interest (shares) is held by	
				the public sector	public sector business companies
as of July 1, 2008*	77461**	9864	62571	3930	1089
as of January 1, 2009*	75878**	9144	61831	3795	1101
as of July 1, 2009*	77082**	8706	63019	4007	1350
as of January 1, 2010.*	76658**	8122	63087	4089	1360
as of July 1, 2010.*	74867**	7230	61493	3915	2229

* – accounting of federal property is kept pursuant to the order of the Government of the Russian Federation dated July 16, 2007 “On Improving Accounting of Federal Property”, No. 447 ;

** – including organizations whose state registered articles of association do not contain specific types, but net of joint-stock companies in which more than 50% of equity interest (shares) is held on the basis of joint public and foreign ownership.

Source : On the development of the public sector of the economy in the Russian Federation in H1 2008 (p. 87), in 2008 (p. 7), in H1 2009 (p. 7), in 2009 (p. 7), in H1 2010. (p. 7). M., Rosstat, 2008–2010. The estimates were made by the Gaidar Institute for Economic Policy.

It can be seen from *Table 2* that over two years the total number of public sector organizations reduced (between July 1, 2008 and July 1, 2010.)¹ by 3.3% (or by almost 2,6 thousand units) to total about 74,9 thousand units as of July 1, 2010.

It is the 26.7% reduction (or by more than 2,6 thousand units) in the number of unitary enterprises that was mainly responsible for the foregoing result. Much less reduction was observed in the number of agencies – by no more than 1.7% (or by almost 1,1 thousand units). As of July 1, 2010, the number of business companies in which more than 50% of equity interest was held by the public sector saw no changes over the two years, while the number of business companies in which more than 50% of equity interest (shares) was held by public sector business companies, doubled. The number of such companies grew up by more than 1140 to total more than 2,2 thousand as of July 1, 2010 thus reaching a historical maximum throughout the entire period of the 2000s.

It should be noted, however, that the foregoing trends were observed mostly within a time-frame covered in the latest statistical data (the period between mid-2009 and mid-2010), be-

¹ The date of July 1, 2008 was used as the comparator, because by the moment of onset of the crisis in September 2008 as well as in mid-2008 and 2009 the total number of public sector organizations was almost equal to the number reported early in 2001 (more than 77 thousand units). At that moment, however, unitary enterprises accounted for a much bigger share against agencies in its structure. Moreover, it was not until mid-2003 when business companies in which more than 50% of equity interest (shares) was held by public sector business companies, were included into the statistical reports.

cause, as of July 1, 2009, the total number of public sector organizations were little different from the respective value recorded as of July 1, 2008, and it is only unitary enterprises that showed reduction among all other types of legal entities in that period.

In the meantime, the total number of public sector organizations reduced by almost 3% (or by more than 2,2 thousand units) over a year between mid-2009 and mid-2010. The number of entities reduced for all types of legal entities, except for business companies in which more than 50% of equity interest (shares) was held by public sector business companies.

It is a 17% reduction (or by almost 1,5 thousand units) in the number of unitary enterprises that was mainly responsible for such a result. Though reduction in the number of agencies was much smaller, by no more than 2.4%, it was almost the same as for unitary enterprises in absolute values. The number of business companies in which more than 50% of equity interest was held by the public sector, reduced by 2.3% (or less than 100 units). It is worth noticing that the number of business companies in which more than 50% of equity interest (shares) was held by public sector business companies, increased significantly (by almost 1,7 times), nearly 900 units.

The crisis of 2008 - 2009 made it important to answer the question on how the crisis affected the participation of the state in the economy as producer of goods (works, services). It is only in part that the Rosstat's monitoring supports the opinion about growth in the state-owned share in different final performance indicators (*Table 3*).

Table 3

Public sector's participation share in 2007 – 2010, %

Indicator	2007	2008	2009	H1 2010
Volume of shipped goods produced by the company, completed works and services w/o subcontracting :				
- mineral resources production	12.8	13.5	11.5	10.2
- fuel and energy resources production	11.8	13.2	11.3	9.0
- manufacturing sector	84	8.5	9.5	8.5
- production and distribution of electric power, gas, and water	11.4	13.0	14.0	18.0
Scope of construction works performed w/o subcontracting	4.0	3.6	3.8	3.9
Passenger turnover at transportation companies *	65.9	63.9	63.2	55.3
Volume of commercial transportation (dispatch) of cargos by transportation companies (net of companies involved in pipeline transportation)	72.9	71.1	76.6	78.2
Commercial cargo turnover performed by transportation companies (net of companies involved in pipeline transportation)	94.6	94.3	93.8	92.6
Communication services **	9.8	9.9	13.9	13.9
In-house research and development costs	72.4	72.6	74.4	71.1
Volume of paid services rendered to the general public	16.4	16.3	16.5	18.8
Capital investments from all sources of financing ***	19.5/ 15.0	21.5/ 15.9	22.8/ 17.1	21.8/ 15.1
Net proceeds from sales of goods, works, services (net of VAT, excise taxes and other similar mandatory payments)	10.2	9.8	10.6	17.2
Average staffing number	24.9	24.0	24.6	24.9

* – net of companies involved in municipal passenger electrical transportation ;

** – net proceeds from sales of goods, works, services (net of VAT, excise taxes and other similar mandatory payments) ;

*** – in the numerator, net of small business entities.

Source : On the Development of the Public Sector of the Economy in the Russian Federation in 2007 (pp. 9, 42, 90-91, 92, 103, 134, 136, 143-144, 164), in 2008 (pp. 13, 43, 45-46, 47, 53, 61-63, 67-68, 88), in 2009 (pp. 13, 45, 47-48, 49, 52, 60-62, 66-67, 87), in H1 2010. (pp. 13, 44, 46-47, 48, 51, 54-56, 60-61, 81). M., The Federal State Statistics Service (Rosstat), 2007 – 2010. The estimates were made by the Gaidar Institute for Economic Policy.

However, as it can be seen from *Table 3*, in 2009 and H1 2010, like throughout the entire period of 2000¹, that the public sector had an insignificant share in most indicators (no more than 10–15%), with a slightly bigger share in the field of investments (more than 15–20%) and employment (24–25%), and a substantial share only in the field of transportation (more than 60–90%, depending on an indicator) and in-house research and development costs (more than 70%).

In addition, all of the official statistical reports highlighted growth in the state-owned share in 2009 – 2010 against 2007 – 2008 in the field of production and distribution of electric power, gas and water, communication services, capital investments, paid services to the general public, and such a generalized financial indicator as net proceeds from sales of goods, works, services (net of VAT, excise taxes and other similar mandatory payments)¹.

On the other hand, the state-owned share decreased in the field of mineral resources production (above all, production of fuel and energy resources). As a result, in H1 2010 the public sector's contribution in the field of production of fuel and energy mineral resources dropped below 10%, for the first time since 2007. The same trend has been developing in the field of passenger turnover of transportation companies and in-house research and development costs.

Taking a closer look at the situation, one can see that the public sector was dominating only in a few of the industries (railway cargo shipment and passenger transportation, forest regeneration, production of sodium carbonate) at the 2008 – 2009 year-end.

In most other cases the public sector accounted for less than 20%, save for production of sodium chloride, ethyl alcohol made of food raw material, railway broad gauge sleepers, a few types of machine building products (tractor grain drills (2008), civil helicopters (2009), long-haul freight car, radio receiving equipment), all types of paid services, where the state-owned share remained less than 50%.

The same situation was observed in H1 2010, except that the public sector's contribution in the production of sodium chloride, including sea water and saline solutions, dropped below 10%, whereas, on the other hand, production of externally powered broadcasting radio receivers, and helicopters, exceeded 50% of the total output of these types of products.

On the other hand, there are *three important factors* which have to be taken into account in making quantitative assessment of the public sector.

The first factor concerns *completeness of accounting of the property owned by public agencies*. Among the dates to be focused on is March 2010, when the Federal Agency for State Property Management published information on that the federal property register could be deemed to have been completed for the first time since 1991.

This information provides a perfect picture of the real quality of administration of the economic policy pursued by the federal government, in particular the federal government's direct functions. Suffice it to say that about 12 years have passed since the date of approval of the Provision on Accounting of Federal Property and Maintaining Federal Property Reregisters by the Order of the Government of the Russian Federation No. 696² dated July 3, 1998, let alone the acute need in such information back in the first half of the 90s, at least by the mo-

¹ However, the data on the H1 2010 must be supported by data on the current year as a whole, both for this indicator and production and distribution, electric power, gas and water, paid services to the general public.

² The Order ceased to be in force under the Order of the Government of the Russian Federation dated July 16, 2007, No. 447, "On Improving Accounting of Federal Property" which regulates accounting of federal property under the new Provision.

ment when the cheque privatization completed in mid-1994, when the privatization process remained quite intensive. However, completeness of the registry prepared to date is questionable, because the Federal Agency for State Property Management itself admits that about 1,5 K legal entities failed to provide information on whether or not they own any assets of federal property.

The issue of completeness of federal property accounting can be well illustrated by comparing the data published by the Federal Agency for State Property Management and the Ministry of Economic Development and Trade the Russian Federation (*Table 4*).

Table 4

Changes in asset accounting in the federal property register

Date	In hard copies	including	
		in electronic form	% of the number of assets accounted in hard copies
as of 5 September 2007	1,293,788		
as of January 1, 2009	701,361 *	14,096	2.0
as of 15 February 2010.	1,304,302	1,273,759	93.9
as of 15 May 2010.	1,369,741	1,367,128 **	99.8
as of 15 September 2010.	1,483,856	1,482,266	99.9

* – on the other hand, the Progress Report for 2008 issued by the Federal Agency for State Property Management specified that, as of January 1, 2009, the register contained information on the following assets owned by title-holders under a relevant corporeal right: 354,085 immovable assets and 240,365 movable assets (net of federally-owned business companies and joint-stock companies which are subject to a special right of participation – Golden Share – in their management);

** – as of June 7, 2010.

Source : , www.rosim.ru, www.economy.gov.ru, The Progress Report for 2008 issued by the Federal Agency for State Property Management, M., 2009.

For example, the number of assets, which the Federal Agency for State Property Management reported as registered in the federal property register early in 2009, was registered in the same as of September 5, 2007 (since September 6, 2007, accounting of federal property, maintaining of the federal property registry and provision of information from the same have been governed by the Provision on Accounting of Federal Property approved by the Order of the Government of the Russian Federation dated July 16, 2007, No. 447), according to the data published by the Ministry of Economic Development and Trade the Russian Federation. According to the data published by the Ministry of Economic Development and Trade, a hardcopy inventory of the federal property in the state federal property database was completed by the beginning of the summer of 2010, before the Order of the Government of the Russian Federation dd. July 16, 2007, No. 447, came into force.

Over the recent few years, a lot of efforts have been made in copying the relevant information into electronic files to enter into the Automated System of Federal Property Accounting, which in 2010 allowed information in hard copies to be fully copied to e-files.

Logically, the issue of completeness in accounting can be referred to the assets owned by constituent territories of the Russian Federation and local government bodies, although it can be assumed that the very logic of the crisis, numerous functions and obligations they have to perform as a result of delineation of authorities in the mid-2000s among different levels of power must have prevented any growth in assets owned by the regions and municipalities in Russia.

The second factor concerns *complexity of the assessment of state-owned share in different resulting data*, because the data published by the Rosstat, which is based on the definition set

forth in the government documents, fails to provide a true picture of the situation in the Russian economy.

Based on the Order No. 1 issued on January 4, 1999 by the Government of the Russian Federation (as amended by the Order of the Government of the Russian Federation dated December 30, 2002, No. 939), it includes four types of economic agents at the federal and regional levels :

- state unitary enterprises on the basis of economic control and operating management rights (state-owned) ;
- public agencies ;
- business companies in which more than 50% of equity interest is held by the public sector ;
- business companies in which more than 50% of equity interest (shares) is held by public sector business companies.

It should be noted, however, that this definition of public sector contains a series of weak points as follows :

- it fails to cover commercial and non-profit entities in which federal and regional unitary enterprises have an interest, at least those in which unitary enterprises hold more than 50% equity interest ;
- the practice shows that there is no need to hold more than 50% equity interest (shares) in order to be able to control a business company. To be more exact, more than 50% of voting shares must be held to be able to control a company, which is relevant for the enterprises at which during the privatization campaign (1992 – 1994) 1/4 of the equity (similar to the preferences granted under option 1 during transformation into a joint-stock company) was transferred as preferred shares to the employees, but the limits imposed on privatization by the specifics of an industry (e.g., the defense industrial sector) required that the public sector retain the majority interest. As a result, the interest to be held by the government accounted for 38% of the charter capital, but more than 50% of voting shares ;¹
- it fails to cover business companies in which a total of public and business companies', in which more than 50% equity interest (shares) is held by the public sector, stockholding exceeds 50% of the charter capital, although individually the public and business companies', in which a state-held share is dominating, stockholdings account for less than 50%² ;
- the same is true of business companies in which a total of more than 50% of the charter capital is held by the public sector and business companies in which more than 50% of

¹ An example of this type is Svyazinvest, a telecommunication holding company. The structural reform of the company, which was completed as early as the first half of the 2000s, was made through consolidation of its subsidiaries by way of establishing seven trans-regional companies (Centertelecom, Severo-Zapadny Telecom, VolgaTelecom, Uzhnaya Telecommunicatsionnyya Kompaniya, Uralsvyazinform, Sibirtelecom, Dalsvyaz) at the levels of respective federal districts and subsequent affiliation of 65 regional telecom joint-stock companies to these companies. The Holding Company holds about 51% voting shares and less than 50% of equity interest in all of these seven joint-stock companies, like in Rostelecom. Meanwhile, a small interest (less than 10%) was held by the federal government in the equity of three regional companies (Centertelecom, Severo-Zapadny Telecom, Uralsvyazinform).

² For example, the state holds the majority interest in the Gazprom's authorized capital indirectly through other companies (Rosneftegaz and Rosgazifikatsiya) in which the state is a shareholder, even after a scheme designed to obtain the public majority interest for 2004–2005 was implemented.

equity interest (shares) is held by public sector business companies, i.e. in which a state-held participating interest in the charter capital exceeds 50%, although individually their stockholdings are less than 50%, as well as when control over a business company can be obtained by putting together stockholdings of public sector business companies and the business companies they control ;

- it lacks transparency with subsidiaries and affiliated companies integrated into business-groups created around public sector organizations controlled indirectly through various levels (lower-tier subsidiaries, etc.) or stockholding less than 50%.

An obvious lack of transparency in the field of proprietary rights to a company or companies, and a multiple-stage, multiple-level system of corporate control at state-owned companies (by analogy with private companies) makes it important to carry out a special applied research in the field of estimation of the state-owned share of participation in the economy.

Based on the foregoing, it is a nontrivial task to define guidelines on the extent the public sector should participate in both the economy at large and specific sectors, because of a small state-owned share, according to the recent official statistical reports, presumable concentration at low stages of “agency chains” inside specific companies, as well as a non-public nature of the proprietary right to the assets of state-owned corporations.

Finally, it is impossible yet to provide unbiased and reliable quantitative assessment of an indirect impact by *state-controlled banks and development institutions* acting as agents in supporting any given companies.

Let us recall that the following options of indirect strengthening of the public proprietary position through launching special programs on urgent support to Russian companies and banks in the fall of 2008 were considered:

- Vnesheconobank GC (VEB) becomes a holder of the blocks of shares pledged under a program on refinancing of external debts owed by a series of companies operating in the fuel and power sector, construction industry, transport and communication sector, metal mining industry, microelectronics, metallurgy and other industries (a total of USD 11,6 bln of loans granted to 10 companies, although the amount of loans approved at the end of Q1 2009 totaled USD 14,33 bln, while USD 50 bln was planned initially through depositing the Central Bank’s foreign exchange reserves in VEB)¹ ;
- upon implementation of a program on support to the stock and bond market, retain holding of the stocks and bonds acquired in the market through VEB at the expense of the National Wealth Fund (NWF) (initially, it was expected to allocate RUB 175 bln in 2008 and 2009 each, a total of RUB 350 bln) ;
- continue further expansion of state-owned corporations (regardless of partial withdrawal of allocated financial resources) ;
- transfer private assets to state-owned banks against granted loans and through direct acquisitions, continue establishing state-owned holding companies ;
- increase a state-held interest in banking capital as part of a program on the banking system recapitalization (USD 40 bln)².

¹ www.veb.ru.

² The key question with regard to the whole package of impact on regulation of proprietary relations is what kind of policy Vneshekonombank GC (VEB), which in the fall of 2008 began to refinance external debts of a series of largest Russian private companies, is going to pursue. Due to a short-term nature of the loans granted to these companies, a question of repayment and, in case of failure to repay, not a simple choice between new lend-

Based on a series of currently available signs, one can infer that the potential of indirect expansion of the public sector through banks and development institutions acting as public agents in supporting specific companies remains outstanding to a great extent due to loyalty to them.

The foregoing can be supported by the following facts: in particular, the loans granted to such companies as Gazpromneft, Sitronics, Evraz Group, Rusal, PIK GROUP and Altimeo so that they could repay their external debt were rolled over in the first half of October 2009, in December 2009, Vnesheconobank made an early repayment of a loan of RUB 175 bln to the Ministry of Finance of Russia, which was allocated in the fall of 2008 from the National Wealth Fund (NWF) to support the stock market (RUB 13,27 bln was paid as interest accrued on the deposit), and a series of Russian private companies began to repay the loans obtained from VEB GC to be able to refinance their external debt. As of the beginning of 2010, the size of the portfolio of loans granted by VEB for these purposes decreased to USD 7,8 bln.¹ The recipients of the VEB's loans consolidate their debts in other banks. For example, on September 30, 2010 Sberbank granted a loan of USD 4,6 bln to Rusal till December 2013, with a 1.5-year roll-over, to refinance the debt owed to VEB. The money covers in full the outstanding debt. Let us recall that VEB granted a loan of USD 4,5 bln in November 2008 to repay the loan obtained in April 2008 from a syndicate of banks to purchase 25% + 2 interest in Norilsk Nickel².

Hence the foregoing allows one to infer, with certain modifications, that Russia escaped counter recession nationalization in a narrow sense, while the scope of this phenomenon in a wider sense remains unclear, given the activity of economic agents with participation of the state, which excludes new assets in the treasury.

Nevertheless, most of the expert assessments agree to that a state share of participation in the Russian economy increased as a result of activities of mixed-sector companies in the corporate control market and due to the public indirect recession counter measures. In particular, indirect effect of state-controlled banks and entities acting as public agents in implementing the recession counter measures increased, however the scope of the process (and *potential* of further growth of public influence) remains unclear.

The data provided in *Table 5* are very illustrative in terms of dynamics, but seems to be understated as applied to the scope of the public sector in Russia. According to the available estimates (Troika Dialog, 2008), the federal and regional agencies controlled about 40% of market capitalization of the Russian stock market late in 2007 against 24% in 2004. By the beginning of 2008, "the depth of concentration of state-owned property" accounted for about 40–45%, according by the Expert-400 Rating. In 2009, different experts reported this indicator in the range of 50%.

ing, debt restructuring (*de facto* roll-over of the loans), initiating bankruptcy proceedings or obtaining the title to the pledged assets – arose.

From a purely formal point of view, it was not an apparent nationalization, because no assets are added to the federal treasury and VEB, being a public corporation, is treated as a non-profit entity.

The largest banks with a state-held interest in their equity, which received public support, have been facing the same dilemma.

¹ www.veb.ru, 20.07.10.

² Sberbank itself considers its loan to Rusal as a business transaction in contrast to the VEB's loan. Direct investments, No. 11 (103), 2010, p. 69 – 70.

Table 5

Private sector's share in GDP in economies in transition¹

Country	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008*	2009*
Central Europe																				
Czech Republic	10	15	30	45	65	70	75	75	75	80	80	80	80	80	80	80	80	80	n/a	n/a
Hungary	25	30	40	50	55	60	70	75	80	80	80	80	80	80	80	80	80	80	80	80
Poland	30	40	45	50	55	60	60	65	65	65	70	75	75	75	75	75	75	75	75	75
Slovakia	10	15	30	45	55	60	70	75	75	75	80	80	80	80	80	80	80	80	80	80
Slovenia	15	20	30	40	45	50	55	60	60	60	65	65	65	65	65	65	65	70	70	70
Baltic states																				
Estonia	10	10	25	40	55	65	70	70	70	75	75	75	80	80	80	80	80	80	80	80
Latvia	10	10	25	30	40	55	60	60	65	65	65	65	70	70	70	70	70	70	70	70
Lithuania	10	10	20	35	60	65	70	70	70	70	70	70	75	75	75	75	75	75	75	75
South-East Europe																				
Bulgaria	10	20	25	35	40	50	55	60	65	70	70	70	70	75	75	75	75	75	75	75
Romania	15	25	25	35	40	45	55	60	60	60	60	65	65	65	70	70	70	70	70	70
CIS countries																				
Russia	5	5	25	40	50	55	60	70	70	70	70	70	70	70	70	65	65	65	65	65
Ukraine	10	10	10	15	40	45	50	55	55	55	60	60	65	65	65	65	65	65	65	60

* – the data on the Czech Republic has not been included into the EBRD's Report on Economies in Transition since 2008.

Source : European Bank for Reconstruction and Development. Transition Reports.

Hence the crisis brought up the issues of defining the scope and manageability of the public sector in the Russian economy, as well as encouraged discussion about launching a new “big privatization”. In any case, intensification of the national policy in the field of privatization becomes relevant.

6.1.2. Current National Privatization Policy

The forecast plan of privatization for 2010 which was approved by the Government of the Russian Federation at the end of November 2009, included shares in 449 joint-stock companies as well as 56 assets belonging to other property in the treasury of the Russian Federation, including immovable assets, sea and river vessels.

The privatization program was extended considerably in mid-March 2010 and included 230 FOUSs for privatization, which was not the case in the original version of the document. The number of joint-stock companies whose blocks of shares would be offered for sale, increased by more than 1.5 times (up to 690 units). The number of treasury entities included into the privatization plan increased in a slightly smaller proportion (up to 74 units).

By comparing the obtained data, which describes the forecast plan (program) of privatization for 2010, with the basic parameters of privatization programs in the previous years, one may infer that the original version is not too different from the previous programs (*Table 6*).

¹ According to the method adopted at the EBRD, “the private sector's share in the GDP” is measured on the basis of statistical data obtained from accredited (public) and unaccredited sources. The share includes income generated by registered private companies from officially accounted business activities, as well as income generated from non-accounted business activities, provided that such activities are backed up by a reliable information thereof. For the purpose of this measurement, private companies mean all companies whose majority interest is held by private individuals and legal entities.

Table 6

Comparative data on dynamics of privatization of federal state-owned unitary enterprises and federally-held blocks of shares in the H2 of the 2000s .^a

Period	FOUSs, units		OJSCs, units	
	Scheduled for privatization ^c	Privatized	Scheduled for privatization ^c	Sold blocks of shares in JSC ,
2006	885	...	383	356 ^d
2007	368	377	911	377 ^e
2008	440	213	404	209 ^f
2009	235	316+256 ^g	291	52 ^h

^a – net of blocks of shares in closed joint-stock companies, participating interest in the charter capital of LLCs and other federally-owned assets ;

^b – in the originally approved versions of the forecast plans (programs) of privatization of federal property (net of the assets transferred from the plans (programs) of the previous year) ;

^c – all of the preliminary measures were completed, and decisions on the terms and conditions of privatization were made ;

^d – the estimated value based on the data obtained from the Federal Agency for State Property Management’s Report “On Privatization of Federal Property in 2007” ;

^e – net of 523 of blocks of shares which were put out to auction scheduled for 2008 ;

^f – including 135 of blocks of shares which were put out for sale under the privatization program of 2007, but net of 268 sales which were scheduled for summation in 2009 ;

^g – the number of FOUSs on which the Ministry of Defense of Russia made a decision on corporization, in addition to those on which the same decision was made by the Federal Agency for State Property Management ;

^h – including 26 of blocks of shares which were put out for sale under the privatization program of 2008, but net of 221 joint-stock companies on which privatization measures in terms of sales continue in 2010.

Source : The Federal Agency for State Property Management’s Report “On Privatization of Federal Property in 2007”. M., 2008; The Progress Report for 2008 issued by the Federal Agency for State Property Management. M., 2009; An interview with Medvedev Y.M., the Deputy Head of the Federal Agency for State Property Management – “Rossiiskaya Gazeta” dd. March 30, 2010; The 2009 Progress Report on the Plan (Program) of Privatization of Federal Property. M., 2010.

After a short break which resulted basically from the global financial crisis, the process of privatization was reported to intensify. According to the preliminary data published by the Federal Agency for State Property Management, 132 blocks of shares (interest) of business companies were sold at RUB 22,67 bln in 2010, 125.95% of the target value (RUB 18 bln) of the forecast plan¹.

Hence one can infer that from the financial point of view income from privatization of this type of assets exceeded the pre-recession level of 2006 – 2007 (less than RUB 20 bln), not to mention the values reported in the period of financial and economic downturn in 2008 – 2009. The number of sold blocks of shares increased 2.5 times against 2009. On the other hand, the final values of this indicator attained under the privatization program in 2010 were modest against those of the previous years (including 2008).

High financial performance figures attained in 2010 resulted basically from the sale of state-held interest (13.1%) in Rosgosstrakh OJSC whereby RUB 8,675 bln was transferred to the federal budget, which is probably the largest privatization transaction since 2005. It should be noted, however, that the opening and closing bids were equal². This transaction is comparable to sale of the entire state-held interest, RUB 7,559 bln, in Mosmetrostoi OJSC, when the closing bid tripled the opening one.

¹ <http://www.rosim.ru>, December 30, 2010 .

² <http://www.prime-tass.ru>, December 13, 2010 .

In addition, the sale of blocks of shares in the "Institute for Research and Development of Tractors NATI OJSC (Moscow, 100%) at RUB 1278 mln, Tyretskiy Salt Mine (the Irkutsk Region, 100%) at RUB 660,667 mln, Isktimcement (the Novosibirsk Region, 25.5%) at RUB 651,858 mln, The VODGEO Scientific Research Institute (Moscow, 100%) at RUB 617,996 mln, the Large Diameter Pipe Works (25% + 1 share) at RUB 258,4 mln, "Nauka" Science and Production Association (Moscow, 20.41%) at RUB 211,134 mln, "Altai" Publishing and Printing Plant (Barnaul, 100%) at RUB 145,6 mln can be highlighted among large privatization transactions. The closing bids were either slightly higher or equal to the opening bids almost in all of the foregoing cases, save for the sale of the entire state-held interest in NATI, when the closing bid increased by almost 20% vs. the opening bid.

On the other hand, in some cases bidders demonstrated a very high activity. For example, the shares in Intour-Khabarovsk OJSC, Khabarovsk International Tourism and Commerce Company, were sold at 60% beyond the opening bid, while the shares in Suvodskiy Lesopunkt OJSC (the Kirov Region) were sold at 90% beyond the opening bid, and 100% of shares in the Dagestan State Research and Development and Planning and Surveying Institute for Land Management OJSC were sold in the auctions which were held on September 30. In the end, The Federal Agency for State Property Management contributed RUB 118,55 mln to the budget of the Russian Federation. Furthermore, the Federal Agency for State Property Management reported the sales of the state-held interest in the Uralyuvelir-Market Trading Company OJSC (Yekaterinburg), Altaivzryvprom (Barnaul), Kotlaskhlebl (the Arkhangelsk Region)¹ as one of the most successful transactions in September.

A visible slump in privatization amidst the financial and economic downturn highlighted the weak points in the legal privatization arrangements and procedures, which slow down growth rates and efficiency of privatization of federal property in the period of economic upturn too.

The Ministry of Economic Development and Trade's and the Federal Agency for State Property Management's proposals on making relevant amendments to the Law of the Russian Federation, which have been developed since 2005 and focused on expansion of a time horizon of the privatization program for a scheduled period with a view to ensure continuous privatization and optimize managerial decisions in this field², logically derive from the foregoing. The proposals were materialized in the Federal Law of May 31, 2010, No. 106-FZ, which made many important amendments to the applicable Law on Privatization³.

A new large-scale program on "big privatization" with a 5-year time horizon (for 2011–2015), which is very unusual for the entire contemporary history of Russia, and an impressive coverage (about 900 enterprises and companies, including the largest ones) was announced in the fall of 2010. In spite of that the economy resumed to grow unlike in the previous year, when the Russian economy developed amidst the economic downturn, it was not until late November that another program of privatization was adopted, like in 2009⁴.

¹ <http://www.rosim.ru>.

² See p. 5, see also the IET Annual Review "The Russian Economy in 2005. Trends and Outlooks (Issue 27)" P. 4.8.1. The Development of Modern Law on Privatization of Public and Municipal Property in the Russian Federation, pp. 499–510.

³ The package of amendments to the Law on Privatization and some other innovations are discussed in detail in section 5.1.5.

⁴ Normally, late in summer, early in fall over the last six years.

The Forecast Plan (program) of privatization of Federal Property and the Guidelines for Privatization of Federal Property for 2011 – 2013, which were finally approved by the Order of the Government of the Russian Federation dd. November 27, 2010, No. 2102-p, were developed by taking into account a longer effective period (from one to three years) of the forecast plan (program) of privatization of federal property based on the recent amendments made to the applicable Law on Privatization as well as the results of the work performed by federal executive agencies in terms of optimization of the structure of federal property.

The document defines privatization *as a tool designed to “meet the goal of transition to innovative and socially oriented economic development”*.

The approved program of privatization consists of two sections.

The first section describes the basic principles and guidelines established by the federal government, as well as plans of privatization of the 10 largest companies. It is the government that will make a decision on when and how each of the companies is to be sold.

In such companies as Rosneft, Rushydro, FSK, Sovkomflot, Russian Railroads, Obyedinnennaya Zeronovaya Kompaniya (OZK), Rosagroleasing, as well as VTB, Sberbank, Rosselkhozbank the federal government considers to reduce its equity interest by selling different sizes of blocks of shares over five years to come (2011 – 2015). It should be noted, however, that the federal government must retain corporate control of almost all of the foregoing companies while it is blocking and minority interest that are to be sold.

The second section contains a list of assets scheduled for privatization according to the normal procedure (114 SUEs, 844 joint-stock companies, including 35 closed joint-stock companies, 10 limited liability companies and 73 assets belonging to other property in the treasury of the Russian Federation, including real estate property, sea and river vessels), the in the manner which has been applied over the few recent years.

The maximum income of near RUB 1 t from privatization is estimated in the forecast plan in the period between 2011 and 2013 with due regard to the market situation and in case the Government of the Russian Federation makes special decisions on privatization of the largest companies which look very attractive in terms of investment. Without such companies, income from privatization in 2011 is estimated only RUB 6 bln, and RUB 5 bln in 2012 and 2013 each.

Today, it is hard to comment on whether or not the set targets can be met, having in mind the particular value of the federal budget revenues from privatization. It should be noted, however, that throughout the entire period of economic growth the value only once approached RUB 100 bln in 2003, although it was outrun three times (in 2003–2004 and 2007) by total income from privatization (sale) and utilization of federal property (i.e. including dividends from state-held blocks of shares, lease payments, etc.). The problem is how to avoid sale of state-owned property assets at dumping prices. One may notice a certain contradiction here: amidst the economic downturn the federal government may have a temptation to get rid of state-owned property as soon as possible, however, it only can realize good money in a favorable economic situation, while it needs no income from privatization in case of budget surplus.

Implementation of the privatization program would therefore face a serious problem in case of severe macroeconomic situation (e.g., caused by a second wave of crisis or global recession). In any case, privatization (due to a non-renewable source and one-time transactions) only can improve the budget system for a while.

6.1.3. Public Sector Structure and Key Economic Agents

Like any of the programs of privatization over the last three years, the Forecast Plan (Program) of Privatization of Federal Property and the Guidelines for Privatization of Federal Property for 2011 – 2013 approved by the Order of the Government of the Russian Federation dd. November 27, 2010, No. 2102-p contain data on the number of federally-owned unitary enterprises (of FOUSs) and joint-stock companies in which the Russian Federation holds an interest, only for the beginning of the calendar year. This is why we have no sufficient information to be able to assess the dynamics of these elements of the public sector in 2010.

Let us examine in detail the changes which took place inside the main categories of economic agents which are regarded as federal property in 2009.

Federally-owned unitary enterprises

Dynamics and the federal structure of FOUSs in 2006 – 2009 are shown below in *Table 7*. In 2009, the total number of federally-owned unitary enterprises reduced by 6.6% (or almost by 250 units) to reach about 3,5 thousand units by the beginning of 2010. Such a volume of reduction in the subsector of FOUSs stands in stark contrast to reduction in the number of economic agents of this business legal structure in the previous 2008, when it reduced by almost two thousand units.

Table 7
Dynamics and federal structure of federally-owned unitary enterprises in 2006–2009

Industry	as of June 1, 2006		as of January 1, 2007		as of January 1, 2008		as of January 1, 2009		as of January 1, 2010.	
	units	%	units	%	units	%	units	%	units	%
Non-production sector	1817	25.3	1670	25.6	1151	20.2	988	26.25	1424	40.5
Production sector	1624	22.6	1539	23.55	1744*	30.5	476	12.65	653	18.55
- machine-building	660	9.2	634	9.7	...	...	...	...	292	8.3
- forestry industry	...	...	...	...	...	...	...	...	94	2.7
- light industry	187	2.6	179	2.7	...	...	...	...	59	1.7
- food-processing industry	55	0.75	51	0.8	...	...	...	...	27	0.75
- constructions materials industry	55	0.75	49	0.8	...	...	...	...	...	...
- chemical industry	34	0.5	33	0.5	...	...	...	...	47**	1.3
- metallurgy industry	30	0.4	28	0.4	...	...	...	...	14	0.4
- other industry	603	8.4	565	8.65	...	...	...	...	120	3.4
agricultural sector	913	12.7	826	12.65	618	10.8	611	16.2	410	11.65
building industry	752	10.5	668	10.2	...	...	300	8.0	252	7.2
transport and communications sector	612	8.55	536	8.2	409	7.2	249	6.6	338	9.6
Forestry management	53	0.75	49	0.75	37	0.65	...	...	...	...
Other industries	1407	19.6	1245	19.05	1750	30.65	1141	30.3	440	12.5
Total	7178	100.0	6533	100.0	5709	100.0	3765	100.0	3517	100.0

* – production sector and building industry put together ;

** – chemical and petrochemical industries.

Source : The Forecast Plan (Program) of Federal Property for 2007 and the Guidelines for Privatization of Federal Property for 2007–2009; The Forecast Plan (Program) of Federal Property for 2008 and the Guidelines for Privatization of Federal Property for 2008–2010, The Forecast Plan (Program) of Federal Property for 2009 and the Guidelines for Privatization of Federal Property for 2010 and 2011 ; The Forecast Plan (Program) of Federal Property for 2010 and the Guidelines for Privatization of Federal Property for 2011 and 2012 ; The Forecast Plan (Program) of Federal Property and the Guidelines for Privatization of Federal Property for 2011-2013 ; The estimates were made by the Gaidar Institute for Economic Policy.

Early in 2010, non-production enterprises formed the biggest group in the sectoral structure of FOUSs (40.5% of the total number of FOUSs). The number of production sector (18.55%), agricultural sector (11.65%) and a group of other industries not included into the base classification (12.5%) was substantial. Transport and communications accounted for 9.6% and building industry for 7.2% of FOUSs.

The changes in the sectoral structure of FOUSs in 2009 mostly tended to slash in the absolute count and share of enterprises in other industries which in total accounted for 30.3% of all of the federally-owned unitary enterprises as of the beginning of 2009 against only 12.5% a year on. A share of agricultural enterprises reduced markedly (by more than 4.5 p. p.) as well. A share of the building industry reduced insignificantly from 8% to 7.2%.

On the other hand, a share of non-production industries (by more than 14 p. p.), production sector (by almost 6 p. p.), transport and communications sector (by 3 p. p.) increased considerably. It is necessary to highlight a growth (by 1,44 times or by almost 440 units) in the absolute count of non-production FOUSs and the production sector (by 1,37 times or by almost 180 units) against reduction in the same by nearly 700 and 200 units, respectively, in the group of other industries not included into the base classification, and the agricultural sector.

In the end, the absolute count of non-production unitary enterprises as of the beginning of 2010 was bigger than two years ago, while it was smaller in other industries. By comparing the number of FOUSs by industry of the production sector as of the beginning of 2010 with the number reported as of the beginning of 2007¹, we can see a country-wide reduction².

Federally-owned joint-stock companies

First of all it should be noted that by the beginning of 2010 the number of federally-owned joint-stock companies reduced by 11.6% (or by almost 400 units) to total 2950 units against the beginning of 2009. Their number was found to be less than three thousand for the first time throughout the 2000s.

Let us examine in detail the changes in the number of federally-owned joint-stock companies by sector over the last few years (*Table 8*).

As of the beginning of 2010, non-production enterprises accounted for the biggest share (39.4% of all of the specified joint-stock companies) in the sectoral structure of federally-owned joint-stock companies, followed by the production sector (about 23%) and the agricultural sector (about 13.5%). The group of other industries, transport and communications sector, building industry accounted for less than 10%.

Referring to the changes in the sectoral structure of federally-owned joint-stock companies in 2009, one may infer with certainty that a share of non-production enterprises increased rapidly (by almost 3,5 times, from 11.5% to 39.4%). A share of the transport and communications sector increased less than 1 p. p. A share of the production sector dropped by half (from 47.5% to 22.9%), and a share of the agricultural sector (by 2.2 p. p.) and the building industry (by 1.6 p. p.) decreased a bit less. A share of the group of other industries remained unchanged in the general structure of joint-stock companies with federal interest (by nearly 10 %).

¹ No industries were specified inside the sectoral structure of FOUSs as of the beginning of 2008 and 2009.

² Except for the chemical industry on which the data as of the beginning of 2010 is provided together with the petrochemical industry. In addition, the data as of the beginning of 2010 specifies the forestry industry, which was not the case in the previous periods, when no data on the constructions materials industry was provided.

Table 8

Dynamics and federal structure of federally-owned joint-stock companies or subject to the special right («golden share»), in 2005 – 2008 .

Industry	as of June 1, 2006		as of January 1, 2007		as of January 1, 2008		as of January 1, 2009		as of January 1, 2010.	
	units	%	units	%	units	%	units	%	units	%
Non-production sector	356	9.6	405	10.1	638	17.4	383	11.5	1162	39.4
Production sector	1772	47.6	1797	44.95	1878*	51.1	1583	47.45	674	22.85
- machine-building	663	17.8	632	15.8	...	...	...	...	245	8.3
- printing industry	...	...	...	...	...	...	...	...	158	5.35
- forestry industry	...	...	...	...	...	...	...	...	35	1.2
- light industry	27	0.7	29	0.7	...	...	...	...	11	0.4
- food-processing industry	141	3.8	127	3.2	...	...	...	...	46	1.55
- constructions materials industry	53	1.4	53	1.35	...	...	...	...	...	...
- chemistry	98	2.6	89	2.2	...	...	...	...	36	1.2
- metallurgy	101	2.7	94	2.35	...	...	...	...	31	1.05
- other industry	689	18.5	773	19.35	...	...	...	...	112	3.8
transport and communications sector	396	10.6	353	8.9	397	10.8	280	8.4	269	9.1
building industry	380	10.2	404	10.1	...	...	234	7.0	160	5.4
agricultural sector	363	9.7	534	13.35	761	20.7	522	15.65	397	13.45
forestry management	99	2.7	88	2.2	–	–	...	...	...	...
Other industries	358	9.6	416	10.4	–	–	335	10.0	288	9.8
Total	3724	100.0	3997	100.0	3674	100.0	3337	100.0	2950	100.0

* – including the production sector itself and the building industry (by 695 units or 18.9%), fuel and energy industry (597 units or 16.25%) and the military and industrial (by 586 units or 15.95%) sector.

Source : The Forecast Plan (Program) of Federal Property for 2007 and the Guidelines for Privatization of Federal Property for 2007–2009 ; The Forecast Plan (Program) of Federal Property for 2008 and the Guidelines for Privatization of Federal Property for 2008–2010, The Forecast Plan (Program) of Federal Property for 2009 and the Guidelines for Privatization of Federal Property for 2010 and 2011 ; The Forecast Plan (Program) of Federal Property for 2010 and the Guidelines for Privatization of Federal Property for 2011 and 2012 ; The Forecast Plan (Program) of Federal Property and the Guidelines for Privatization of Federal Property for 2011 – 2013 ; The estimates were made by the Gaidar Institute for Economic Policy.

A triple growth in the absolute count (by almost 780 units) of federally-held non-production joint-stock companies, with their number decreasing in all of the other industries, is worth noting, with the highest decrease in the production (by 2,34 times or by more than 900 units) and agricultural sectors (by more than 120 units).

In the end, as of the beginning of 2010, the absolute count of non-production joint-stock companies with a state-held interest was found to be larger than over the previous periods, except for a period between 2003 and 2004.

With regard to other industries as of the beginning of 2010, the number of joint-stock companies with a state-held interest was less than in the preceding year. The same picture can be seen in comparing the number by industry as of the beginning of 2010 against the changes that took place as of the beginning of 2007¹.

Equally important characteristic of joint-stock companies with a state-held interest is how these companies can be structured based on the size of a state-held interest in the same (*Table 9*).

¹ No industries were specified in the sectoral structure of joint-stock companies in which the federal government held an interest as of the beginning of 2008 and 2009.

Table 9

**Dynamics and structure of joint-stock companies with a state-held interest in 1999–2008
(including the special right («golden share»)) based on the size of state-held interest**

Date	Total		up to 25 %		between 25 and 50 %		between 50 and 100 %		100 %		Golden Share	
	units	%	units	%	units	%	units	%	units	%	total	with-out shares
1999	3316/ 3896 ^a	100	863	26.0	1601	48.3	470	14.2	382	11.5	580 ^b	
January 1, 2001	3524 ^c	100	1746	49.55	1211	34.4	506	14.35	61	1.7	...	...
August 2001	3949 ^d	100	1843	46.7	1393	35.3	625	15.8	88	2.2	542 ^b	
January 1, 2002	4407	100	2270	51.5	1401	31.8	646	14.65	90	2.05	750 ^b	
January 1, 2003	4222 ^e	100	2152	51.0	1382	32.7	589	13.95	99	2.35	1076	118
June 1, 2003	4205	100	2148	51.1	1339	31.8	600	14.3	118	2.8	...	...
October 1, 2003	4035	100	2051	50.8	1308	32.4	552	13.7	124	3.1	640	148
January 1, 2004	3704	100	1769	47.75	1235	33.35	540	14.6	160	4.3	591	251
June 1, 2004	3905	100	1950	49.9	1183	30.3	499	12.8	273	7.0	...	...
March 1, 2005	4075/ 3791 ^f	100	1697	44.8	1154	30.4	487	12.85	453	11.9	...	284
June 1, 2005	3783/ 3524 ^g	100	1544	43.8	1093	31.0	474	13.5	413	11.7	...	259
June 1, 2006	3724/ 3481 ^g	100	1063	30.5	885	25.4	397	11.4	1136	32.6	...	243
January 1, 2007	3997/ 3816 ^g	100	932	24.4	814	21.3	368	9.6	1702	44.6	...	181
January 1, 2008	3674	100	771	21.0	645	17.6	269	7.3	1989	54.1	...	...
January 1, 2009	3337/ 3047 ^h	100	769	23.0	510	15.3	200	6.0	1858	55.7	...	136
January 1, 2010.	2950/ 2646 ⁱ	100	697	23.6	358	12.1	138	4.7	1757	59.6	...	...

^a – 3896 business companies (including 3611 open joint-stock companies, 251 closed joint-stock companies, and 34 limited liability partnerships and limited liability companies) in which the Russian Federation holds an interest are mentioned in the text of the Concept of State-Owned Property Management and Privatization of 1999. 3316 units is the estimated value which was estimated by totaling the number of blocks of shares (interest) of different size which was mentioned in the text of the Concept ;

^b – total number of joint-stock companies which are subject to the special right («golden share»), without specifying the number of those in which the federal government holds no interest ;

^c – joint-stock companies, net of 48 interest and blocks of shares in foreign companies, in addition, there is data on that Russia holds 119 shares, interest, and blocks of shares in foreign companies with a book value of USD 1,4 bln ;

^d – the data of the draft program of privatization for 2002 which the Federal Agency for State Property Management submitted to the Government of the Russian Federation, whereas according to the data of the Registry of the Federal Agency for State Property Management, 4308 of blocks of shares joint-stock companies were held by the federal government as of September 1, 2001 ;

^e – only open joint-stock companies, net of 118 open joint-stock companies subject to the special right («golden share») (without shares), blocks of shares in 102 joint-stock companies transferred to operating management of Rosspirtoprom FOUS, 75 closed joint-stock companies and participating interest in the charter capital of LLCs transferred under the Order of the Government of the Russian Federation dd. April 2, 2002, No. 454-p “On Cessation of State Shareholding in the Charter capital of Credit Institutions” or obtained by way of inheritance, gift, etc ;

^f – 3791 units is the estimated number of joint-stock companies owned by the Russian Federation, net of 284 joint-stock companies which are subject to the special right («golden share») (without block of shares). This value was used to calculate a share of joint-stock companies with a specific equity interest to compare with the data on previous dates. For reference: as of January 1, 2005, the federal government held an interest in 3767 joint-stock companies, net of the abovementioned 284 joint-stock companies subject to the special right («golden share») and equity stakes in 24 LLCs transferred to the treasury under the Order of the Government of the Russian Federation dd. April 2, 2002, No. 454-p “On Cessation of State Shareholding in the Charter capital of Credit Institutions” ;

^g – the estimated number of joint-stock companies whose shares are held by the Russian Federation, net of joint-stock companies which are subject to the special right («golden share») (without block of shares). This value was used as the basis for estimation of a share of joint-stock companies with a certain equity interest for comparison with the data on the previous dates ;

^h – the number of blocks of shares (interest, stakes) of federally-owned business companies according to the data of the Progress Report for 2008 of the Federal Agency for State Property Management (net of 136 joint-stock companies subject to the special right («golden share») to their management) ;

ⁱ – the number of blocks of shares in joint-stock companies owned by the Russian Federation, according to the federal property register, as based on the data published by the Federal Agency for State Property Management.

Source : www.mgi.ru ; On the Results of Privatization in the Russian Federation in 2000, and Tasks for 2001 (based on the materials prepared for the Meeting of the Government of the Russian Federation on 08/02/2001); Materials for the Meeting of the Government of the Russian Federation dedicated to “On the Results of Privatization of State-Owned Property in 2001, and the Program of Privatization in 2002” ; Russian Economy in 2001. Trends and Outlooks (Issue 23). Volume 2. M.: IET, March 2002 p. 62; Braverman A.A. “On Measures to Improve Efficiency of Federal Property Management and Assessment Criteria Thereof // Bulletin of the Federal Agency for State Property Management. 2003, No. 1. pp. 13–14; Medvedev Y. M., Performance Results of the Federal Agency for State Property Management of Russia and Territorial Agencies Thereof in 2002 and Tasks for 2003 // Bulletin of the Federal Agency for State Property Management. 2003, No. 1. pp. 30–31; Enterprises with State-Held Interest. Institutional and legal aspects and economic efficiency. Series “Scientific Reports: Independent Economic Analysis”, No. 155. M.: Moscow Social Scientific Foundation ; Association for Studies in Public Economics, 2004. p. 47; The Program of Privatization of Federal Property for 2004 (The Forecast Plan (Program) of Federal Property for 2004 and the Guidelines for Privatization of Federal Property till 2006) // Bulletin of the Federal Agency for State Property Management. 2003, No. 3. pp. 4–5. The Key Issues of Improving Effectiveness of Federal Property Management and the Dividend Policy Guidelines in the Russian Federation// Bulletin of the Federal Agency for State Property Management. 2003, No. 4. p. 8; Andrianov V. Russia in Global Economy // Society and Economy. 2003, No. 11., p. 84; The Forecast Plan (Program) of Federal Property for 2005 ; Materials related to the Meeting of the Government of the Russian Federation on March 17, 2005, “On Measures to Improve Efficiency of Federal Property Management” ; The Forecast Plan (Program) of Federal Property for 2006 and the Guidelines for Privatization of Federal Property for 2006–2008 ; The Forecast Plan (Program) of Federal Property for 2007 and the Guidelines for Privatization of Federal Property for 2007–2009 ; The Forecast Plan (Program) of Federal Property for 2008 and the Guidelines for Privatization of Federal Property for 2008–2010, The Forecast Plan (Program) of Federal Property for 2009 and the Guidelines for Privatization of Federal Property for 2010 and 2011 ; the Progress Report for 2008 of the Federal Agency for State Property Management, M., 2009 ; The Forecast Plan (Program) of Federal Property for 2010 and the Guidelines for Privatization of Federal Property for 2011 and 2012 ; The Forecast Plan (Program) of Federal Property and the Guidelines for Privatization of Federal Property for 2011 – 2013 ; The estimates were made by the Gaidar Institute for Economic Policy.

The upward trend in a interest allowing the federal government to have a full-fledged corporate governance due to the size of such interest which emerged in the mid-2000s, continued to develop in 2009.

As of January 1, 2010, the federal government could hold majority or full control in more than 64 % of the total companies against less than 62 % in the preceding year. Such a development was caused by growth in a share of full (100 %) interest from 55.7 % to 59.6%, though a share of majority interest (by more than 50% but less than 100% of the equity) in the general structure of state-held blocks of shares reduced from 6% to 4.7%. A share of blocking

interest (from 25 to 50% of the equity) reduced more (by more than 3 p. p.) whereas a share of minority (up to 25% of the equity) interest increased insignificantly.

The absolute count of blocking and majority interest reduced by some 30 – 31%. Minority and full interest reduced less, by 9.4% and 5.4% respectively.

Vertically integrated structures continued to grow actively in the year just ended. Eight of such structures were completed as early as 2009. Sixteen vertically integrated structures were expected in 2010. Such structures as Control Systems OJSC and Concern Avtomatika began to set up in the Russian defense industrial sector (Defense Industry).

The United Shipbuilding Corporation (USC) expanded considerably. Blocks of shares in 11 enterprises were contributed in the USC's charter capital as payment for its follow-on offering due to its expansion. Most of them constitute a blocking interest, and only two of them are 100% less one share. A new USC's subsidiary, the South facility, was added to the three available subsidiaries, the West, the North, and the Far East central shipbuilding and ship repairing facilities. The charter capital of the newly established subsidiary joint-stock company of the USC must be financed by contributing a blocking interest in seven open joint-stock companies and 5%-interest in the Lotos Shipbuilding Company held by the Astrakhan Region. In addition, the USC may subsequently contribute core assets owned by the United Industrial Corporation of Mezhprombank which in 2010 committed a substantial delay in payment under unsecured loans of RUB 32 bln granted by the Central Bank of Russia for the purpose of restructuring and had to pledge a majority interest in three shipbuilding companies located at St. Petersburg (Baltiiskiy Zavod (88.32%), Severnaya Verf (75.82%), Aceberg Design Engineering Bureau (64.82%)) to the Central Bank of Russia. Mezhprombank previously made efforts to sell these assets to the USC, but the deal fell through, as the parties thereto had differences in how to value the assets.

Besides, it should be noted that the structural policy plan contains decisions related to the electric power and communications industries.

State-held blocks of shares in 20 open joint-stock companies are planned to be contributed to the charter capital of the above mentioned INTER RAO UES OJSC, in which state-held share is allowed to be reduced down to an amount equal to a minority interest, as payment to a supplement offering by this joint-stock company due to increase in the charter capital of the same. Irkutskenergo (40%) and Enel OGK-5 (26.43%) account for the biggest share of these, while a state-held share in other companies, which are mostly represented by territorial power generating companies, is miserable, not more than 3%¹.

State-held blocks of shares in Central Telegraph (21.78%) and three regional telecom companies, including Bashinformsvyaz (28.24%), Moscow Long-Distance Telephone Station No. 9 (MMTS-9) (38%) and Chukotkasvyazinform (75%) will be contributed to the charter capital of Svyazinvest OJSC, a holding company, as payment for a supplement offering by the company due to increase in the charter capital of the same. The 100% interest in Ingushelektrosvyaz OJSC was previously transferred to Svyazinvest. These measures are in line with a plan of reorganization of the group through consolidation of trans-regional communication companies (MRK) to Rostelecom OJSC, which was approved by the Svyazinvest's Board of Director as early as 2009, Rostelecom is a subsidiary of the All-Russian telecommunication

¹ This is referred to the interest which was transferred to the federal government as a result of restructuring in the electric power industry upon winding-up of RAO UES of Russia in 2008.

holding company and will serve as the base company for setting up an integrated operator providing a complete bundle of services in the field of telecommunications.¹

It is evident that active position of companies with a state-held interest in the corporate control market was limited, which is logical given the post-recession environment. It should be noted that Sberbank purchased a blocking interest in Detskiy Mir – Center OJSC from Sistema JSFC at RUB 3,4 bln², and also may purchase a controlling interest in Troika Dialog, an investment company, and 20% in Scartel, the leading mobile telephony operator in the Wi-max network in Russia, Rostelecom may obtain another 5%. The blocking interest in Scartel is already held by Russian Technologies State Corporation³. Sberbank sold the debts and assets of bankrupt Izh-Auto to Avtovaz and the Russian Technologies State Corporation Group of Companies, though the transaction itself is scheduled for 2011 and implies that Sberbank will subsequently participate in financing investment programs of the United Automobile Group (UAG) set up by Sberbank, as the principal creditor of Izh-Auto to manage the same. In addition to UAG, the largest bank in the country has a direct relationship with other two car assembly plants which were established after the collapse of the Soviet Union: Sberbank Capital which manages non-core assets of Sberbank, holds a blocking interest in the Derways Works located at Karachay-Cherkessia, while the bank itself is a creditor of TagAz (the Rostov Region)⁴.

In February 2011, VTB purchased, at RUB 103 bln, an interest of 46.48% in Bank of Moscow on a sole source basis and a blocking interest in Stolichnaya Insurance Group which holds another 17% in this bank. These assets, which previously were in the municipal ownership, were transferred to the municipally controlled Central Heating Company which closed a transaction with VTB.⁵

In the meantime, in the year to date, *no any significant actions whatsoever were reported in the field of reincorporation of state-owned companies as joint-stock companies* under control of the federal government with subsequent liquidation of the companies which are subject to specific time frames in terms of operation, as was pointed out in the Message of the President of the Russian Federation addressed to the Federal Assembly in November 2009.

According to the estimates made by the representatives from the Ministry of Economic Development and Trade, the Russian Technologies State Corporation cannot be reincorporated as a joint-stock company until 2013 – 2014 when holding and subholding companies will appear inside the company. Vnesheconobank (VEB) (a state-owned company) and the Deposit Insurance Agency (DIA), after carving-out and sale of problem assets which were transferred to them amidst the crisis, will remain non-profit institutions focusing on the tasks which were set originally by the federal government at the time of their establishment⁶.

The Housing and Public Utilities Reformation Foundation Group of Companies will continue to operate for a period of one year, though the Group was planned to be shut down on January 1, 2012. It is obvious that liquidation of the Group will be painful from the point of view of social security, because over the recent few years the Group has been actively in-

¹ www.rbc.ru, December 8, 2010.

² <http://www.prime-tass.ru>, December 8, 2010.

³ www.lenta.ru, January 31, 2011.

⁴ Belikov D. Izh-Auto Will Drive Up to Avtovaz Through Public Financing // Kommersant, No. 235P (4535) dd. 20.12.2010.

⁵ www.lenta.ru, February 24, 2011 .

⁶ www.rbc.ru, December 7, 2010 .

volved in the programs of housing stock overhaul whose format of implementation is uncertain, above all in terms of participation of the general public in such programs.

6.1.4. The Impact of the National Policy in the Field of Property Management on the Budget

The crisis which hit the Russian economy in the fall of 2008, naturally resulted in overall reduction in all of the revenue items of the federal budget in 2009, including revenues generated from the implementation of the national policy in the field of property management. A sizable growth in budget revenues which somehow are linked with state-owned property was reported in 2010 after economic growth recovery.

Let us recall that all of the federal budget revenues generated from the property owned by the public sector can be broken down into two groups according to the nature and sources of the same. The first group consists of revenues generated from utilization of state-owned property (renewable sources). The second group comprises lump-sum revenues which can be renewable due to transition of the title thereto from the federal government to other legal and physical bodies upon sale thereof, which includes the privatization process (non-renewable sources).

The (*Table 10* and *11*) below contains data on revenues which (with only a few exceptions) is included into the laws on the execution of the federal budget in 2000 – 2010 to the extent relating to utilization and sale of state-owned property only in the form of tangible objects¹.

¹ The following revenues are not included into consideration: federal budget revenues generated from payments for natural resources (which include aquatic biological resources, revenues generated from forest resources and subsurface resources management), compensations for agricultural losses which are connected with the retirement of agricultural lands, as a result of financial operations (revenues from budget allocations (revenues on federal budget balances and allocation of the same, since 2006 также revenues from management of the funds of the Stabilization Fund of the Russian Federation (in 2009 – the Reserve Fund and the National Wealth Fund), revenues from allocation of money accumulated as a result of auctions on sale of shares held by the Russian Federation), interest received from domestic federal budget loans, interest on public loans (revenues from payments of the governments and legal entities of foreign nations as payment of interest on loans granted by the Russian Federation, revenues from enterprises and organizations as payment of interest and guarantees on loans obtained by the Russian Federation from the governments of foreign nations and international financial institutions)), from the provision of paid services or compensation for public costs, transfer of profits of the Central Bank of Russia, a few types of payments due by federal and municipal enterprises and organizations (patent fees and registration dues payable for official registration of software, data warehouses and integrated circuit topographies and other revenues which prior to and including 2004 were an integral part of payments due by public organizations (apart from business revenues generated by the Vietsovetpetro Joint Venture since 2001 and transfer of a share of profits of FOUSs since 2002)), revenues from execution of production sharing agreements (PSAs), revenues from disposal and sale of confiscated and other assets which are converted into public revenues (including assets which became public ownership by way of an inheritance or gift or treasure troves), revenues from lotteries, other revenues from utilization of federally owned assets and rights (revenues from exercising the rights to military, special- and double-purpose intellectual property (R&D and technological works), revenues from exercising the rights to scientific and research property owned by the Russian Federation, revenues from operation and utilization of motor roads assets, and other revenues from utilization of assets owned by the Russian Federation), as well as permitted types of activity of organizations, credited to the federal budget, revenues from sale of national stocks of precious metals and precious stones.

Table 10

**Federal budget revenues generated from utilization of state-owned property
(renewable sources) in 2000 – 2010, RUB mln**

Year	Total	Dividends on shares (2000–2009) and revenues from other forms of equity interest (2005–2010)	Lease payment for land owned by the public sector	Revenues from lease of property owned by the public sector	Revenues from of a share of profits which remains after FOUSS pay taxes and mandatory fees	Business revenues generated by Vietsovpetro Joint Venture
2000	23244,5	5676,5	–	5880,7	–	11687,3 ^a
2001	29241,9	6478,0	3916,7 ^b	5015,7 ^c	209,6 ^d	13621,9
2002	36362,4	10402,3	3588,1	8073,2	910,0	13388,8
2003	41261,1	12395,8		10276,8 ^e	2387,6	16200,9
2004	50249,9	17228,2	908,1 ^e	12374,5 ^e	2539,6	17199,5
2005	56103,2	19291,9	1769,2 ^h	14521,2 ⁱ	2445,9	18075,0
2006	69173,4	25181,8	3508,0 ^h	16809,9 ⁱ	2556,0	21117,7
2007	80331,85	43542,7	4841,4 ^h	18195,2 ⁱ	3231,7	10520,85
2008	76266,7	53155,9	6042,8 ^h	1 14587,7 ⁱ	2480,3	–
2009	31849,6	10114,2	6470,5 ^h	1 13507,6 ⁱ	1757,3	–
2010	69728,8	45163,8	7451,7 ^h	12349,2 ⁱ	4764,1	–

^a – according to the data published by the Federal Agency for State Property Management, no separate entries were made, just a total payment from state-owned enterprises (RUB 9887,1 mln) (without specific components) was specified in the law on execution of the federal budget for 2000 ;

^b – the amount of payment for lease of (i) agricultural lands and (ii) urban and municipal lands ;

^c – the amount of revenues generated from lease of the property assigned to (i) scientific and research institutions, (ii) educational institutions, (iii) medical and healthcare institutions, (iiii) public museums, public institutions of arts and humanities, (iiiii) public archive bodies, (iiiii) Ministry of Defense of Russian Federation, (iiiii) organizations subordinate to the Ministry of Railway Communication of Russian Federation, (iiiii) public institutions which provide scientific and research services to academies of science and (iiiii) other revenues generated from lease of property owned by the public sector ;

^d – according to the data the Federal Agency for State Property Management, no separate entries were made, the value coincided with the value of other revenues generated from payments due by public and municipal organizations, in the law on execution of the federal budget for 2001;

^e – the amount of revenues generated from lease of property owned by the public sector (without specifying payment for lease of land) ;

^f – payment for lease of (i) urban and municipal lands and (ii) federally-owned lands upon delineation of the state's title to land ;

^g – the amount of revenues generated from lease of the property assigned to (i) scientific and research institutions, (ii) educational institutions, (iii) medical and healthcare institutions, (iiii) public institutions of arts and humanities, (iiiii) public archive bodies, (iiiii) federal post offices subordinate to the Ministry of Communications and Informatization of Russia, (iiiii) public institutions which provide scientific and research services to academies of science and (iiiii) other revenues generated from lease of federally-owned assets (property) ;

^h – lease payment upon delineation of the state's title to land, and revenues from sale of the right to conclude agreements on lease of federally-owned land (for 2008 – 2010, save for the land plots owned by federal autonomous institutions) ;

ⁱ – revenues generated from lease of property being under operating management by federal bodies of state authority and the entities set up by such bodies, and in operating control of FOUSS: transferred for operating management to public (i) scientific and research institutions, (ii) institutions which provide scientific and research services to the Russian Academy of Science, (iii) educational institutions, (iiii) medical and healthcare institutions, (iiiii) federal post offices subordinate to the Ministry of Communications and Informatization of Russia, (iiiii) public institutions of arts and humanities, (iiiii) public archive bodies, and (iiiii) other revenue generated from lease of property being under operating management by federal bodies of state authority and the enti-

ties set up by such bodies, and in operating control of FOUSs¹ (for 2006 – 2009 net of revenues from permitted types of activity and utilization of federal property located outside the Russian Federation, which are generated outside of the country and were not specified at all in the previous years²);

^j – revenues generated from lease of property being under operating management by federal bodies of state authority and the entities set up by such bodies (save for autonomous bodies): transferred for operating management to public (i) scientific and research institutions, (ii) institutions which provide scientific and research services to the Russian Academy of Science, (iii) educational institutions, (iiii) medical and healthcare institutions, (iiiii) public institutions of arts and humanities, (iiiii) public archive bodies, (iiiii) being under operating management by the Ministry of Defense and agencies which report to the same, (iiiii) owned by the federal government and administered by the General Affairs Department of the President of the Russian Federation and (iiiii) other revenues generated from lease of property being under operating management by federal bodies of state authority and the entities set up by such bodies (net of revenues from permitted types of activity and utilization of federal property located outside the Russian Federation, which are generated outside of the country).

Source: laws on execution of the federal budget for 2000 – 2009; The Report on Execution of the Federal Budget as of January 1, 2011, www.roskazna.ru; The estimates were made by the Gaidar Institute for Economic Policy.

Proceeding to a preliminary analysis of the outcomes of the budget impact on the national policy in the field of property management in 2010, as related to renewable sources, a substantial growth in revenues which constitute direct derivatives of the results of the current economic operations (dividends and transfers of a share of profits of unitary enterprises) should be focused on, above all.

Dividends on federally-held blocks of shares increased by 4,5 times against 2009, failing to catch up with the pre-recession figures of 2008 (RUB 53,2 bln), but outran the level of 2007 (RUB 43,5 bln)³. Transfers of a share of profits of FOUSs increased less (by 2,7 times) to reach the ceilings (RUB 4,76 bln) throughout the entire 2000s.

The situation with revenues from lease, which in 2009 seemed to be more favorable against decrease in revenues from current economic operations, was found to be less optimistic in 2010. Revenues from lease of federal property (RUB 12,35 bln) reduced by 8.6%, corresponding to the level of 2004. Revenues from lease of land continued to grow like in 2009 (by more than 15%), outrunning in absolute value (RUB 7,45 bln) all of the previously reached levels.

The structure of federal budget revenues from renewable sources came back to be in line with the pre-recession structure.

¹ In 2008 – 2009, FSUEs were not mentioned as a source of revenues generated from lease of the property they operate, and lease of the property being under operating management by federal bodies of state authority and the entities set up by such bodies don't include the property of the federal autonomous agencies.

² According to the data published by the Federal Agency for State Property, revenues from utilization of federal property located outside the Russian Federation (apart from the revenues generated by the Russian participant in Vietsovpetro Joint Venture), totaled RUB 315 mln in 1999 and RUB 440 mln in 2000. In the future a major role in the organization commercial utilization of the federal real estate property located outside the country shall play FSUE "Overseas Property Management Enterprise" which reports to the Administration Office of the President of the Russian Federation.

³ It should be noted, however, that in 2007, apart from dividends on the shares of Russian joint-stock companies inside the country, the federal budget generated about RUB 10,5 bln as revenues generated by the Russian participant in the Vietsovpetro Joint Venture. However, upon completion of measures aimed at developing Zarubezhneft OJSC whose charter capital was enriched in 2007 with a 50% interest held by the Russian participant in the Vietsovpetro Joint Venture, apart from blocks of shares of two joint-stock companies as research and development establishments, the federal budget ceased to generate revenues from this source which in 2008 – 2010 ceased to exist in the structure of revenues from renewable sources.

Like in 2008, more than half of the total revenues from the analyzed sources were comprised of dividends whose share doubled to reach 64.8% against 31.8% in 2009. Revenues from lease of federal property resumed their share at the same level (17.7% against 42.4% in 2009 and 19.1% in 2008). A share of revenues from lease of land, which surged forward in 2009 (20.3%), dropped by half to 10.7%, but nevertheless outran the figures reported in 2006–2008. (5–8% of total revenues from renewable sources). Revenues from the profits transferred by FOUSs (6.8%) outran not only the result obtained in 2009 (5.5%), but also the ceiling reported in 2003 (5.8%) during the 2000s.

Proceeding to analysis of federal budget revenues from privatization and sale of state-owned property (*Table 11*), it should be noted that since 1999 revenues from sale of the main share of such assets (shares, and also land plots in 2003 – 2007¹) became to be referred to sources of financing of the federal budget deficit.

Table 11

Federal budget revenues from privatization and sale of property (non-renewable sources) in 2000 – 2010, RUB mln

Year	Total	Sale of federally-owned interest (2000–2009) and other forms of equity interest (2005–2010) ^a	Sale of land plots	Sale of different types of property
2000	27167,8	26983,5	–	184,3 ^b
2001	10307,9	9583,9	119,6 ^c	217,5+ 386,5+0,4 (IAs) ^d
2002	10448,9	8255,9 ^e	1967,0 ^f	226,0 ^g
2003	94077,6	89758,6	3992,3 ^h	316,2+10,5 ⁱ
2004	70548,1	65726,9	3259,3 ^j	197,3+1364,6+0,04 (IAs) ^k
2005	41254,2	34987,6	5285,7 ^l	980,9 ^m
2006	24726,4	17567,9	5874,2 ^l	1284,3 ⁿ
2007	25429,4	19274,3	959,6 ^o	5195,5 ^p
2008	12395,0	6665,2+29,6	1202,0 ^r	4498,2+0,025 (IAs) ^s
2009	4544,1	1952,9	1152,5 ^r	1438,7 ^s
2010	18677,6	14914,4	1376,2 ^r	2387,0+0,039 (IAs) ^s

^a – these are referred to domestic sources of financing of the federal budget deficit, a total of RUB 29,6 mln in 2008 (according to the data included into the Report on Execution of the Federal Budget as of January 1, 2009) is referred to federal budget revenues, but not available in the law on execution of the federal budget for 2008 ;

^b – revenues from privatization of entities owned by the public sector which are referred to domestic sources of financing of the federal budget deficit ;

^c – revenues from sale of land plots, and leasehold rights to the land plots owned by the public sector (specifying land plots on which privatized enterprises are located) which are referred to as federal budget revenues ;

^d – the amount of revenues generated from (1) disposal of federally-owned assets (property) which are referred to sources of internal financing of the federal budget deficit, (2) revenues (i) from sale of apartments, (ii) from sale of public productive and non-productive assets, means of transportation, other equipment and other tangible assets, as well as (3) revenues generated from disposal of intangible assets (IAs) which are referred to as federal budget revenues ;

^e – including RUB 6 mln from sale of shares held by the constituent territories of the Russian Federation ;

^f – revenues from sale of land and intangible assets whose value was not drilled down, which are referred to as federal budget revenues ;

^g – revenues from sale of assets owned by the public sector (including RUB 1,5 mln from sale of the assets owned by the constituent territories of the Russian Federation) which are referred to sources of internal financing of the federal budget deficit ;

¹ In 2003 – 2004, given sale of the leasehold right.

^h – includes revenues: (1) from sale of land plots which contain immovable assets owned by the federal government prior to the alienation, to be credited to the federal budget, (2) from sale of other land plots, as well as from sale of the right to conclude agreements on lease of such land plots, (3) from sale of land plots upon delineation of state's title to land, as well as from sale of the right to conclude agreements on lease of such land plots to be credited to the federal budget which are referred to sources of internal financing of the federal budget deficit ;

ⁱ – the amount of (1) revenues from sale of federally-owned assets (property) which are referred to sources of internal financing of the federal budget deficit, and (2) revenues generated from sale of intangible assets which are referred to as federal budget revenues ;

^j – includes revenues: (1) from sale of land plots prior to delineation of state's title to land on which immovable assets which the federal government owned prior to alienation, are located to be credited to the federal budget, (2) from sale of other land plots, as well as from sale of the right to conclude agreements on lease of such land plots, (3) from sale of land plots upon delineation of state's title to land, as well as from sale of the right to conclude agreements on lease of such land plots to be credited to the federal budget which are referred to sources of internal financing of the federal budget deficit ;

^k – the amount of (1) revenues from sale of federally-owned assets (property) which are referred to sources of internal financing of the federal budget deficit, (2) revenues (i) from sale of apartments, (ii) from sale of equipment, means of transportation and other tangible assets to be credited to the federal budget, (iii) from sale of byproducts resulting from disposal of vessels, (iiii) from sale of the property owned by SUEs, entities and military assets, (iiiii) from sale of by-products resulting from disposal of military equipment and ammunition, (3) revenues generated from disposal of intangible assets (IAs) which are referred to as federal budget revenues;

^l – includes revenues generated: (1) from sale of land plots prior to delineation of state's title to land on which immovable assets which the federal government owned prior to alienation, are located, (2) from sale of land plots upon delineation of state's title to land, to be credited to the federal budget, (3) from sale of other land plots owned by the public sector prior to delineation of state's title to land and not intended for residential housing construction (the latter only refers to 2006) which are referred to sources of financing of the federal budget deficit ;

^m – revenues generated from sale of tangible and intangible assets (net of federal budget revenues generated from disposal and sale of escheat and other property converted into public revenue), include revenues (i) from sale of apartments, (ii) from sale of the assets owned by FOUSs, (iii) from disposal of the property being in operating control by federal agencies , (iiii) from sale of military assets, (iiiii) from sale of by-products resulting from disposal of military equipment and ammunition, (iiiii) from sale of other federally-owned assets (property), (iiiii) from sale of intangible assets which are referred to as federal budget revenues ;

ⁿ – revenues generated from sale of tangible and intangible assets (net of revenues generated as a state-held share in profit products in executing production sharing agreements (PSAs) and federal budget revenues generated from disposal and sale of escheat and other property converted into public revenue), include revenues (i) from sale of apartments, (ii) from sale of the assets owned by FOUSs, (iii) from disposal of the property being in operating control by federal agencies , (iiii) from sale of military assets, (iiiii) from sale of by-products resulting from disposal of military equipment and ammunition, (iiiii) revenues generated from disposal of other federally-owned assets (property) which are referred to as federal budget revenues ;

^o – revenues generated from sale of federally-owned land plots upon delineation of state's title to land, which are referred to sources of financing of the federal budget deficit ;

^p – revenues generated from sale of tangible and intangible assets (net of revenues generated as a public share in profit products in executing production sharing agreements (PSAs) and federal budget revenues generated from disposal and sale of escheat and other property turned into public revenue, revenues from sale of sequestered lumber), include revenues (i) from sale of apartments, (ii) from sale of the assets owned by FOUSs, (iii) from disposal of the property being in operating control by federal agencies , (iiii) from disposal of released movable and immovable assets of federal bodies of state authority in which military and equivalent services are provided for , (iiiii) from sale of military products from federal executive authorities as part of military and technical co-operation, (iiiii) revenues generated from disposal of other federally-owned assets (property) which are referred to as federal budget revenues ;

^r – revenues generated from sale of federally-owned land plots (save for the land plots owned by federal autonomous institutions) which are referred to as federal budget revenues ;

^s – revenues generated from sale of tangible and intangible assets (net of revenues generated as a share in profit products to which the state is entitled in executing production sharing agreements (PSAs), federal budget revenues from disposal and sale of escheat and other property converted into public revenue, money generated from sale of sequestrated lumber, revenues from sale of special raw materials and fissionable materials), include revenues (i) from sale of apartments, (ii) from sale of the property being in operating control by federal agencies (save for autonomous federal agencies), (iii) from disposal of released movable and immovable assets of federal bodies of state authority in which military and equivalent services are provided for, (iiii) from sale of by-products resulting from disposal of military equipment and ammunition, (iiiii) from sale of military products from federal executive authorities as part of military and technical cooperation (only in 2008 and 2010.), (iiiiiii) from sale of byproducts resulting from disposal of military equipment and ammunition as part of the Industrial Disposal of Military Equipment (2005 – 2010) Federal Special Program, (iiiii) revenues generated from disposal of other federally-owned assets (property), as well as revenues generated from sale of intangible assets (IAs) which are referred to as federal budget revenues ;

Source : laws on execution of the federal budget for 2000 – 2009, The Report on Execution of the Federal Budget as of January 1, 2011, www.roskazna.ru; The estimates were made by the Gaidar Institute for Economic Policy.

Property-related federal budget revenues generated from nonrenewable sources grew by more than four times in 2010 against the previous year.

Revenues from sale of shares grew up most (by 7,6 times), and revenues from sale of different assets (property) increased almost 1,7 times. In absolute values, the revenues from the latter source decreased drastically (about RUB 2,4 bln), whereas the revenues from sale of shares (RUB 14,9 bln) doubled, reaching more than 3/4 of the 2007 level, against the 2008 revenues. Revenues from sale of land plots grew up by 19.4% to reach about RUB 1,38 bln thereby outrunning the level of 2008.

Like in 2007, revenues from sale of shares accounted for almost 80% of the total revenues generated from nonrenewable sources against 43% in 2009. Other sources were less significant: sale of different types of property accounted for about 13% (against 31.7% in 2009), while revenues from sale of land accounted for only 7.4% (against about 1/4 in 2009).

Total federal budget revenues generated from privatization (sale) and utilization of state-owned property (*Table 12*) grew up by more than 2,4 times in 2010 against 2009. The absolute value (RUB 88,4 bln) resumed the pre-recession level of 2008, in which case revenues from privatization (sale) of property outran it by more than 1\5 times, whereas revenues from utilization of state-owned property failed to reach this mark.

A share of nonrenewable sources in the structure of total revenues from privatization (sale) and utilization of state-owned property in 2010 increased up to 21%, which is markedly beyond the figures reported in 2008 – 2009 (12 – 14%). On the other hand, revenues from utilization of state-owned property continued prevailing to reach nearly 79%, likewise in 2001 – 2002 and 2006 – 2007. In terms of absolute value, it corresponded to the level of 2006 whereas revenues from privatization and sale of different types of property were found to be lower.

Table 12

Structure of property-related federal budget revenues generated from different sources in 2000–2009

Year	Total revenues from privatization (sale) and utilization of state-owned property		Revenues from privatization (non-renewable sources)		Revenues from utilization of state-owned property (renewable sources)	
	RUB mln	as % of total	RUB mln	as % of total	RUB mln	as % of total
2000	50412,3	100.0	27167,8	53.9	23244,5	46.1
2001	39549,8	100.0	10307,9	26.1	29241,9	73.9
2002	46811,3	100.0	10448,9	22.3	36362,4	77.7
2003	135338,7	100.0	94077,6	69.5	41261,1	30.5
2004	120798,0	100.0	70548,1	58.4	50249,9	41.6
2005	97357,4	100.0	41254,2	42.4	56103,2	57.6
2006	93899,8	100.0	24726,4	26.3	69173,4	73.7
2007	105761,25	100.0	25429,4	24.0	80331,85	76.0
2008	88661,7	100.0	12395,0	14.0	76266,7	86.0
2009	36393,7	100.0	4544,1	12.5	31849,6	87.5
2010	88406,4	100.0	18677,6	21.1	69728,8	78.9

Source: laws on execution of the federal budget for 2000 – 2009; The Report on Execution of the Federal Budget as of January 1, 2011, www.roskazna.ru; The estimates were made by the Gaidar Institute for Economic Policy.

6.1.5. A New Stage in Implementation of the National Policy in the Field of Privatization of State-Owned Property: Basic Priorities and Objects, Actions and Risks

A New Stage of “Structural Privatization”: Priorities, Objectives, and Guidelines

Privatization of state-owned property nearly 20 years has been an integral part of the economic policy in the Russian Federation. The nature, scope, and “shape” of the process used to undergo fundamental changes more than once. Goals and implementation emphases of privatization were changed markedly; legal framework of privatization¹ was revised dramatically twice.

The process of privatization gradually lost its “large scale” nature: while in the first half of the 1990s the number of annually privatized enterprises ran into tens of thousands, the respective federal budget revenues have dropped almost by half (in money terms) over the recent few years. Over the recent 3–4 years, in spite of reduction in the number of entities in the public sector, the role of the latter in the national economy even became more important, including through the processes of formation and expansion of integrated entities in which the federal government has an interest.

The global economic downturn forced the Government of the Russian Federation to take urgent measures aimed at supporting various large companies and banks thereby creating extra preconditions for enlargement and strengthening of economic potential of the Russian public sector.

Declaration of having to carry out a new stage of “structural privatization” in 2010 was governed mostly by the fact that the federal government realized the three fundamental principles available when the economy recovers from a severe stage of the economic downturn :

¹ The third in succession legal act which sets forth the principles and arrangements of privatization – the Federal Law dd. December 21, 2001, No. 178-FZ “On Privatization of State and Municipal Property” – is currently applicable.

- excessive state participation in the economy which became even more excessive in the course of the downturn ;
- insufficient competitive power of a series of large companies included into the public sector, the need for restructuring and upgrade thereof ;
- limited capability of the federal government in effective management of state-owned property.

The risk of further strengthening of state participation in the economy in the post-recession period due to uncertainty as to what to do with companies' blocks of shares which were pledged as security in providing public recession counter support, became a possible extra incentive to discuss at the government level the objectives of structural privatization.

In September – October 2009, official statements of high-rank officials¹ from the Government of the Russian Federation set a clear-cut *objective of structural privatization aimed at reducing the scope of direct state participation in the Russian economy, developing competition in the industries, attracting investments for long-term development of companies, improving effectiveness of large companies in which the federal government holds an interest.*

Legally, the beginning of a new stage of privatization can be related to November 30, 2009 when the Government of the Russian Federation approved a new plan, the Forecast Plan (Program) of Privatization of Federal Property for 2010 and Guidelines for Privatization of Federal Property for 2011 and 2012², which set forth the following objectives for the national policy in the relevant field :

- *carrying out structural reforms in relevant economic sectors ;*
- forming integrated entities in the strategically important economic sectors ;
- privatization of federal property which is not involved in exercising public functions and authorities of the Russian Federation ;
- creating conditions allowing extrabudgetary investments to be attracted for the development of *joint-stock companies ;*
- generating federal budget revenues.

Though the general goal in the field of privatization set forth in the Forecast Plan of Privatization of Federal Property for 2010 was defined in detail – “achieve a strict compliance in the composition of state-owned property with public functions”, however, *both the contents and priority of privatization objectives became an evidence of the development of a new public approach towards privatization of state-owned property.*

A “new vector” in the priorities of privatization can be seen clearly by comparing the forecast plans (programs) of privatization of federal property which were adopted in the period between 2002 and 2009³.

¹ See, for example,; a opening statement made by the Chairman of the Government of the Russian Federation Putin V.V. at the meeting held on October 6, 2009 on the subject matter of guidelines of privatization of federal property for 2010-2012 and shortening the list of strategically important enterprises and joint-stock companies (<http://premier.gov.ru/events/news/5104/>); specific theses in the statement and answers to the questions, by the First Deputy Chairman of the Government of the Russian Federation I. Shuvalov as part of the report on implementation of recession counter measures at the State Duma I. Shuvalov: Russia needs new privatization // *Vedomosti*, 16 September 2009. <http://www.vedomosti.ru/politics/news/2009/09/16/839587>; I. Shuvalov: Corporization of SUEs must continue// *RIA Novosti*, September 16, 2009 <http://www.rian.ru/economy/20090916/185258340.html>).

² Approved by the Order of the Government of the Russian Federation dd. November 30, 2009, No. 1805-p.

³ The Forecast Plan (Program) of Privatization of Federal Property for 2003 (approved by the Order of the Government of the Russian Federation dd. August 20, 2002 , No. 1155-p); The Forecast Plan (Program) of Privatiza-

Such objectives as privatization of property which is not involved in ensuring execution of public functions, and generation of federal budget revenues remained unchanged for all of the forecast plans (regardless of their versions). The objective of reducing the number of unitary enterprises was set in most of the plans of privatization (for 2005 – 2009)¹. With regard to the forecast plan for 2010, it should be noted that at the moment of approval it contained no list of unitary enterprises subject to privatization, and only mentioned competed privatization of nearly 250 FOUSSs for which relevant procedures were initiated in 2009 (as early as March 2010, however, a fairly extensive list of FOUSSs subject to privatization was attached to the program).

Another general feature pertaining to all of the programs of privatization was the goal of reducing the number of state-held small blocks of shares²: each of the forecast plans contained (not among the “official” objectives though) provisions under which all of the state-held interest were subject to privatization in the foreseeable future, save for the shares in joint-stock companies which fall under a specially stated categories – strategically important joint-stock companies, organizations participating in formation of integrated entities, enterprises in specific industries (the programs for 2003 – 2005 provided for sale of blocks of shares constituting an interest of not more than 25%, whereas the programs for 2006 and beyond allowed for sale of blocks of shares constituting an interest of up to and including 50%).

Together with the common features pertaining to the plans of privatizations under review, it is noteworthy specifying differences in the composition of the objectives set forth in the plans :

- the objective of attracting investments in the real sector, which was mentioned in the forecast plan for 2003, was not included into the plans for the subsequent six years, but appeared in the plan for 2010 ;

tion of Federal Property for 2004 and Guidelines for Privatization of Federal Property till 2006 (approved by the Order of the Government of the Russian Federation dd. August 15, 2003 , No. 1165-p); The Forecast Plan (Program) of Privatization of Federal Property for 2005 год (approved by the Order of the Government of the Russian Federation dd. August 26, 2004, No. 1124-p) ; The Forecast Plan (Program) of Privatization of Federal Property for 2006 and Guidelines for Privatization of Federal Property for 2006 - 2008 (approved by the Order of the Government of the Russian Federation dd. August 25, 2005 , No. 1306-p); The Forecast Plan (Program) of Privatization of Federal Property for 2007 and Guidelines for Privatization of Federal Property for 2007 - 2009 (approved by the Order of the Government of the Russian Federation dd. August 25, 2006 , No. 1184-p); The Forecast Plan (Program) of Privatization of Federal Property for 2008 and Guidelines for Privatization of Federal Property for 2008 - 2010 (approved by the Order of the Government of the Russian Federation dd. April 29, 2007, No. 543-p) ; The Forecast Plan (Program) of Privatization of Federal Property for 2009 and Guidelines for Privatization of Federal Property for 2010 and 2011 (approved by the Order of the Government of the Russian Federation dd. 1 September 2008 No. 1272-p); The Forecast Plan (Program) of Privatization of Federal Property for 2010 and Guidelines for Privatization of Federal Property for 2011 and 2012 (approved by the Order of the Government of the Russian Federation dd. November 30, 2009 , No. 1805-p).

¹ It is noteworthy that the forecast plans which contain the task in question, also contain the thesis of that all of the federal state unitary enterprises (FSUEs) which are not involved in exercising public functions, will be suggested for privatization in three years to come.

² It should be noted that a serious progress was achieved in this respect: early in 2002 a share of blocks of shares constituting an interest of up to 50% in the total federally held blocks of shares of joint-stock companies accounted for 82%, whereas by the beginning of 2009 this share reduced almost by half down to 38%. The Russian Economy in 2009. Trends and Outlooks. (Iss. 312). – M.: IET, 2010

- the objective of structural reforms in the economy was mentioned in the first and the second forecast plans (for 2003 – 2004) and the two latest (within the period under review) plans for 2009 – 2010 ;
- the objective of creating integrated entities in the strategically important industries was only set in the plans of privatization for 2009 – 2010¹ .

Analyzing the sectoral structure of the forecast plans approved in the period between 2002 and 2009, it should be noted that enterprises operating in the agricultural and non-production sectors accounted for a big share in each. On the other hand, some of the programs emphasized enterprises operating in other industries: military and industrial and construction sectors in 2006, the above mentioned sectors as well as design & print and fuel and energy sectors in 2007, public road sector as well as geology and precious metals and precious stones sectors in 2009.

Identification of large (major budget revenue generating) entities subject to privatization became an important “innovation” in the plan of privatization for 2010 – this role was assigned to the blocks of shares in five joint-stock companies. In addition, a special allowance was made for privatization of a series of transportation facilities included into the list of strategically important joint-stock companies if the President of the Russian Federation made relevant decisions.

Hence the following *important changes in the stated plans and “ideology” of privatization from 2010* it can be highlighted:

(1) upgrading the priority of the objective of structural reforms in industries (the objective of privatization of the property which is not involved in ensuring execution of public functions and authorities and authorities used to be ranked as top-priority) ;

(2) creating conditions allowing extrabudgetary investments to be attracted for the development of companies is defined as a priority objective;

(3) focusing on privatization of a series of the largest (major budget revenue generating) companies, on the possibility of discontinuing or reducing a state-held interest in a series of joint-stock companies which are included into the list of strategically important enterprises.

In general, the plan of privatization for 2010 is to some extent connected with the “revival” of structural approach towards privatization which was stated early in the 2000s, as well as widening of the basis for subsequent privatization of large companies in the public sector (above all, through transportation infrastructure enterprises)².

¹ It is noteworthy that in spite of that the objective of setting up integrated entities (which was included into the two latest programs only) constitutes a relative “novelty” for the forecast plans, the work on setting up such entities (above all, state-owned holding companies) with the use of privatization arrangements has been in progress over a period of 20 years, since 1992. Public active initiation of integration processes ‘on the eve of’ the economic downturn, in 2007 – 2008, should be focused on. During that period the federal government took part in setting up more than 30 holding companies through preparation and privatization of nearly 200 FOUSs and blocks of shares of joint-stock companies. In addition, it is important to mention about the decisions made in 2008 on transfer of the blocks of shares of about 400 joint-stock companies to Russian Technologies State Corporation (by the way, this transaction is beyond the scope of the Federal Law dd. December 21, 2001, No. 178-FZ, “On Privatization of State and Municipal Property”), a great number of which still remained to be set up through corporization of FOUSs.

² An important feature pertaining to the plan for privatization for 2010 became a 1/5 times increase in expected revenues from privatization in 2010 against the previously planned revenues: RUB 18 bln against RUB 12 bln provided for by the programs for 2008-2009. However, this amount was a very conventional benchmark at the moment when it was officially approved; the stated public plans related to the scope of privatization in 2010

It should be noted that the beginning of a new stage of privatization (November 2009 – March 2010) was associated clearly with a highly intensive discussion at the federal level of objectives and tools of privatization¹ by focusing on structural reforms and modernization of the economy. However, later, especially since the H2 2010, the focus was gradually switched to the role of privatization in terms of generating extra revenues for the federal budget, which resulted from growing doubts in any positive prospects for the Russian economy to grow rapidly in the post-recessionary period, increase in social security budget expenditures and, as a consequence, aggravation of the problem related to federal budget deficit for the years immediately ahead.

As part of the *Forecast Plan (Program) of Privatization of Federal Property and the Guidelines of Privatization of Federal Property for 2011 – 2013*² approved in November 2010, the structural approach towards privatization was more evident than in the forecast plan for 2010 (Table 13).

Table 13

Key objectives of the national policy in the field of privatization of federal property set by the forecast plans (programs) of privatization of federal property for 2010 and 2011–2013

Forecast plan for 2010.	Forecast plan for 2011 – 2013 .
<ul style="list-style-type: none"> – structural reforms in the relevant industries ; – setting up integrated entities in the strategically important economic sectors ; – privatization of federal property which is not involved in ensuring execution of public functions and authorities of the Russian Federation ; – creating conditions allowing extrabudgetary investments to be attracted for the development of joint-stock companies ; – generating federal budget revenues 	<ul style="list-style-type: none"> – creating conditions allowing extrabudgetary investments to be attracted for the development of joint-stock companies on the basis of new technologies ; – reducing the public sector in the economy with a view to developing and encouraging innovative initiatives by private investors ; enhancing corporate governance ; – encouraging the development of the stock market ; – setting up integrated entities in the strategically important economic sectors ; – generating federal budget revenues

It should be noted that the forecast plan for 2011 – 2013, like the program for 2010, provides for sale of blocks of shares in a series of large and extra large companies whereby ensuring most of the budget revenues.

Hence, in spite of increased role of privatization in terms of generating budget revenues, *the structural priority in the program of privatization for 2011 – 2012 is stated more explicitly and in detail than in the forecast plan for 2010, and the structural objectives of privatization acquired an explicitly innovative and modernizational trend.*³

were revised more than once, both upward and downward.

¹ See, for example: an interview with the Deputy Head of the Federal Agency for State Property Management E. Adashkin, RIA Novosti, on November 24, 2009 (<http://www.rian.ru/interview/20091124/195316794.html>); I. Zinenko, N. Govorova, A. Smirnow. Privatization Has Widened Horizons. – Newspaper dd. February 5, 2010; documents of the “round table” dedicated to the subject matter of “Increasing the Role of Privatization as a Tool for Attracting Investments in the Russian Economy”, which was held at the Ministry of Economic Development and Trade Of Russia (http://www.economy.gov.ru/minec/press/news/doc20100329_05).

² Approved by the Order of the Government of the Russian Federation dd. November 27, 2010, No.2102-p.

³ It should be noted that the “structural element” also can be seen to an extent in the efforts which the federal authorities have been making in intensifying privatization processes at the regional level. For example, the Head of the Ministry of Economic Development and Trade Of Russia E. Nabiullina believes that privatization is needed not only to cover the budget deficit – regional programs of privatization must become an integral part of regional programs aimed at enhancing the investment climate. E. Kukol. Taxes Cast Shadows. – Rossyiskaya Gazeta, November 25, 2010.

Let us consider and assess the state practical measures in the field of privatization in 2010. We are of the opinion that *it is reasonable to highlight the following basic steps (approaches) as part of the national policy in the field of privatization of federal property should* :

- widening the base for privatization, which includes reduction in the number enterprises which are included into the list of strategically important enterprises ;
- developing the legal framework for privatization ;
- improving privatization planning procedures; ensuring transparency of privatization processes ;
- developing and widening the range of tools (options) of privatization for large companies ;
- improving privatization arrangements for relatively small companies and lowering the access barriers to privatization for potential buyers of privatized property (assets) ;
- defining a list of the largest companies and banks which are planned for privatization, setting terms and conditions and specific features of privatization thereof.

Widening the Base for Privatization of State-Owned Property by Way of Reducing the List of Strategically Important Enterprises and Joint-Stock Companies and Amending the Original Plan of Privatization for 2010 – 2012 .

The applicable laws and regulations for privatization provide for that the President of the Russian Federation make a special list of federally-owned unitary enterprises (FOUSs) producing products (works, services), which are strategically important for the national defense and security, protection of the principles of public order and morality, health, rights and legal interests of the citizens (strategically important enterprises), as well as federally-owned open joint-stock companies and participation of the Russian Federation in management thereof ensures strategic interests of the nation, defense potential and national security, protection of the principles of public order and morality, health, rights and legal interests of the citizens (strategically important joint-stock companies)¹. *Strategically important enterprises and shares in strategically important joint-stock companies cannot be included into the forecast plan (program) of privatization of federal property provided unless they are excluded from the list.* Therefore, the latter serves as an extra barrier for privatization of specific companies, because these are recognized as strategically important ones.

A list of strategically important companies and joint-stock companies was approved by the President of the Russian Federation in the mid-2004² – more than two years following the date on which the Federal Law “On Privatization of State and Municipal Property” came into force, which required such a list. The original version of the list included 514 FOUSs and 549 blocks of shares in open joint-stock companies. Over the six subsequent years the President of the Russian Federation made more than 100 decisions allowing for various amendments to the contents of the list (*Table 14*)³.

¹ The Federal Law of December 21. 2001, No. 178-FZ, “On Privatization of State and Municipal Property”.

² The Order of the President of the Russian Federation dd. August 4, 2004, No. 1009, “On Approval of the List of Strategically Important Enterprises and Joint-Stock Companies”.

³ Orders of the President of the Russian Federation dated 22.11.2004 No. 1470, dated 29.11.2004 No. 1483, dated 07.12.2004 No. 1502, dated 19.01.2005 No. 41, dated 26.08.2005 No. 985, dated 02.09.2005 No. 1034, dated 12.12.2005 No. 1442, dated 01.02.2006 No. 68, dated 20.02.2006 No. 140, dated 03.03.2006 No. 176, dated 27.03.2006 No. 262, dated 25.04.2006 No. 427, dated 03.05.2006 No. 456, dated 09.06.2006 No. 578, dated 22.06.2006 No. 623, dated 12.10.2006 No. 1135, dated 22.11.2006 No. 1301, dated 30.11.2006 No. 1320,

As a result, as of the beginning of 2011, the list included 148 FOUSs (by 3,5 times less than the original list) and 49 blocks of shares in open joint-stock companies (by 11 times less). Thirty unitary enterprises were included into the list upon August 2004 (or about 1/5) against 19 (or about 40% of all of the blocks of shares) open joint-stock companies. Companies with a full (100%) state-held interest (31 units or 63.3%), with a majority interest (9 units or 18.4%), with a blocking interest (8 units or 16.3%), and even with a minority interest – 1, prevail in the structure of strategically important joint-stock companies.

Table 14

Annual changes in the number of organizations included into the list of strategically important enterprises and joint-stock companies in 2004 – 2010 and the number of the orders on amendments to the list issued by the President of the Russian Federation

Period	The number of Orders on amendments to the list issued by the President of the Russian Federation	Strategically important FOUSs		Strategically important OJSCs	
		included	excluded	included	excluded
2004	3	1	–	1	5
2005	4	2	13	–	4
2006	11+1*	2	18	4	8
2007	42	20	75	12	130
2008	20+2*	1	175	2	195
2009	12	1	23	4	16
2010	11+2*	5	93	8	174

* – the number of orders which changed the name or the format of participation (a new location was specified or a state-held interest was reduced) of a company in the list, without excluding the company from the same. Specific points of the same contents were included into the Orders of the President of the Russian Federation which made amendments to the list.

It is important to point out that it was not always the case when companies were excluded from the list for the purpose of subsequent selling the same :

dated 30.12.2006 No. 1489, dated 26.01.2007 No. 67, dated 03.02.2007 No. 122, dated 03.02.2007 No. 126, dated 03.02.2007 No. 128, dated 05.02.2007 No. 135, dated 14.02.2007 No. 164, dated 23.02.2007 No. 242, dated 21.03.2007 No. 394, dated 21.03.2007 No. 395, dated 21.03.2007 No. 396, dated 21.03.2007 No. 397, dated 21.03.2007 No. 398, dated 21.03.2007 No. 399, dated 21.03.2007 No. 400, dated 13.04.2007 No. 473, dated 27.04.2007 No. 556, dated 28.04.2007 No. 567, dated 28.04.2007 No. 569, dated 28.04.2007 No. 570, dated 27.05.2007 No. 664, dated 20.06.2007 No. 784, dated 26.06.2007 No. 805, dated 20.07.2007 No. 931, dated 03.08.2007 No. 1019, dated 06.08.2007 No. 1031, dated 10.08.2007 No. 1048, dated 11.08.2007 No. 1039, dated 11.08.2007 No. 1040, dated 27.08.2007 No. 1102, dated 11.09.2007 No. 1162, dated 18.10.2007 No. 1382, dated 20.10.2007 No. 1392, dated 03.11.2007 No. 1452, dated 19.11.2007 No. 1536, dated 21.11.2007 No. 1560, dated 21.11.2007 No. 1563, dated 21.11.2007 No. 1564, dated 26.11.2007 No. 1577, dated 06.12.2007 No. 1642, dated 19.12.2007 No. 1715, dated 28.12.2007 No. 1753, dated 28.12.2007 No. 1754, dated 20.02.2008 No. 217, dated 28.02.2008 No. 259, dated 28.02.2008 No.273, dated 01.03.2008 No. 292, dated 03.03.2008 No. 303, dated 08.04.2008 No. 460, dated 08.04.2008 No. 464, dated 11.04.2008 No. 486, dated 16.04.2008 No. 497, dated 26.04.2008 No. 592, dated 29.04.2008 No. 610, dated 27.05.2008 No. 855, dated 29.05.2008 No. 861, dated 09.06.2008 No. 917, dated 10.06.2008 No. 935, dated 12.06.2008 No. 956, dated 10.07.2008 No. 1052, dated 15.07.2008 No. 1096, dated 27.09.2008 No. 1409, dated 03.10.2008 No. 1432, dated 16.12.2008 No. 1785, dated 23.12.2008 No. 1837, dated 06.03.2009 No. 243, dated 10.03.2009 No. 260, dated 19.03.2009 No. 286, dated 20.03.2009 No. 290, dated 20.03.2009 No. 297, dated 11.05.2009 No. 526, dated 11.06.2009 No. 659, dated 24.08.2009 No. 972, dated 19.09.2009 No. 1053, dated 05.11.2009 No. 1251, dated 06.11.2009 No. 1253, dated 26.12.2009 No. 1474, dated 29.03.2010 No. 383, dated 05.04.2010 No. 419, dated 22.04.2010 No. 504, dated 23.04.2010 No. 513, dated 10.05.2010 No. 568, dated 09.06.2010 No. 696, dated 18.06.2010 No. 762, dated 21.06.2010 No. 769, dated 30.09.2010 No. 1186, dated 30.09.2010 No. 1190, dated 01.10.2010 No. 1197, dated 16.10.2010 No. 1261, dated 03.11.2010 , No. 1324.

- *in most cases, organizations were excluded from the list due to integration processes* (which includes build-up of the property portfolio of state-owned corporations). At least 500 of about 930 organizations excluded from the list at different times, were excluded due to set-up of integrated entities of different types whose number (including state-owned corporations such as Rosatom and Russian Technologies State Corporation) reached 30. In particular, integrated entities such as United Shipbuilding Corporation OJSC, “AVRORA Scientific and Production Association” Concern, “Electropribor Central Scientific and Research Institute Concern, the Center for Shipbuilding and Shiprepairing Technology, the Russian Corporation for Rocket and Space Instrument Engineering and Information Systems, High-Precision Instrument Engineering Systems, the Center of Excellence for Farm Livestock Reproduction were included into the list of strategically important companies and joint-stock companies in 2010 ;
- since corporization of a 100% state-owned unitary enterprise means privatization of the same¹, the corporization procedure (even without subsequent sale of the shares in a new joint-stock company) required that the unitary enterprise be excluded from the list (it should be noted that in some cases, the shares in open joint-companies were included into the list upon registration of the same) ;
- some of the organizations were excluded from the list due to wind-up of the same.

The list was not only shortened but also widened at the same time. Both previously existing organizations (whose strategic importance previously seemed to be insignificant or unobvious) and newly established companies, above all, joint-stock companies resulted from corporization, as well as the head companies of established integrated entities were included into the list. However, the total number of added organizations (throughout the entire period of the list) is much smaller than that of excluded ones (only 63 organizations against about 930).

Since its approval in August 2004 till the end of 2006, the list underwent no drastic changes, only about 5% of changes were made in its contents over the same period. Large-scale shortening of the list began in 2007, when more than 200 organizations (almost 20% of the original contents) were excluded from the list, most of which were excluded for the purpose of setting up different integrated entities. In 2007, the President of the Russian Federation made the most of the decisions providing for such actions (more than 40 presidential orders were issued).

The most significant shortening of the list took place in 2008, when 370 organizations – more than one third of its original contents – were excluded therefrom. However, the overwhelming majority of the organizations (95%) were excluded due to integration processes (which includes the property deposit made by the Russian Federation to the Russian Technologies State Corporation).

The large-scale shortening continued in 2010, when about 270 organizations, or almost one fourth of the original contents and more than a half of the enterprises which were in the list as of the beginning of the same year, were excluded from the list.

The shortening in 2010 differed largely from the previous ones :

¹ Under the regulations and provisions of the civil law, the title to the property owned by a unitary enterprise is to be vested in the state. As part of the corporization procedure, a newly established joint-stock company is to own such property while the state is to hold a 100% interest in the same.

(1) *it is not integration that is mainly responsible for exclusion of organizations from the list* (at least no integration was mentioned in the Order of the President of the Russian Federation which contains most of the organizations which are subject to exclusion¹);

(2) the previous large-scale shortening of the list took place in the period between 2007 and 2008. The number of the excluded unitary enterprises and joint-stock companies was almost equal. As a result, their percentage ratio in the list remained almost equal (52% against 48%, respectively) by the beginning of 2010. In 2010 *joint-stock companies* (the ratio of more than 2:1) *prevailed among the organizations excluded from the list*, which resulted in a reduction of up to 23% of the organizations of such a form of incorporation in the list.

(3) *joint-stock companies in which less than 50% of equity interest was held by the Russian Federation accounted for more than 4/5 of the joint-stock companies which were excluded from the list in 2010*. Such joint-stock companies accounted for nearly 2/3 of the total number of the joint-stock companies included into the list as of the beginning of 2010 against nearly 18% of those included by the end of the same year. Furthermore, the state acts as a majority shareholder in a whole range of the companies left in list, which less than 50% of equity interest was held by the Russian Federation (Transinzhstroj OJSC, Gazprom OJSC, Korolev 'Energy' Rocket and Space Corporation OJSC, Pervy Kanal OJSC)².

(4) examining by industry a total of the organizations excluded from the list in 2010, it is noteworthy that *a large number (nearly one forth) of them are somehow connected with the transport sector and the relevant infrastructure*. For example, a considerable number (almost 40) of organizations operating in the field of transportation (sea and river ports, airports, more than 10 sea and river shipping companies, an airline company, several enterprises operating in the sector of transport machinery industry, specific research and training organizations operating in the sector of civil aviation)³ were among those excluded from the list. In addition, a series of companies operating in such sectors as electronic industry and instrument engineering were excluded from the list.

The process of reducing the list of strategically important companies and organizations in 2010 was accompanied by *a large-scale expansion of the original (approved in November 2009) plan of privatization for 2010*. During the year the Government of the Russian Federation made 16 decisions on amendments to the forecast plan⁴ thereby doubling the number, from 449 to 1004, of companies subject to privatization in 2010. Unitary enterprises accounted for nearly half (250 of 557) of the companies included into the program (we remind that the original forecast plan for 2010 contained no list of FOUSs subject to privatization). In

¹ The Order of the President of the Russian Federation dated June 18, 2010, No. 762. At the same time, the State Legal Directorate issued a note on the Order, which specified that "decisions have already been made on transfer of the state-held blocks of shares (74.5 to 100 percent) in specific organization to the charter capitals of different integrated entities" (<http://www.kremlin.ru/acts/8098>). It should be noted that until 2010 the relevant presidential orders not always contained a direct order to subsequently set up integrated entities.

² <http://www.kremlin.ru/acts/8098>.

³ The shortening of the list of strategically important companies and organizations in June 2010 made it legally possible to extend the forecast plan of privatization of federal property for 2010 - 2012 in August 2010 by adding large entities operating in the field of transport and transport infrastructure.

⁴ Orders of the Government of the Russian Federation dated 03.02.2010, No. 132-p, dated 27.02.2010, No. 233-p, dated 17.03.2010, No. 346-p, dated 15.05.2010, No. 735-p, dated 05.07.2010, No. 1122-p, dated 04.08.2010, No. 1321-p, dated 13.09.2010, No. 1536-p, dated 24.09.2010, No. 1608-p, dated 14.10.2010, No. 1770-p, dated 23.10.2010, No. 1837-p, dated 11.11.2010, No. 1953-p, dated 27.11.2010, No. 2092-p, dated 03.12.2010, No. 2165-p, dated 08.12.2010, No. 2191-p, dated 08.12.2010, No. 2206-p, dated 17.12.2010, No. 2293-p.

nearly half of the cases, however, such enterprises were included into the program as part of plans of their further affiliation with integrated entities (as a rule, Russian Technologies State Corporation). In addition, the forecast plan included 297 open joint-stock companies¹, 100% interest in most of which was subject to privatization.

The Government of the Russian Federation made two decisions which are considered the most relevant in terms of widening the base for privatization² :

(1) 467 companies were added at a time to the plan in March 2010³. According to this decision, another 227 entities (above all, through a relatively small companies operating in the agricultural industry, non-production sector, construction industry) were added to the list of open joint-stock companies whose shares were planned for privatization. In 2/3 of the cases, 100% interest was subject to privatization; furthermore, the state planned to privatize the 100% interest less one share in a series of open joint-stock companies (most of which belong to the defense industrial sector). In addition, 230 FOUSS (most of which belonged to the defense industrial sector, agricultural sector, public road industry and nonproductive sector) were included into the forecast plan, 99 of which (including all of the enterprises operating in the defense industrial sector) were included for the purpose of further integration ;

(2) in August 2010, 26 fairly large joint-stock companies operating in the transport sector and the transport infrastructure⁴ were added to the plan of privatization: 13 sea and river ports, 11 sea and river shipping companies and two airports. Allowance was made to sell all of the remainder of state-held blocks of shares (25.5%, as a rule). It should be noted that this decision became legally applicable after the list of strategically important companies and organizations was shortened in June 2010.

Hence, as early as *September 2010, regulatory support was provided for initiating privatization of a considerably larger number of companies against the beginning of 2010 thereby widening visibly the range of large companies which are planned for privatization.*

Developing Regulatory Control in the Field of Privatization

Substantial modernization of privatization arrangements, the relevant regulations of the law was required to meeting the set objectives of making structural changes in the national economy, attracting investments in the development of privatized companies, reducing direct participation of the state in the economy and the scope of the public sector through privatization of state-owned property. There are several reasons for this.

First, *immaturity of regulatory arrangements of the procedures for privatization of large companies*. According to Clause 3, Article 13 of the previously applicable version of the Federal Law “On Privatization of State and Municipal Property”, the set of tools of privatization

¹ It should be noted that seven closed joint-stock companies and three limited liability partnerships were included, apart from FOUSS and open joint-stock companies, into the forecast plan for 2010.

² Another supplement to the forecast plan for 2010 is worth mentioning: pursuant to the Order of the Government of the Russian Federation dated October 23, 2010, No. 1837-p, the blocks of shares of 20 power generating companies were added. The overwhelming majority of these blocks of shares were minority stakes (less than 1%) and included into the forecast plan, because they were to be contributed to the charter capital of Inter RAO UES OJSC.

³ The Order of the Government of the Russian Federation dated March 17, 2010, No.346-p.

⁴ The Order of the Government of the Russian Federation dated August 4, 2010, No.1321-p.

of large companies (fixed assets' book value of more than five million minimum wages¹) was very limited to auctions, corporization of unitary enterprises, and contribution of assets to the charter capitals of strategically important joint-stock companies.

Second, *lack of the possibility within the framework of privatization arrangements to define investment terms and conditions for those who buy state-owned property*, as well as terms and conditions for modernization, restructuring of privatized enterprises. Tender is the sole privatization arrangement which provides for specific terms and conditions to be met by buyers of state-owned property. However, Clause 21, Article 20 of the Federal Law "On Privatization of State and Municipal Property" specifies an exhaustive list of terms and conditions of a tender, which only includes preservation of jobs, advanced training of personnel, retaining the core activity, restoration, repairing of heritage and social security sites.

Third, *restrictions imposed on reduction of state-held interest in companies during additional issue of shares*. Though Article 40 of the Federal Law "On Privatization of State and Municipal Property" allows a state-held interest to be reduced during additional issue of shares in accordance with the decisions made by the President of the Russian Federation, the Government of the Russian Federation, it is strictly established that :

- where a state-held interest accounts for more than 25% but not more than 50% of votes, the charter capital may grow by issuing additional shares, provided that the state retains a blocking interest (25% plus one voting share);
- where a state-held interest accounts for more than 50% of votes, the charter capital may grow, provided that the state keeps holding a controlling interest (50% plus one voting share).

Though it is obvious that the foregoing restrictions were imposed in order to prevent the risk of dilution of state-held blocks of shares, reduction of revenues from privatization, such restrictions are regarded as a serious barrier hindering companies with a state-held interest from attracting strategic investors by way of additional issues of shares, generating inflow of financial resources².

Forth, *excessive regulatory control of a series of arrangements oriented to privatization of small enterprises*, which interfered with rapid reduction in the number of public sector enterprises and raised extra barriers for access of a wide range of potential buyers, in particular small and medium-size businesses.

The first three restrictions were most significant given the stated plans of privatization of large enterprises, which include the primary entities of the transport infrastructure.

*Federal Law of May 31, 2010, No. 106-FZ, "On Amendments to the Federal Law "On Privatization of State and Municipal Property"*³ was adopted following a very intensive process of work-out of different approaches as part of regulatory support to a new stage of privati-

¹ Since January 1, 2009, the minimum monthly wage has been established in the amount of RUB 4,330 (Art. 1 of the Federal Law 91-FZ dd. June 24, 2008 "On Amendments to Article 1 of the Federal Law "On Minimum Monthly Wage").

² It is obvious that in certain cases it may be considered more reasonable from the economic (political, etc.) point of view to retain state control (blocking interest in) of a company than provide inflow of direct, additional investments in the development of the company, however the question at issue is that the applicable legislation leaves no room for choice.

³ A group of PMs submitted a draft law to the State Duma on March 25, 2010. After passing the first reading on April 16, 2010, the draft law was seriously amended and (a single amendment which derived from another draft law which was developed at the same time) and adopted on May 19, 2010 in the second reading, and the State Duma adopted its final version as early as May 21.

zation,. The law includes a series of *regulations which change essentially the terms and conditions and specific privatization tools*. The following innovations are most relevant :

- (1) transition to mid-term planning of privatization of federal property ;
- (2) entitling the Government of the Russian Federation to make decisions on privatization of state-owned property beyond the scope of the “standard” procedures specified by the Federal Law “On Privatization of State and Municipal Property” ;
- (3) allowing the Government of the Russian Federation to delegate the functions of buyer of federal property to legal entities ;
- (4) removing restrictions as to potential arrangements of privatization of large state-owned properties whose book value is more than five million minimum monthly wages ;
- (5) simplifying the application of an arrangement of privatization such as deposition of state-owned property to the charter capital of joint-stock companies ;
- (6) discarding the concept of standard price of property which is subject to privatization;
- (7) simplifying privatization of small federal properties, widening access for participation of potential buyers in privatization ;
- (8) extending significantly requirements to transparency of privatization procedures.

Let us examine these innovations in detail.

(1) Transition to mid-term planning of privatization of federal property

While it was previously stated that the Government of the Russian Federation is to adopt the forecast plan of privatization of federal property on an annual basis, now Clause 1, Article 7 of the Federal Law “On Privatization of State and Municipal Property” *specifies that the Government of the Russian Federation may approve the forecast plan (program) of privatization for a period of 1 to 3 years*. In September 2010, the Government of the Russian Federation made relevant amendments to the Rules of Development of the Forecast Plan (Program) of Privatization of Federal Property¹ .

Hence, the scope of privatization planning, longer, more consistent and meaningful actions and procedures for preparation of entities for privatization became wider. It should be noted that "structural" trend in privatization is supported by that the plan of privatization must contain *a forecast of the impact of privatization of property on structural changes in the economy*, including specific industries.

In the meantime, it should be noted that the new forecast plan of privatization of federal property for 2011 – 2012 approved by the Government of the Russian Federation in November 2010 contains the relevant section on a formal basis, because its contents are no different from the previous forecast plans (e.g., the focus is placed on breakdown by industry of companies of the public sector and entities for privatization); however, it contains no even the most general assessment of expected changes in a share of the public sector in the economy or specific industries.

(2) Entitling the Government of the Russian Federation to make decisions on privatization of state-owned property beyond the scope of the “standard” procedures specified by the Federal Law “On Privatization of State and Municipal Property”

This innovation seems to be both most “revolutionary” and arguable. Clause 2, Article 3 of the Federal Law “On Privatization of State and Municipal Property” was supplemented by paragraph 15 under which from now on this law may not be applied to relations arising during

¹ The Order of the Government of the Russian Federation dd. September 13, 2010, No. 725, “On Amendments to the Rules of Development of the Forecast Plan (Program) of Privatization of Federal Property”.

alienation “of federal property in accordance with the decisions which the Government of the Russian Federation makes with a view to creating terms and conditions for attracting investments, encouraging development of the stock market as well as modernization and technological development of the economy”. Such a general wording seems to impose no limits to the application of this regulation, and the law neither contains requirements whatsoever to potential buyers of alienated property, nor any specific terms and conditions for the application of this arrangement.

Of course, one may suggest that this arrangement would be applied on a “custom-made” basis – to the largest and unique or very important entities. Furthermore, it should be noted that under the last paragraph in Clause 2, Article 3 of the Federal Law “On Privatization of State and Municipal Property” alienation of the property listed in this clause must be regulated by other federal laws and relevant by-laws. Hence it may be inferred that practical implementation of the given approach will require development and adoption of a relevant statutory instrument which would resolve a high level of uncertainty prevailing for the moment.

Most probably the regulation in question was introduced into the Federal Law “On Privatization of State and Municipal Property” in an effort to extend the potential of “investment-driven” privatization of large companies, in particular by way of *direct sale of a federally-owned block of shares to strategic investors of a company which already hold a control interest in the same (50 – 75%)*¹. One of the preconditions for application of such an approach became a widely-held perception of that for fear of new investors the existing strategic investors of companies may act as a break on the process of privatization². In this respect, it should be noted that orientation towards the existing shareholders of companies seems to be unreasonable in some cases, because at least they may not be strategic investors.

One way or another, it only may be assumed for the time being that the arrangement in question – the Government of the Russian Federation makes decisions on alienation of specific federal properties beyond the scope of the Federal Law “On Privatization of State and Municipal Property” – will be applied exclusively to direct sales of small blocks of shares to strategic investors. No regulation for this option of privatization has been established to date thereby leaving a wide range of different solutions and compromises. In this respect, it is worth mentioning a recently discussed (also at the level of high-ranking officials) possibility of *placing, on a sole source basis, a state-held interest in a large entity of the transport infrastructure (Sheremetyevo Airport) in management of a strategic partner for a long-term period (20–30 years)*³. In addition, the business community more than once submitted a proposal on *granting to all private shareholders the priority right to buy out privatized shares in a semi-*

¹ See, for example: M. Tovkailo, A. Nepomnyaschiy. The Property Will Be Transferred to a Single Owner. – *Vedomosti*, March 3, 2010.

² See, for example, statements made in follow up of the round table dedicated to the subject matter of “Increasing the Role of Privatization as a Tool for Attracting Investments in the Russian Economy” which was held at the Ministry of Economic Development and Trade Of Russia on March 29, 2010, as attended by the First Deputy Chairman of the Government of the Russian Federation I. Shuvalov, the Minister of Economic Development E. Nabiullina, and representatives of investment banks and business entities http://www.economy.gov.ru/minec/press/news/doc20100329_05.

³ *ibid.*

*public company*¹. It should be noted that a relevant draft law was submitted to the State Duma by a PM as early as May 2008², but the initiator withdrew the same in six months.

In our opinion, all of the above listed options contradict (maybe in different ways) the principle of fair competition and may result in undervaluation of alienated properties.

(3) Allowing the Government of the Russian Federation to delegate the functions of buyer of federal property to legal entities

This innovation is *directly related to the development of instruments of “new” privatization*³.

Before that (prior to the date when the Federal Law "On Privatization of State and Municipal Property" was amended), only designated public agencies which were in the service of the Government of the Russian Federation, could act as sellers of privatized property (apart from an executing agency authorized by the Government of the Russian Federation). Under the new version of the law, clause 1 (paragraph 16), article 6 of the Federal Law “On Privatization of State and Municipal Property”, the Government of the Russian Federation is entitled to commission *legal entities* to make arrangements for sale of privatized federal property and/or *act as buyers*. The Government of the Russian Federation’s decision on commissioning a specific legal entity to perform such functions must specify federal properties which are subject to privatization, specific actions to be performed by the legal entity, the size of and payment procedure for a fee due to the legal entity. Under paragraph 8.1, clause 1, article 6 of the Federal Law “On Privatization of State and Municipal Property”, a list of such legal entities is to be approved by the Government of the Russian Federation. A new version of clause 2, article 14 of the Federal Law “On Privatization of State and Municipal Property” specifies that the Government of the Russian Federation may decide not to set the initial price thereof in employing this type of sale of privatized property.

Neither terms and conditions for application of this arrangement, nor selection criteria for legal entities were defined. Only a series of statements made by officials on the subject matter are available, according to which legal entities are planned to be engaged only *in exceptional cases* related to sale of large and significant assets; large Russian and foreign investment banks are suggested to be engaged as sellers (sales managers); a sort of a ‘scoring procedure’ will be used in selecting a bank for a specific transaction⁴.

In October 2010, the Government of the Russian Federation made a list legal entities which may be commissioned to sell of privatized property and/or act as buyers⁵. The list comprised 10 well-known financial institutions, in particular, VTB Capital, Vnesheconobank

¹ See, for example: Titov B., Privatization: New Arrangements] <http://slon.ru/blogs/titov/post/344182/>.

² Federal Draft Law No. 87293-5 «On Amendment to Article 43 of the Federal Law “On Privatization of State and Municipal Property”».

³ It should be noted that the relevant initiative was launched by the decisions made in mid-November 2009 at a meeting of the Government of the Russian Federation dedicated to the improvement of the legislation with a view to enhancing effectiveness of privatization. It is until the 2009 year-end that the Ministry of Economic Development and Trade prepared a respective draft law which was sent out to the concerned agencies for approval, and early in March 2010, the Ministry published the same (as slightly amended) for independent due diligence on propensity for corruption (http://www.economy.gov.ru/minec/activity/sections/govProperty/doc20100301_05). In the spring of 2010, the relevant regulation was included into a more general draft law on amendments to the law on privatization, which was adopted shortly (the Federal Law dd. May 31, 2010, No. 106-FZ, “On Amendments to the Federal Law “On Privatization of State and Municipal Property”).

⁴ See, for example: T. Zykova. Public Sales. – Rossiyskaya Gazeta, July 29, 2010.

⁵ The Order of the Government of the Russian Federation dd. October 25, 2010, No. 1874-p.

Investment Company, Renaissance Broker, Credit Suisse Bank (Moscow), Deutsche Bank, Merrill Lynch Securities. Another 13 institutions were added to the list in December 2010¹.

As part of preparation for the first privatization transaction under a new scheme, the Government of the Russian Federation selected Merrill Lynch Securities LLC as the seller of a 10% interest in VTB Bank, which was the sole contractor of the relevant government contract². However, neither the decision of the Government, nor the follow-up comments by officials contained any details as to the choice³. A scheme providing for a single contractor for a government contract was used.

Basically, one may expect that by engaging investment banks and companies which have experience in this type of transactions, skilled personnel as well as well-established relations with large global investors, to take part in privatization of federal property would allow a comprehensive analysis of a to-be transaction to be made, which would take account of a privatized joint-stock company's needs for investments, technological modernization, and, in the long run, would allow effectiveness of privatization to be enhanced. On the other hand, one cannot but note a poor transparency of the processes related to compilation of a list of organizations – potential sellers – as well as selection of a specific seller for the initial transaction, and uncertainty of the relevant procedures and criteria. Perhaps, due to a “custom-made” nature of transactions which require engagement of legal entities, explicit criteria of their selection from the already approved list are not considered vital, however, the state (represented by authorized agencies) should at least explain choice it makes.

(4) Removing restrictions as to potential arrangements of privatization of large state-owned properties whose book value is more than five million minimum monthly wages

Clauses 3 and 4, article 13, under which it is understood that the portfolio of assets owned by FOUSs and federally-owned shares in open joint-stock companies whose fixed assets' book value is more than five million minimum monthly wages only could be privatized by way of five of the 10 legally established options of privatization, ceased to be in force in the new version of the Federal Law “On Privatization of State and Municipal Property”; *in particular, options such as sale of property through a tender; sale of shares through a market maker in the security market, sale of shares based on trust management results were not allowed.*

Hence, one of the barriers which interfered with flexibility and case-driven approaches towards privatization of large companies, was eliminated. Most importantly, there is existing possibility of a “smooth” privatization of large companies based on trust management results, because this, on the one hand, allows direct participation of the state in management of such companies to be reduced, and, on the other hand, ensure correct measurement of the results and “quality” of a new potential owner in making future decisions on alienation of state-owned property.

(5) Simplifying the application of an arrangement of privatization such as deposition of state-owned property to the charter capital of joint-stock companies

¹ The Order of the Government of the Russian Federation dd. December 20, 2010 , No. 2349-p.

² The Order of the Government of the Russian Federation dd. November 2, 2010 , No. 1928-p.

³ It was reported in mass media, with reference to public officials and representatives from VTB Bank, that Merrill Lynch Securities was selected because of the company has experience in the field of privatization of financial institutions in emerging markets, as well as support of this choice by the top management of VTB Bank. M. Tovkailo, N. Asker-zade. Who is Going to Sell VTB. – Vedomosti, November 9, 2010.

The amendments made to the Federal Law “On Privatization of State and Municipal Property” in May 2010 relaxed the restrictions imposed on contributing state-owned property to the charter capital of open joint-stock companies. Article 7 thereof was supplemented with clause 2.1 under which *no amendments must be made to the forecast plan (program) of privatization for a planning period* in contributing, as decided by the President of the Russian Federation and the Government of the Russian Federation, federally-owned shares in open joint-stock companies arising from corporization of FOUSs to the charter capital of open joint-stock companies. Though this amendment could have been regarded as technical one, aimed at reducing costs incurred by setting up integrated entities, in our opinion, the need in amendments to the plan of privatization at least provided an opportunity to make adjustments and updates to previously made decisions, in particular when multiple of blocks of shares are contributed.

A more important innovation was *elimination of the restriction on contribution of shares in large companies (whose fixed assets’ book value is more than 5 million minimum monthly wages) to the charter capital of joint-stock companies* – formerly, such shares *only* could be contributed to the charter capital of *strategically important* joint-stock companies under regulations issued by the President of the Russian Federation – after clause 3 was deleted from article 6 of the Federal Law “On Privatization of State and Municipal Property”. It should be noted that the explanatory note to the draft law on amendments to the Federal Law “On Privatization of State and Municipal Property” specified that the need in such an amendment was directly linked with the need to complete the processes of contribution of state-owned property to the charter capital of large companies, namely Russian Railroads OJSC and Rosselkhozbank OJSC.

Hence additional preconditions for setting up integrated entities in the course of privatization were created. This aspect seems to be very important at the moment, because contribution of blocks of shares to the charter capital of joint-stock companies constitutes a very specific way of privatization which results in short-term increase in state participation in the economy rather than its increase due to expansion and strengthening of state-controlled integrated entities in the market. Of course, it is not so simple at all: set-up of integrated entities may be related to “alignment” of efficient businesses which are assumed to be subsequently privatized. For some reasons, however, it is this option of privatization that may become most preferable for privatized companies, because it is more predictable and allows for preliminary arrangements as to the future of managers and owners of such companies.

(6) Discarding the concept of standard price of property which is subject to privatization

The concept of standard price – a minimum price at which properties can be alienated, which is to be set pursuant to the procedure established by the Government of the Russian Federation, was discarded from article 12 of the Federal Law “On Privatization of State and Municipal Property”. Only a single option of valuation of property subject to privatization as part of article 12 thereof is left – initial price is to be set under the law on valuation. From now on the initial price of a property is to be specified (clause 2, article 14)¹ in decisions on terms and conditions of privatization of state-owned property (apart from other terms and conditions) as opposed to the standard price which had to be specified in the previous years.

¹ On the other hand, initial price can be set when the Government of the Russian Federation commissions legal entities to sell privatized property (under paragraph 16, clause 1, Article 6).

Hence, abolition of the standard price principle created additional preconditions for valuation of a fair market value in the course of privatization of property.

(7) Simplifying privatization of small federal properties, widening access for participation of potential buyers in privatization

A package of amendments simplifying access to participation in sale of privatized state-owned property and competition development was made to the Federal Law "On Privatization of State and Municipal Property" in May 2010.

First, *e-trading may be used for privatization of property*. The Federal Law "On Privatization of State and Municipal Property" was supplemented with Article 32.1 under which :

- state-owned property may be sold electronically, in which case a decision on terms and conditions of privatization of the property must contain information thereof ;
- open and free of charge access to the relevant information must be ensured in the course of e-trading; bidders may electronically submit their bids and attached documents ;
- e-trading bidders must not be charged any extra legal payments ;
- contents and terms and conditions of e-trading announcement were specified.

It should be noted that a procedure for e-trading still remains to be developed by the Government of the Russian Federation.

Through e-trading is not provided for all of the options of privatization (it is obvious that e-trading cannot be applicable to corporization (transformation into open joint-stock companies) of unitary enterprises, contribution of assets to the charter capital of open joint-stock companies, sale based on trust management results), it can be applied to auction-based options of privatization as well as tender-based sale of property, through IPO, without price quotation. According to the contents of article 32.1 of the Federal Law "On Privatization of State and Municipal Property", e-trading of state-owned property is primarily oriented towards options of privatization such as auction-based options and through IPO.

Second, *the terms and conditions of sale through IPO* (for reference: this option of privatization is applied when an auction has been declared void) *were widely updated and improved* in the new version of article 23 of the Federal Law "On Privatization of State and Municipal Property". It should be noted that sale through IPO was used in the previous years, because a large part of property was normally failed to be sold at auctions, though it was poorly protected against different types of manipulation.

Following are the most important amendments to the IPO option which focus on improvement of competition and valuation of fair market value :

- the opening bid gradually goes down as part of a single procedure (clause 5, article 23) rather than through specific periods ;
- an auction must be held when there are more than one bidder with the same bid (clause 5, article 23) ;
- property may not be sold through IPO with only one bidder (clause 6, article 23) ;
- the Government of the Russian Federation must establish the procedure for sale of property through IPO¹.

¹ It should be noted that late in July 2010 the Ministry of Economic Development and Trade of Russia announced that it had prepared a draft order of the Government of the Russian Federation on amendments to government acts in connection with the amendments made to the Federal Law "On Privatization of State and Municipal Property" which was sent out for interdepartmental approval, in particular of a new version of the Provision on Sale of State and Municipal Property Through IPO (http://www.economy.gov.ru/minec/about/structure/depreal/doc20100729_07), the text of this document was not published though.

Third, *the size of the required bid bond for auction* (clause 6, article 18) or *tender* (clause 5, article 20) *was reduced considerably: from 20% to 10% of the opening bid of privatized property.*

Hence, in our opinion, preconditions for rapid and large-scale sale of small assets of state-owned property, “clearing” of the public sector composition were created in general. This may ensure a better transparency and competition in privatization transactions, extended participation in privatization as buyers of small companies.

(8) Extending significantly requirements to transparency of privatization procedures

A considerable number of amendments to clause 15 of the Federal Law “On Privatization of State and Municipal Property” enhanced significantly the requirements to information support of privatization. It is worth highlighting the following most relevant amendments :

- information *on all stages of privatization at all levels of ownership* must be published in print and electronic media, in which case decisions made by public authorities *may only supplement the requirements to contents and quantity of published information* ;
- open joint-stock companies and unitary enterprises must disclose information (in accordance with the procedure and form to be approved by a regulator in the securities market or an authorized executive authority¹) from the date when they are included into the forecast plan;
- provision of additional information support with regard to specific property assets.

The adopted regulations certainly deserve a positive appreciation. One cannot note, however, inconsistency and variance of public measures in this sector. Efforts have been made to provide regulatory support of the privatization process at all stages, on the one hand, while a series of the above discussed public “individual” solutions and measures in the field of privatization are extremely nontransparent, on the other hand.

In general, the following can be abolished with the regard to the completed innovations in the Federal Law on Privatization of State-Owned Property.

First. Changes in legal regulation of privatization are strictly subject to the two objectives: (1) widen the scope and develop the tools of privatization of large and largest companies and (2) reduce costs and restrictions for large-scale privatization of relatively small companies.

Second. The innovations made as part of the second objective look very positive, promoting better transparency of privatization transactions, ensuring competition, lowering barriers to participation in privatization of property of small companies. Active privatization of small state-owned companies can “clean” the public sector out of many insignificant assets, show its real structure.

Third. As applied to large companies, the range of acceptable options of privatization was widened, which seems to be important at the stage when generation of additional budget revenues from privatization is not regarded as the sole objective.

The innovations related to privatization of the largest companies and banks seem to be most controversial. Perhaps, in an effort to reduce the required time, taking into account specific features of this type of privatization transactions, the state offered an opportunity to exclude thereof from the scope of the Federal Law “On Privatization of State and Municipal Property”. Hence, on the one hand, a series of obstacles for “structural privatization” of large

¹ According to the Order of the Government of the Russian Federation dd. September 8, 2010, No. 693, “On Specific Powers of the Ministry of Economic Development and Trade of the Russian Federation”, the Ministry of Economic Development and Trade is entitled to approve the procedure and form of information disclosure by unitary enterprises and open joint-stock companies from the date when they are included into the forecast plan.

companies was eliminated, but, on the other hand, no legal frameworks for making relevant decisions were defined.

Forth. The powers vested in the Government of the Russian Federation in the field of privatization, in particular as applied to privatization of largest companies, were enlarged dramatically. In the absence of regulatory frameworks, predictability of such decisions for potential investors may be found low. To date, practical public measures in the field of privatization of the largest companies have been nontransparent and the decisions ill-founded publicly. Generally, lack of official comments and explanations is “replaced” with multiple statements in mass media which are based on “insider” information.

Specifics of the Process of Decision-Making and Update of Plans of Privatization for 2010 and Beyond

Late in 2008 and 2009, the global economic downturn resulted in a considerable decrease of potential investors’ interest in purchase of state-owned property whereby revenues from privatization at the 2009 year-end hit historical lows – RUB 3,4 bln (by 3,5 times less than planned). This fact together with numerous repeated governmental statements on prohibition of privatization at knockdown cost¹ resulted in historically low planned revenues from privatization, mere about RUB 7 bln², in the budgetary prospects for 2010 prepared by the Ministry of Finance of Russia in mid-2009 contained (see *Fig. 1*).

A slight recovery in the Russian economy in Q3 2009 raised considerably the degree of expectations of representatives of public authorities at to potential volumes of privatization of federal property in 2010. As a result, as early as October 2009 the Ministry of Economic Development and Trade of Russia announced a total of nearly RUB 70 bln of potential revenues from privatization in 2010, i.e. 10 times more than was expected in the budgetary prospects which the Ministry of Finance of Russia made a few months prior to that³. The Forecast Plan of Privatization of Federal Property for 2010 which was approved late in November 2009 contained a much less amount of budget revenues (RUB 18 bln) which, according to officials, was preliminary and subject to increase up to RUB 70 – 100 bln, above all, through sale of shares in a series of companies to be excluded from the list of systemic companies⁴. Such an optimistic forecasts for revenues from privatization were mentioned in the statements of public officials till mid-2010 roughly, until early in August the Ministry of Finance of Russia published the guidelines of the budgetary policy for 2011 and planning period of 2012 – 2013, which provided for a mere RUB 7 bln of revenues from privatization for 2010, as much

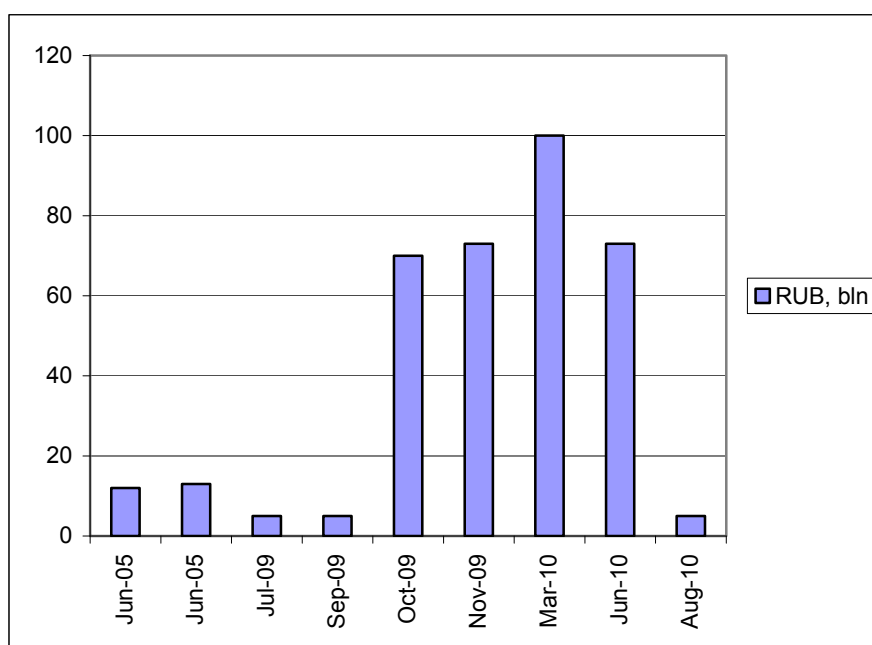
¹ See, for example, pronouncements made by the Chairman of the Government of the Russian Federation V. Putin at the meeting of the Presidium of the Government of the Russian Federation held on March 26, 2009 (<http://premier.gov.ru/events/news/3676/>), as well as at the meeting dedicated to the guidelines of privatization of federal property for 2010 – 2012 and shortening of the list of strategically important enterprises and joint-stock companies (<http://premier.gov.ru/events/news/5104/>).

² See Comments made by the Minister of Finance A. Kudrin to information agencies following the meeting of the Government of the Russian Federation held on July 30, 2009 (<http://www1.minfin.ru/ru/press/speech/index.php?pg4=17&id4=7912>).

G. Maslov. The State Will Generate RUB 70 bln from Privatization. – Infox.ru. October 6, 2009 (http://www.infox.ru/business/finances/2009/10/06/Gosudarstvo_zarabota.phtml).

⁴ See, for example: R. Falyakhov. State-Owned Property Will be Booked On the Assets Side. *Gazeta.ru*, November 24, 2009 (<http://www.gazeta.ru/business/2009/11/24/3290513.shtml>); Interview with the First Vice Prime Minister I. Shuvalov to *Commerzant-online* on December 22, 2009 (<http://www.kommersant.ru/doc.aspx?DocsID=1297142&NodesID=4>).

as the Ministry of Finance planned in budget prospects in the preceding year. This document forecasts revenues from privatization for a period 2011 – 2013 which exceed many times (in nominal figures) those generated at the end of any of the previous 15 years: a total of RUB 883,5 bln over three years, which includes RUB 298 bln in 2011, RUB 276,1 bln in 2012, RUB 309,4 bln in 2013. Finally, in September 2010 the Ministry of Finance of Russia assumed that within five years to come total revenues from privatization would total nearly USD 50 bln (RUB 1,5 t at the current exchange rate), which is nearly USD 10 bln (RUB 300 bln) annually¹.



Sources : The Forecast Plan (program) of privatization of Federal Property for 2008 and the Guidelines for Privatization of Federal Property for 2008 – 2010 (approved by the Order of the Government of the Russian Federation dd. April 29, 2007, No. 543-p) ; The Forecast Plan (program) of privatization of Federal Property for 2009 and the Guidelines for Privatization of Federal Property for 2010 and 2011 (approved by the Order of the Government of the Russian Federation dd. September 1, 2008, No. 1272-p); pronouncements made by the Minister of Finance A. Kudrin to information agencies following the meeting of the Government of the Russian Federation held on July 30, 2009] (<http://www1.minfin.ru/ru/press/speech/index.php?pg4=17&id4=7912>); pronouncements made by the Minister of Finance A. Kudrin to information agencies following the meeting of the Government of the Russian Federation held on September 23, 2009] (<http://www.minfin.ru/ru/press/speech/index.php?id4=8175>); Maslov G.. The State Will Generate RUB 70 bln from Privatization. – Infox.ru. October 6, 2009] (http://www.infox.ru/business/finances/2009/10/06/Gosudarstvo_zarabota.phtml); R. Falyakhov. State-Owned Property Will be Booked On the Assets Side. – Gazeta.ru, November 24, 2009] (<http://www.gazeta.ru/business/2009/11/24/3290513.shtml>); A. Makryashina. Revenues from Privatization will Total RUB 100 bln in 2010. – Infox.ru, March 17, 2010 (http://www.infox.ru/authority/state/2010/03/17/Dohodyy_ot_privatiza.phtml); V. Silayev, E. Nabiullina. Privatization Will Generate RUB 72 bln. – Infox.ru, June 18, 2010] (http://www.infox.ru/business/finances/2010/06/18/Nabiullina_Privatiz.phtml); The Budget Policy Guidelines for 2011 and the Planning Period in 2012 and 2013] ([http://www.minfin.ru/common/img/uploaded/library/2010/08/ONBP_2011 – 2013.doc](http://www.minfin.ru/common/img/uploaded/library/2010/08/ONBP_2011-2013.doc)).

Fig. 1. Planned volumes of privatization of federal property in 2010.

¹ See Comments made by the Minister of Finance A. Kudrin to information agencies at the Reuters Summit held on September 15, 2010] (<http://www.minfin.ru/ru/press/speech/index.php?id4=10574>).

It is important to point out that the *reported “volatility” of planned volumes of privatization in 2010 resulted in lack of unified public position as to which large companies must be privatized.* For example, in different periods different public officials expressed sometimes totally contradictory opinions on the issue. Among assets which were offered for privatization in 2010 were blocks of shares in the largest companies and banks, namely Rosneft, Sovkomflot, Rosgosstrakh, Rosagroleasing, VTB Bank, Sberbank, Rosselkhozbank. In July 2010, the principal participants in the process of privatization (The Ministry of Economic Development and Trade of Russia и the Ministry of Finance of Russia) approved a tentative list of 11 companies and financial institutions whose blocks of shares must be put up for sale in the mid-term perspective, namely Transneft, Sovkomflot, Rosneft, Sberbank, VTB Bank, Rosagroleasing, FGS, Rosselkhozbank, RusHydro, Rosspirtprom, and United Grain Company (however, the state planned to retain a controlling interest in all of these companies)¹, and in September the list was approved in general and extended by the Chairman of the Government of the Russian Federation V. Putin². However, it was unclear yet whether the shares in any of the listed companies (or, maybe, other large economic agents) would be privatized till the end of 2010.

A meeting of the Government of the Russian Federation was held late in October 2010, which discussed plans of privatization till 2016: as part of the program of privatization till 2013 and plans of privatization for 2013 – 2015. Following the meeting, it was announced that about 900 companies were planned for privatization and a total of RUB 1,8 t generated till and inclusive 2015. The blocks of shares in large banks and companies such as VTB Bank, Sberbank, Sovkomflot, FGS UES, Rushydro, United Grain Company were expected to be sold till 2013, and Rosneft, Russian Railroads, Aeroflot, Sherenetyevo, Rosselkhozbank, Rosagroleasing from 2013. Furthermore, it was announced that in the coming 3–4 years privatization of large companies would not be linked with decrease in a state-held share below a controlling interest, however, it was reported that the state planned to get rid of its controlling interest in Rosneft, Rushydro, VTB Bank, Aeroflot in a more distant prospect – after 2015.

It was not until the meeting of the Government of the Russian Federation on November 17, 2010 when plans of privatization of large and the largest companies became clear. The meeting approved the Forecast Plan and Guidelines for Privatization of Federal Property for 2011 – 2013 which contained, in particular, the following important provisions :

- restrictions on privatization of specific types of federal property which cease to be relevant, will continue to be abolished;
- the approved plan of privatization in the course of time will be supplemented on the basis of the results of optimization of the structure of state-owned property ;
- tight deadlines for privatization of the largest companies are not set, some time frames are set, sometimes for a more distant perspective (beyond 2011 – 2013).

A very important feature of the forecast plan of privatization for 2011 – 2013 is that it includes 10 largest companies which are leading in respective industries, whose blocks of shares will be privatized on the basis of specific decisions of the President of the Russian

¹ T. Zykova. Public Sales. – Rossiyskaya Gazeta, July 29, 2010.

² See Comments made by the Minister of Finance A. Kudrin to information agencies at the Reuters Summit held on September 15, 2010] (<http://www.minfin.ru/ru/press/speech/index.php?id4=10574>).

Federation and the Government of the Russian Federation (*Table 15*)¹. Revenues from their privatization in 2011 – 2013 are estimated at a level of RUB 1 t.

Together with the above mentioned largest companies which seem to be privatized according to “custom-made” schemes, the forecast plan also provides for privatization of the blocks of shares (the value of each exceeds RUB 500 mln) of eight large companies, namely Apatit, Prosvescheniye Publishing House, Sibir Airline, Archangelsk Traiwing Port, Ulyanovsk Motor Plant, Murmansk Fishery Seaport, Vostochny Port, Almazny Mir in 2011 – 2013.

In general, total revenues from privatization in the period between 2011 – 2013 are estimated at a level of RUB 1 t. The biggest part of the revenues is linked to privatization of 10 largest companies. Net of these companies, revenues from privatization in 2011 are estimated RUB 6 bln, in 2012–2013, RUB 5 bln each year (but these revenues are also are forecasted in connection with planned privatization of eight large companies).

Table 15

**Plan of privatization of the largest open joint-stock companies leading
in relevant industries**

Largest privatized companies and banks	State-held block of shares						
	As of November 1, 2010	2010	2011	2012	2013	2014	2015
VTB Bank	85.5%	75.5%	65.5%	50% +1 share			
Sovkomflot	100%	100%	75%	50% +1 share		<50%	
United Grain Company	100%	100%	0%				
Unified National Electric Grid	79.11%	79.11%	75% +1 share				
Sberbank of Russia	57.58%*	57.58%	50% +1 share				
Rosneft Oil Company	75.1%	75.1%	50% +1 share				
RusHydro	57.9%	57.9%	50% +1 share				
Rosselkhozbank	100%	100%	75% +1 share				
Rosagroleasing	99.9%	99.9%	99.9%	99.9%	50% +1 share		
Russian Railroads	100%	100%	100%	100%	75% +1 share		

* – owned by the Bank of Russia.

Source: the forecast plan of privatization of federal property for 2011 – 2013 and the document of the Ministry of Economic Development and Trade of Russia “Planned Sales of the Shares of Large Companies Leading in the Industries of the Russian economy, in 2011–2015” (http://www.economy.gov.ru/minec/activity/sections/investmentpolicy/doc20101123_08).

It was previously reported that the state would invest a part of the revenues from privatization in privatized companies: according to the comments made by public officials, about RUB 1 t is expected to go to the budget and RUB 800 bln to privatized companies (in particular, through IPO and SPO) of the total of revenues from privatization generated over five years (RUB 1,8 t). It remains to be seen, however, which companies and under which terms and conditions will become the recipients.

In general, the following should be highlighted with regard to work-out and approval of plans of privatization in 2010 :

1. Terms and scope of privatization of specific large companies continue to be the subject-matter of heated discussion. In particular, there is a serious contradiction between ministries and government agencies as to privatization of Russian Railroads, Aeroflot, Svyazinvest,

¹ It should be noted that this list didn't include a few of the largest companies which previously were not mentioned as potential targets for privatization, namely Aeroflot and Sheremetyevo.

AIZHK, Transneft and Zarubezhneft. For example, в the Ministry of Transport of Russia insists that privatization of Russian Railroads and Aeroflot should be postponed until reorganization of these companies is completed: Aeroflot is expected to receive the shares in six airline companies, and Russian Railroads is expected to become an infrastructural company.

2. In spite of the declared principle of transparency of privatization at all stages, the processes of discussion of the list of large companies which are planned for privatization were far from being public, which, however, was compensated by numerous comments in mass media as to the decisions made and existing disagreements.

3. Generation of additional revenues to the budget progressively became the dominating issue in privatization planning while structural objectives fell by the wayside. Such a shift of emphasis was logically accompanied by focusing on privatization of expensive and liquid blocks of shares in large financial institutions, banks, oil companies.

4. In spite of planned privatization of the blocks of shares in a series of largest companies, the state tends to retain its dominating participation in the charter capital of such companies in years to come, whereupon it is needless to talk about any large-scale reduction of the state-held share in the economy (in GDP).

Finalizing examination of actual plans of privatization, it may be reasonable to note that the federal authorities intend to initiate privatization at the regional level in 2011 – 2013, which is supposed to be comparable with the planned privatization of federal property in terms of revenues from sale of assets.

In the fall of 2010, the regional authorities were assigned to prepared and approve large-scale programs of privatization. Many regions, holding blocks of shares in major companies, are qualified for allocations from the federal budget. In the meantime, the regions own a great deal of property and assets which can be offered in the market. The Ministry of Economic Development and Trade and the Ministry of Finance of Russia have been discussing a scheme under which account will be taken of whether or not the regions have a program of privatization when they apply for transfer from the federal treasury in order to keep their budget in balance. If the regions are holding any attractive assets, they are not entitled to apply for transfers from the federal budget unless they sell such assets.

Potential Risks Arising from “New Privatization”

The development and implementation of the national policy in the field of privatization may result in a series of internal contradictions and issues. It is hard to holistically characterize such risks, because the process of development of terms and conditions and principles of “new privatization” remains to be completed, and the state measures give ground to both increase the relevance and restrict specific risks. Nevertheless, we consider the following risks as relevant.

First, the risk arising from immaturity of legislative procedures for privatization of large companies and extension of terms and conditions for the “custom-made” approach towards privatization of large state-owned properties.

This risk will remain relevant until the single issue is resolved: restrictions on options of privatization of large companies have been lifted, but new options of privatization have not been defined, even the framework, on a regulatory basis.

The gaps in the legal structures of new arrangements of privatization and disposal of property (such as sale of shares to a strategic investor on a sole source basis, tender under investment terms and conditions, or transfer of assets for management), first of all – lack of explicit

criteria for application thereof – extend preconditions for making “rule-of-thumb”, situational decisions, lobbying and “administrative bargain”. Uncertainty of to-be rules (and even non-transparent motives) makes the policy of privatization of large state-owned companies less predictable, sidelines participation of foreign investors in privatization of large Russian companies.

It should be noted that lack of explicit rules and regulations as applied to new tools of alienation of state-owned property and the “custom-made” nature of decisions may raise questions about “invalidity of privatization” in the future.

Second, the risk of imposing serious formal and informal restrictions on participation of “external” investors in privatization, providing specific buyers with preferential terms and conditions.

The basic precondition for this is that in some cases the state is not ready give up on direct participation in companies due to immaturity of regulation for a given industry. Foreign investors may find themselves to be exposed to high risks for the same reason. To avoid such risks, investors must have a clear picture of the statutory framework in which companies are operating (this is particularly true for companies operating in infrastructural industries) .

After the Government of the Russian Federation was entitled to sell specific state-owned properties outside of the law on privatization, the risk of biased, subjectively selective treatment of shareholders and potential investors became higher. Let us recall that this innovation was connected with the need to enlarge options of privatization, in particular by way of direct sale of federally-owned blocks of shares to the strategic investors of company. This is because the existing strategic investors of the company may act as a break on the process of privatization in fear of that new investors may come.

Perhaps, public representative presumed that specific large shareholders who would buy blocks of shares through direct sale would assume more strict and explicit obligations for modernization and development of a given company. It is not inconceivable that the state intends to prevent potential corporate conflicts in large companies in case of reallocation of assets in the course of privatization. As likely as not, however, the state intends to maintain a usual composition of the owners with whom it has long-term relationship.

In any case, assessment of when the Government of the Russian Federation should apply this arrangement may be found to be nontransparent and related to a subjectively “custom-made” judgment on “good” and “bad” shareholders in terms of the development of a company, incorrect assessment of the value of blocks of shares in case of direct sale.

Third, the risk of that control over large companies management may be retained and even “nationalized” in the course of privatization of the property owned by large companies. This can be manifested both directly by “inviting” representatives from public authorities at different levels to participate in boards of directors, and indirectly, e.g., through, in particular, participation of state-controlled entities in boards of directors. The main problem here is even worse transparency of public interests with regard to such companies, appearance of even greater number of preconditions for replacing public interests with narrowly-specialized interests (both bureaucratic and private interests) against the option of direct public participation in charter capital.

Forth, the risk of expansion of public and quasi-public entities in the course of privatization on the basis of contribution of state-owned property assets to the charter capital of open joint-stock companies.

It should be noted that through from outside this would look like privatization of state-owned property, shortening of the list of strategically important enterprises and companies, reduction in the number of state-owned companies, but indeed may result in strengthening of direct participation of the state in management of economic affairs in specific industries due to widening of the scope and scale of business of the remainder companies in which the state holds an interest.

Though under the law on privatization legal entities in which the state holds an interest of more than 25%, may not participate in privatization of state-owned property, this prohibition is not applied to the type of privatization such as contribution of state-owned property to the charter capital of open joint-stock companies. In addition, since the law on privatization is not applied to arrangements of alienation of state-owned property assets by the decision of the Government of the Russian Federation and transfer of property to state-owned corporations, this prohibition cannot be applied to such corporations.

Public measures in this field are very controversial. On the one hand, regulation of terms and conditions for setting up and expanding integrated entities of the public sector through contribution of federal property to the charter capital of open joint-stock companies is relaxed, whereas the need to begin and complete integration processes is used as a ground for a long-term postponement of privatization of specific large companies.

On the other hand, efforts have been made to withdraw non-core assets from state-owned companies, restrict their potential for expansion. For example, the need to sell non-core assets by the largest state-owned companies (Gazprom, Russian Railroads, Russian Technologies State Corporation, etc.) is being under discussion¹. It is assumed that in 2010 the companies will prepare plans of sale of the said assets², and begin to sell the same in 2011³. In addition to this, restriction on the right of state-owned companies to set up subsidiaries (by including relevant regulations into their charters) is being under discussion.

In our opinion, in some cases, completion of the processes of establishment of large integrated entities is an important element for enhancing their effectiveness, however, explicit deadlines and scope of subsequent denationalization of such integrated entities should be set in the first place.

Fifth, the risk of limited private fundraising, shortening of “planning horizon” by new owners and managers, and utilization of public resources in privatization, state banks, including those which were assigned in the course of recession counter measures.

Since “inner-circle” potential investors have limited private resources, large state banks are likely to participate at the administrative level with a view to providing support to respective transactions. This course of events would lower considerably new owners’ interest in developing the privatized business, defining explicit terms and conditions for its operation, on the other hand they act as operators governed by the principle of “behavior in accordance with informal restrictions and requirements in exchange for additional public support”. Conse-

¹ Such actions are formally not regarded as privatization, because the assets of state-owned companies (save for unitary enterprises) are not held by the state.

² According to the available information, Russian Railroads Open Joint-Stock Company already prepared and submitted such a plan to the concerned agencies for approval. (See, M. Tovkailo, A. Nepomnyashiy. The Property Will Be Transferred to a Single Owner. – Vedomosti, March 3, 2010.]).

³ T. Zykova. Public Sales. – Rossiyskaya Gazeta, July 29, 2010.

quently, the range of large, formally private companies which nonetheless will be regarded as being in need in unconditional public support and constant care, may expand.¹

Sixth, the risk of competition at the public level between different approaches towards privatization, and broadening of conditions for “under-the-counter” struggle of competing interests.

One may assume that first group of public representatives (political elite) would focus on privatization for the purpose of structural economic reconstruction, the second group on generating more budget revenues from privatization, and the third group on broadening the opportunities for state-controlled companies in order to simplify immediate public influence on specific industries. Competition between these groups may result in creation of poorly regulated compromises which would broaden the possibilities for making custom-made decisions. Hence the struggle between the groups with different points of view on the role of privatization may be found to be even less transparent.

Furthermore, very important is the risk of excessive “fiscalization” of privatization, emphasis on short-term interests in generating budget revenues, which would inevitably relegate more relevant long-term objectives of privatization (structural reorganization, promotion of the development of enterprises and industries) to the background.

Ideology of New Privatization: Structural and Budgetary Approaches

The scale of plans of privatization in a mid-term perspective makes the main “ideologeme” of this process critically important. Analysis of a population of key events which are somehow related to making the national policy in the field of privatization, allows two system priorities to be highlighted :

(1) “structural priority” – the use of privatization as a tool for reducing direct participation of the state in the economy, providing structural reorganization in industries, developing competition, encouraging the development of companies, attracting strategic investors ;

(2) ”budgetary priority” – the use of privatization for widening budget revenues, reducing the public sector as “consumer” of public resources.

Strictly speaking, the foregoing priorities are not fully “antagonistic”, each of them offering advantages and weaknesses in terms of development of the Russian economy, in terms of the above considered potential risks.

As part of the “structural priority”, the emphasis is placed on whether or not it is expedient that some or other companies belong to the public or private sectors in terms of development of the companies as well as relevant industries and markets. This priority imposes strict requirements to the composition of privatized companies, the size of blocks of shares offered for sale, to buyers and, above all, actions of the buyers with regard to privatized companies. This approach requires careful selection of potential buyers, preferred emphasis on sale of companies to strategic investors who are interested in their long-term development; buyers may have to meet requirements related to operation and development of privatized companies.

This priority if focused on a mid-term perspective, in combination with creation of conditions for development of privatized companies, reformation of the same, considerable reduction of public participation in the economy. However, implementation of this priority may be

¹ An illustrative example of the fourth and fifth risks is sale, on a single source basis, of a nearly controlling interest in Bank of Moscow to VTB Bank in February 2011.

exposed to material risks related to low transparency of the processes of sale of property to strategic investors, inexplicit reciprocal obligations of the state and buyers, uncertainty of arrangements designed to discharge such obligations. Once again, one may get the impression of “cheap” privatization and defaulted obligations in the future.

Second, the “budgetary priority” provides for maximization of budget revenues from sale of federal property, for a short-term period though. In implementing this priority, companies for privatization are chiefly selected on the basis of their market value. The principal point is correct valuation of assets as well as selection of the “auspicious moment” for privatization, which can be done through careful monitoring and forecasting of the market situation. This is why it is reasonable to engage specialized organizations to perform sales. In the meantime, it is inexpedient in this case to impose any requirements to buyers (except for timely discharge of obligations for payment for privatized assets), because limited circle of potential buyers may reduce budget revenues. Therefore, it also becomes reasonable to define any terms and conditions (especially those of investment nature) as to what buyers may do with the privatized property.

In general, this priority organically implies transparency of privatization, acquisition of a wide range of potential, including foreign, buyers, lowering barriers on participation in privatization, considerable reduction of the scale of “cashless privatization” (in particular, on the basis of contribution of federal property to the charter capital of joint-stock companies). The same priority may become a relevant incentive for activating privatization processes at the level of constituent territories of the Russian Federation. However, to implement the same priority, it is not important to what extent the degree of public control over large companies is reduced (at least in the short-term perspective). Neither is important privatization of many small state-owned properties. This priority is rather of short-term nature, it has almost nothing to do with the objectives of reorganization, rehabilitation of large companies which require considerable time, and is less connected with improvement of institutional terms of development of sectors and industries.

At the level of federal agencies, the Ministry of Economic Development and Trade of Russia is the principal advocate of the first, “structural” priority, whereas the Ministry of Finance of Russia acts as an advocate of the second, “budgetary” priority. Indeed, such a division of priorities “by government agency” is conditional: government officials who represent the Ministry of Economic Development and Trade pointed out many times that privatization is important for generating budget revenues¹, whereas the officials from the Ministry of Finance mentioned from time to time that privatization is relevant as a tool for development of business environment and acquisition of private investments².

The relevance of the two foregoing priorities chanted considerably in the course of creation conditions for “new privatization”. The “structural” priority was more relevant for privatization late in 2009, whereas the “budgetary” priority became prevailing by H2 2010. It is noteworthy that this approach was also supported by representatives of large business associa-

¹ See, e.g.: O. Redkina. The Government Will Keep Hold of Rosneft. – Infox.ru, September 29, 2009] (http://www.infox.ru/business/finances/2009/09/29/Vlast_nye_otdast__R.phtml).

² See, e.g., comments made by the Ministry of Finance A. Kudrin to information agencies following the meeting of the Russian-British Intergovernmental Committee for Trade and Investments held in London on November 5, 2009 (<http://www1.minfin.ru/ru/press/speech/index.php?pg4=13&id4=8583>).

tions which considered large-scale privatization of state-owned companies as an alternative to potential tax increase intended to generate budget revenues¹.

Though both “structural” and “budgetary” priorities are relevant for decision-making in practice, compromises in the struggle between the two ideologies are currently reached at the cost of regulatory uncertainty, by increasing the role of “rule-of-thumb” decisions and broadening nontransparent, positional struggle between different parties.

In our opinion, in spite of attractiveness of the “structural” priority in terms of long-term development of the Russian economy, it is the lack of long-term and transparent “rules of the game” in interaction between the state and businesses that will become a relevant barrier. In this respect, *it is the “budgetary” approach that seems to be more balanced in terms of advantages and risks in the short-term perspective.*

Preconditions for strengthening the structural trend of privatization in the mid-term perspective will appear, provided that a substantial progress is gained in the development of institutional environment, harmonization in interaction between the state and businesses. It should be noted that solution of a series of principal structural objectives within privatization (e.g., drastic reduction of the public sector, the state should give up on control at the level of specific large companies) is scheduled for 2013–2015 and beyond. In the meantime, it should be made possible to define the most relevant goals and objectives of privatization, the “future” of the largest state-owned companies in the mid- and long-term perspectives.

Basic Conclusions and Recommendations

1. During 2010, privatization was one of the top-priority objectives set by the Government of the Russian Federation. In the same period, the base for privatization was enlarged considerably through both large-scale shortening of the list of strategically important companies and organizations and broadening of the forecast plan of privatization. However, shortening of the list of strategically important companies and organizations in 2010 was of a slightly different nature as compared to the previous years: (1) set-up of integrated entities was not the principal “keynote” for excluding organizations from the list; (2) joint-stock companies prevailed among those excluded from the list, in most of which the Russian Federation held less than 50% of equity interest; (3) most of the excluded organizations operate in the transport sector and related infrastructure.

2. Major amendments were made to the law on privatization. Following are listed the most relevant innovations in this field. Transition to mid-term planning of privatization of federal property; the Government of the Russian Federation was entitled to make decisions on privatization of state-owned property beyond the scope of “standard” procedures set forth in the law on privatization; the Government of the Russian Federation can decide on the possibility to authorize legal entities to act as sellers of privatized federal property; the admissible options of privatization of large companies were extended, which includes contribution of state-owned property assets to the charter capital of joint-stock companies; privatization of small state-owned property assets was simplified, access of potential buyers to participation in privatization was broadened; the requirements for transparency of privatization procedures were broadened substantially.

¹ The President of the Russian Union of Industrialists and Entrepreneurs (RUIE) A. Shokhin: The Dialogue Between the Business Community and the Chairman of the Government of Russia is Highly Effective. – RUIE official webpage, May 17, 2010 (http://www.pcnr.pf/Default.aspx?CatalogId=283&d_no=8261).

Considering the innovations as part of the law on privatization, it should be noted that they are well-defined for solution of the two objectives: (1) improve capability and development of tools for privatization of large and largest companies and (2) reduce costs and restrictions on large-scale privatization of relatively small companies. Judging by the approved regulations as applied to privatization of large companies, the emphasis is placed on “custom-made” decisions, however, not even general frameworks for making such decisions have been defined to date, and the role and powers vested in the powers of the Government of the Russian Federation in making such decisions were strengthened and broadened considerably.

The most controversial and uncertain is the innovation related to delegation of powers to the Government of the Russian Federation for decision-making on privatization of state-owned property beyond the scope of “standard” procedures set forth in the law on privatization, especially in cases of direct sale of blocks of shares to the existing shareholders.

3. The beginning of a new stage of privatization was closely associated with emphasis on structural reorganization and modernization of the economy, improvement of competitive environment and facilitation of investments, restructuring and development of enterprises. Later, however, in particular by the H2 2010, the focus gradually shifted towards the role of privatization in generation of additional budget revenues. This resulted from growing doubts as to the prospects of rapid post-recession growth in the Russian economy, broadening of budgetary expenditures, which includes social security expenditures, and, consequently, aggravation of the issue related to federal budget deficit in years to come.

This shift of emphasis was logically accompanied by focusing on privatization of expensive and liquid blocks of shares in large financial institutions, banks, oil companies. In spite of planned privatization of the blocks of shares in a series of largest companies, the state tends to retain its dominating participation in the charter capital of such companies in years to come. Hence solution of the objectives of considerable reduction of the state participation in the economy, structural transformation was postponed in the mid-term perspective.

4. The process of development of plans of privatization, discussion of terms and conditions of privatization of large companies seems to be very situational. Government agencies have been struggling between each other as to the terms and scopes of privatization of specific large companies. In spite of the declared principle of transparency of privatization at all stages, the processes of discussion of its expediency, effects, the list of large companies which are planned for privatization and specific options of this process remain far from being transparent, and the state fails to provide and/or hardly provides enough reasons for the decisions made.

5. Solution of structural objectives in the course of privatization are exposed to a series of material risks, which include :

- the risk arising from immaturity of legislative procedures for privatization of large companies and extension of terms and conditions for the “custom-made” approach towards privatization of large state-owned properties ;
- the risk of imposing serious formal and informal restrictions on participation of “external” investors in privatization, providing specific buyers with preferential terms and conditions ;
- the risk of expansion of public and quasi-public entities in the course of privatization on the basis of contribution of state-owned property assets to the charter capital of open joint-stock companies ;

- the risk of limited private fundraising, shortening of “planning horizon” by new owners and managers, and utilization of state banks’ money in privatization ;
- the risk of competition at the public level between different approaches towards privatization, and broadening of conditions for “under-the-counter” struggle of competing interests.

6. Two system priorities – “structural” and “budgetary” – appeared in the field of implementation of the national privatization policy.

The first priority if focused on a mid-term perspective, in combination with creation of conditions for development of privatized companies, reformation of the same, considerable reduction of public participation in the economy. However, implementation of this priority may be exposed to material risks related to low transparency of the processes of sale of property to strategic investors, inexplicit reciprocal obligations of the state and buyers, uncertainty of arrangements designed to discharge such obligations.

The second priority implies transparency of privatization, acquisition of a wide range of potential, including foreign, buyers, lowering barriers on participation in privatization, considerable reduction of the scale of “cashless privatization” (in particular, on the basis of contribution of federal property to the charter capital of joint-stock companies). The same priority may become a relevant incentive for activating privatization processes at the level of constituent territories of the Russian Federation. However, to implement the same priority, it is not important to what extent the degree of public control over large companies is reduced (at least in the short-term perspective), no investments are attracted for the development of companies.

7. In spite of attractiveness of the “structural” priority in terms of long-term development of the Russian economy, it is the lack of long-term and transparent “rules of the game” in interaction between the state and businesses that will become a relevant barrier. In this respect, it is the “budgetary” approach that seems to be more balanced in terms of advantages and risks in the short-term perspective. Preconditions for strengthening the structural trend of privatization in the mid-term perspective will appear, provided that a substantial progress is gained in the development of institutional environment, harmonization in interaction between the state and businesses.

8. In our opinion, to improve a privatization-based contribution to the long-term economic development, it is important to develop and take a set of measures which go beyond the scope of privatization. In particular, much efforts should be made to enhance corporate governance. It is well known that due to weaknesses that can be found in the field corporate governance, foreign investors value the shares of Russian companies at a relevant discount.

In addition, the existing regulation of foreign investments in strategically important economic sectors must be improved: it is expedient to define such sectors and establish a transparent and explicit procedure for making and approval of decisions.

The policy in the field of privatization must be coordinated with the measures aimed at establishing an international financial center in the Russian Federation. Over the longer term, when decisions on discontinuing public control in specific large companies may be made, privatization of the relevant blocks of shares may become a powerful impulse for the establishment of the financial center.

9. It should be taken into account that if the state discontinues participation in the charter capital of large companies, including infrastructural companies, the lack of legislative regulation of their activity will be replaced with intervention of public officials into business deci-

sion-making. To avoid such a situation, the quality of legislative regulation in relevant business segments and industries must be improved.

It is advisable to take measures on substantial regulatory development of the option of privatization such as sale of shares based on trust management results. In our opinion, this option allows direct public control to be withdrawn from specific companies while the state retains its participating share throughout the entire period of trust management, in which case specific key objectives of business development may be defined within the framework of trust management.

10. The following measures seem to be advisable in order to avoid outgrowth of the public sector through remaining state-owned companies. First, companies in which the state holds an interest must be restricted in terms of acquiring new assets as part of privatization. Second, with regard to integrated entities whose establishment by the state is still in progress, it is advisable to decide on whether or not they can be privatized over the longer term. Third, large state-owned must be somehow held responsible for writing off non-core assets in deciding where revenues from their sale should be allocated to.

With regard to the companies whose privatization is postponed in a more distant future due to uncompleted process of restructuring thereof, these processes should be subject to strict deadlines, and managers and board members should be held responsible for observance of the deadlines.

11. Poor transparency of plans and decisions on large state-owned property assets is perfectly evident in the national policy in the field of privatization. In general, at least a general frameworks for terms and conditions for privatization of the largest companies should be gradually created. In our opinion, to ensure mitigation of risks of hidden lobbying of different decisions, it is important that ministries and agencies' opinions on these issues should be more transparent, and final decisions should be publicly reasoned.

It is obvious that when there is a need for providing support to dynamic practical decision-making in the field of privatization, launching large privatization transactions for the first time, it is not always that respective terms and conditions can be worked out in advance, concurrently with discussion of different approaches, but efforts will have to be intensified in refining rules for privatization in the future.

12. In our opinion, in order to make the national policy in the field of privatization more predictable, better coordinated with other measures, a concept of privatization for a period of 6–8 years should be developed, which would set forth key principles of privatization, specifics of alienation of different types of property, some strategy guidelines for the maximum permissible level of state (not only at the federal level) participation in the economy, including specific sectors.

13. Measures aimed at promoting privatization processes at the regional and municipal levels should be continued and intensified. In addition, legal limits on setting up new SUEs and MUEs (municipal unitary enterprises), joint-stock companies in which the state holds an interest could be imposed at the regional level.

14. It is important that regular efforts in enhancing corporate governance at companies in which the state holds an interest should be continued along with promotion of processes of privatization of state-owned property. The policy of introducing independent directors into the management of state-owned companies must be further enhanced, requirements to such directors must be elaborated, strategic objectives and milestones in activity of key state-owned companies must be defined.

6.2. The 2006-2010 Corporate Law: Some Results and Novelties

Adopted in the mid-2000s, the Concept of development of corporate law for the period through 2008 pursued fairly ambitious objectives of reforming the emerged by then corporate law system for the sake of creation of institutional conditions of economic growth. A whole string of its fundamental provisions nonetheless formed a rationale for that conclusion regarding *a radical re-orientation of the corporate regulation model towards majority shareholders*. Certain moves with regard to implementation of measures provided for by the Concept became concomitant with the process of activation of *the state (largest state-owned corporations') operations* on the market for corporate control. This necessitates an evaluation of results of the Concept implementation in the first place. To this end, we deliberately picked the period until 1 January 2010, for, while measures of urgent anti-crisis regulation had already kicked off by then, the factor of the 2008-09 crisis had not yet affected corrections of measures provided for by the Concept.

As evidenced by *Table 16* and *Fig. 2*, the progress in implementation of the Concept across multiple directions appeared fairly different.

Table 16

Progress in Implementation of the Concept of Development of Corporate Law for the Period through 2008*

Key directions of development of corporate law	Spheres of modification of regulation	Specific weight of novelties of the block in the Concept's general structure, as %	Specific weight of legislative implementation of proposed measures of the block, as %
Block I – prevention of corporate conflicts and their regulation	1) Solving corporate disputes; 2) Public registration of legal entities; 3) Account of securities	25	60
Block II – development of the corporate governance system	1) Structure of corporate management bodies and allocation of competences between them; 2) Responsibility of individuals engaged in management bodies; 3) Conflicts of interests (prevention and regulation); 4) Profit allocation; 5) Non-arm's length transactions and large transactions	44	33
Block III – organizational and legal forms of legal entities	1) Commercial organizations; 2) Non-profits	15	18
Block IV – development of integrate business structures (IBS)	1) Reorganization of legal entities; 2) Peculiarities of regulation of IBSs; 3) Tax regulation of a group of affiliated entities; 4) Affiliated entities	16	34

* Quantitative assessments presented in *Table 16* and *Fig. 2* are exclusively of estimated and illustrative nature

It was measures aimed at regulation and prevention of corporate conflicts that enjoyed the greatest demand (the level of their implementation accounts for more than 60%). Meanwhile, despite their impressive volume (slightly under 50% of all the novelties in the Concept), the measures on development of corporate governance were implemented in a volume of roughly 1/3. The measures on development of IBSs likewise were implemented in roughly the same volume, while those in the area of organizational and legal forms of legal entities were implemented in a volume less than 1/5. That said, the levels of legislative implementation of new legal norms differ substantially across the spheres of regulation.

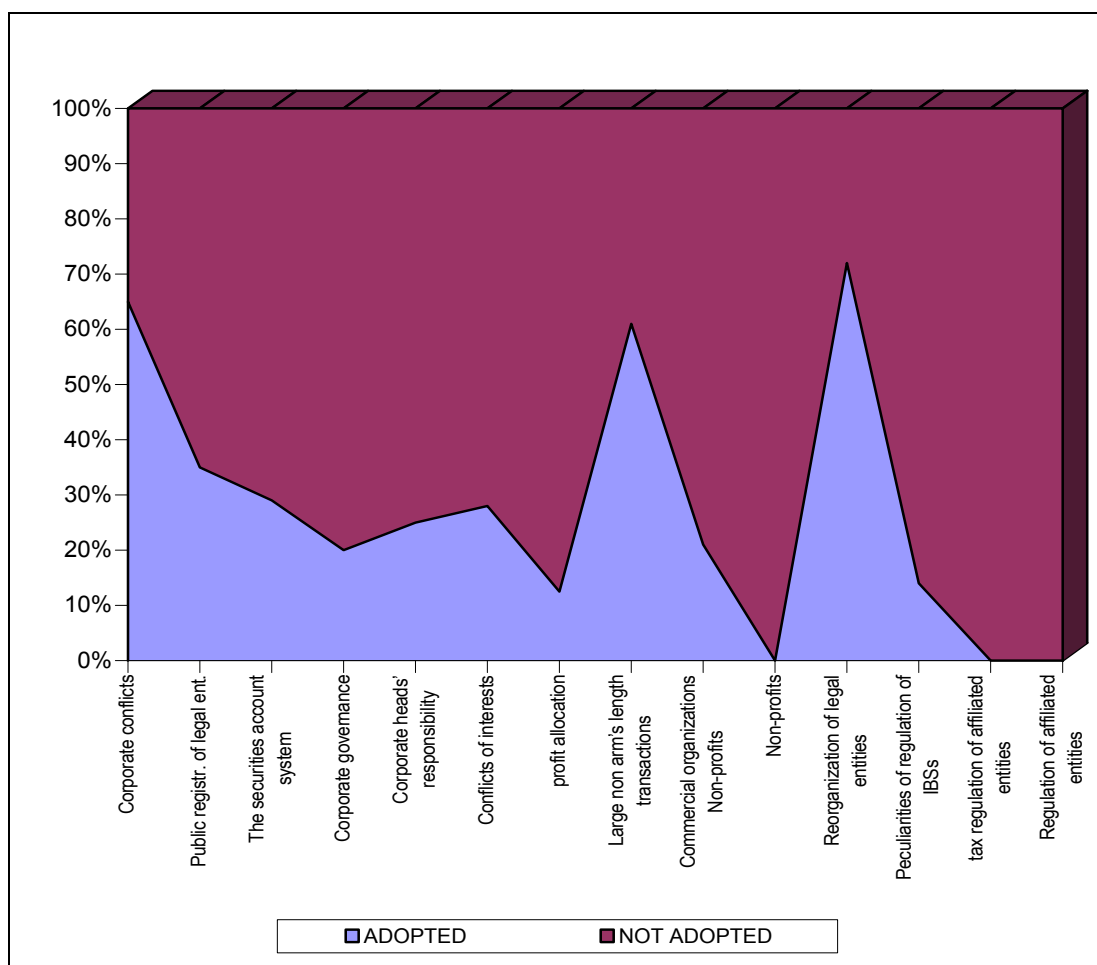


Fig. 2. Implementation of the Concept of Development of Corporate Law for the Period through 2008 across Directions of Regulation by 1 January 2010.

Out of measures the RF Government planned and approved in the frame of the Concept in 2006 practically untouched remained novelties that concern:

- Conflicts of interests;
- Non-profits;
- Regulation of integrate business structures;
- Tax regulation of affiliated entities;
- Profit allocation.

So, the changes to the least extent affected the most controversial and potentially lucrative for fixers directions of the corporate governance law reform¹.

¹ As to tax regulation of affiliated entities' operations, because of numerous large corporations' increasingly complex financial standing between late 2008 and 2009, the problem was once again became a pressing one. In May 2009, the RF Ministry of Finance unveiled a concept of the bill on consolidated group of taxpayers. By July 210 the bill had been passed in the first reading at the State Duma and was set to be passed, together with bill on transfer pricing, in the second reading; however, as of March 2011, the bills failed to be signed into law. The bill introducing changes into the law on affiliated entities was presented by the RF ministry of Economy in February 2010. The document provides for a broadening of the concept of affiliation and its introduction into the

Meanwhile, some directions of development of corporate law underwent insignificant changes, with individual mechanisms, which today are capable of protecting the largest creditors, being improved, while fundamental objectives left for the future. Specifically, measures in the sphere of responsibility of persons sitting on management bodies were implemented with a great deal of selectivity. The month of July 2009 saw implementation of the mechanism of collective lawsuits, which provides for the possibility for one person to file a lawsuit on behalf of a whole group of entities concerning corporate disputes in particular. The sizes of fines for economic offenses were slightly changed too (in February 2009). Since June 2006 the clause of the Labor Code, which caps the amount of recovery of losses resulted from individuals sitting on management bodies of an economic company causing damage to the company, has no longer applicable to the individuals in question.

Meanwhile, a string of challenges remained untouched, such as:

- Reasons for the torts liability of individuals who hold positions in management bodies, including the right to claim for compensation of losses;
- Matters relating to insurance of individuals who hold positions in corporate management bodies;
- The shareholders' right to disqualify directors and managers by judicial means;
- Development of the procedures of regulation of collateral actions.

The securities accounting system was modified solely with regard to definition of the nature and volume of responsibility of the registrar and issuer for breaching the procedure of running the register and fixing ways of protection of the rights of owners of securities, the rights to which are proved by making an entry into the account in the event of an unpermitted write-off. At this point, likewise, numerous problems remained unresolved, including:

- Identification of the securities' status;
- Insurance of the registrar's professional responsibility;
- Exclusion of a possibility for withdrawal of original documents on accounting of rights to securities.

In the frame of the registration system of legal entities, requirements to the application forms for registration of legal entity were tightened slightly: now they should be certified by a notary. In addition, a new justification for refusal of public registration was introduced - namely, disqualification of an individual having the right to act on a legal entity's behalf without the power of attorney (December 2008).

Regulation of commercial companies' operations was modified by tightening requirements to disclosure of information (in December 2007¹ and in April 2009² -with regard to foreign investors), improvement of the institution of joint-stock agreements (in June 2009³). Prior to

Civil Code of RF; introduction of the parent company's presumption of innocence with regard to a daughter one, provided the former has the right to control 50%-plus of the latter's equity or shares, etc. As of March 2011, the bill failed to be signed into law.

¹ Federal Act of 06.12.2007 № 334-FZ "On introducing amendments to the Federal Act "On investment funds" and individual legislative acts of Russian Federation".

² Federal Act of 28.04.2009 № 74-FZ "On introducing amendments to the Federal Act "On securities market" and art. 5 of the Federal Act "On protection of rights and legal interests of investors on the securities market".

³ Federal Act of 03.06.2009 № 115-FZ "On introducing amendments to the Federal Act "On joint-stock companies" and art. 30 of the Federal Act "On securities market".

that (in July 2006¹), the Government imposed a ban on issuance by joint-stock companies of obligations in an amount exceeding their authorized capital in the event there are no external guarantees or a letter of comfort.

That the 2000s saw an objective trend towards a gradual improvement of corporate law, including certain aspects of corporate governance in a narrow sense of the word, to the benefit of a broad circle of agents concerned, cannot be challenged. That said, the government's recent vigorous activity on the market for corporate control (in the form of obtaining control over the largest assets, establishment of public corporations, boosting state-owned equity) was unfolding in parallel with the stagnation in promoting the institution of property and corporate law.

The only exception became "S.W.A.T" measures aimed at preclusion of corporate conflicts – a new procedure of consideration of corporate disputes and some measures aimed at countering stripping bankrupt and indebted corporations of their assets, which – and this is typical of recent years, proved too late to implement. Adoption of systemic measures on a further development of the institution of property and corporate law was postponed.

Let us now more thoroughly consider *typical novelties of the late 2000s*.

The general public economic policy, one of manifestations of which since mid-2000s has been the state's more pro-active direct intervention in the economy, emerged as the most significant factor that determined the nature of modifications in the corporate law (as the corporate governance's regulative base) between 2006 and 2010. The corporate governance's advancement in the period in question was to a significant extent determined by pursuance of tasks on securing the public and quasi-public interests on the market for corporate control.

All that lied at the core of establishment of a new legal base on reorganization of corporations in 2006, which to a significant extent helped amalgamate hundreds of companies into 7 public corporations and a number of large holdings. The process had been complete by and large by 2008.

According to FAS's assessments made in 2008, enjoying the political and administrative resources and greater financial capacity, public corporations can exert a critical influence on general conditions of circulation of goods on respective commodity markets. Threats to competition arising due to the rise of public corporations lie in mandating to them some public functions and powers in respect to pursuance of the public policy. Plus, the state created exclusive conditions for the public corporations' economic operations, which makes it impossible for private corporations to compete with them. Finally, seeking collective domination, the public corporations are keen to create horizontally or vertically integrated structures².

Inspections the legal enforcement agencies ran in 2009 afforded ground to conclude the public corporations failed to accomplish their functions and mandate; what's more, their operations appeared inconsistent with objectives set in federal acts on their creation, and their

¹ Federal Act of 27.07.2009 № 138-FZ "On introducing amendments to the Federal Act "On securities market" and some other legislative acts of Russian Federation.

² To solve these challenges FAS believes it is appropriate to: 1) strengthen the anti-trust control over public corporations; 2) return to the state the public functions currently exercised by public corporations; 3) broaden the use by public corporations of tender-based mechanisms in the course of procurement of goods, works, services from private Russian companies; 4) secure transparency in the public corporations' operations; 5) impose a moratorium on founding new public corporations; 6) exclude the possibility of a government's permanent financial support of public corporations. See: Report of the RF Federal Anti-Monopoly Service "O sostoyanii konkurentsii", www.fas.gov.ru.

use of public assets and financial resources assigned to them was inappropriate or inefficient. The examination of the public corporation's operations resulted in filing more than 20 criminal cases; as well, the results became yet another argument in favor of their gradual reorganization and liquidation. The head of the presidential Control Department has reckoned recently that the Government was tasked to develop proposals until 1 March 2011 on transformation of operating in the competitive environment public corporations into other organizational and legal forms, including, in particular, joint-stock companies.

In addition, as early as since 2004 the Government began undertaking legal measures aimed at protection, retention and simplification of tasks of consolidation of new assets. More specifically, such measures were undertaken in the areas of corporate regulation, bankruptcy, anti-monopoly law¹. The problem of conflict of interests the government faced *as the regulator and an active player* on the M&A market became evident already in 2006-08. A greater attention to interests of public companies and backbone corporations (with the latter entities being a fuel for expansion of the former ones) entails the deterioration of the quality of the *general state regulation of the corporate sphere, for narrow and bespoke provisions designated for servicing the public sector's interests expanded to encompass all the economic agents*.

The provision of the state relief to companies between late 2008 and early 2009 in the frame of the combat with effects of the financial crisis by loans-for-shares means demanded for creation of mechanisms which would enable one to easily acquire the companies in question and control them. That gave rise to new, more flexible levers of allocation and pawns involving shares in limited liability companies, changes in assignment of powers between the companies' management bodies towards simplification of critical decisions concerning company management practices. For instance, Federal Act of 30 December 2008 № 306-FZ "On introducing amendments to some legislative acts of RF in connection with improvement of the procedure for the levy of execution on pledged property" established a mechanism of the extrajudicial reassignment of rights to Russian corporations' pledged stakes and other assets. The procedure for, and conditions of, exit of participants from LLCs and/or pledging their shares were fundamentally modified, too. As well, one can reference to a much disputed 2009 bill "On financial rehabilitation" which in the first place was set to meet the interests of the largest groups that had amassed sizeable debts.

The need to secure interests of the banks that are mostly controlled by the state dictated unprecedented limitations of timelines for attempts to challenge decisions made by management bodies of economic companies and a drastic reduction of the list of rationales for filing respective suits, and of introduction of much-needed proceedings measures which help an efficient consideration of corporate disputes.

Against that background the government implemented measures developed and proposed back in 2008 in the Concept of development of corporate law through 2008. That said, while key players on the market for corporate control saw their interests be promoted quite flawlessly, the said measures had enjoyed no demand whatsoever until recently.

The acts adopted with regard to LLCs partly helped close the gap between the respective legislation and the urgent needs and the company legislation. Meanwhile, the introduction of

¹ See, for example: Radygin A., Entov R., Apevalova E. et al. Vnutrenniye mekhanizmy korporativnogo upravleniya: nekotorye prikladnye problem. M., IEPP, 2009; Apevalova E., Radygin A. Razvitiye institute bankrotstva.- V: Ekonomika perekhodnogo perioda: ocherki ekonomicheskoy politiki postkommunisticheskoy Rossii. Ekonomichesky rost 2000-2007. M., Delo, 2008, p. 463-497.

simplified mechanisms of change of owners in the conditions of a limited access to financial resources and the “dictatorship” of banks, which was born by the state, constitutes an assets redistribution lever.

The government and the group of controlled by it banks’ active operations on the financial market between late 2008 and early 2009 were backed by measures on modification of circulation of marketable securities. Specifically, there arose and was legitimized a new concept of “qualified investors”. They became eligible for an access to a broader array of securities, while benefiting from more lenient requirements to transparency of such operations, for they no longer are subject to the concept of public offer and respective information disclosure requirements.

In anticipation of a rise in corporate raids in the regions against the backdrop of crisis and a drastic fall in costs of assets¹, the government took a pro-active stance with regard to modifications of the *law in the corporate disputes area*. Made in July 2009², the most significant changes in this particular sphere determined:

- a) Special procedures of consideration by arbitration courts of this particular category of cases, including such disputes being subject to exclusive *locus standi* of the court of law at a given legal entity’s location;
- b) Special provisions that concern employment of interlocutory injunction, which is supposed to preclude the nuisance and collective lawsuits;
- c) Obligation to disclose information on the initiated dispute or preparations thereto;
- d) The ban on extension of the limitation period with regard to suits on annulment of corporate acts.

That said, not adopted remained a string of modifications that concern the “healing” of the legal entity founded or reorganized in contravention of the law, the ban on extension of the period of limitations with regard to lawsuits on annulment of acts of the public registration of legal entities.

In 2009, arbitration courts witnessed a drastic growth in the number of cases on failure to honor obligations, which became one of the reasons behind the implementation in July 2010 of the *act on mediation*, which came into effect on 1 January 2011³. The document provides for the possibility for a dispute regulation mechanism, with an independent entity playing a mediator. The procedure can be applied to disputes arising from civil relationships, including entrepreneurial or other economic activities, as well as to disputes engendered by labor of family legal relations. As to other categories of disputes, it can be applied only in the event the federal law provides for that.

The exercise of the mediation procedure is voluntary and confidential, and it is run on the basis of an agreement between the sides. It can be employed to a dispute that arose both prior

¹ Addressing the Collegiums of the Attorney General’s Office, Pres. Medvedev asserted that corporate raiding could spark social tensions in urban areas. Mr. V. Pligin, Chairman of the State Duma Committee for constitutional law and nation-building prognosticated a possible rise of the so called “raider captures” (*Rossiyskaya Biznes-gazeta*, 09.12.2008) and by Yu. Korotky, the First Deputy Head of Rosfinmonitoring (*Rossiyskaya finansovaya razvedka opasayetsya vspleska reyderstva na fone krizisa*, 14.4. 2009. – <http://www.raudspb.ru/node/45>), ti name a few.

² Federal Act of 19.07. 2009. № 205-FZ “On introducing amendments to individual legislative acts of Russian Federation”. The amendments in question took effect on 21. 10.09.

³ Federal Act of 27.07. 2010. № 193-FZ “On the alternative procedure for regulation of disputes with the participation of the intermediary (the procedure for mediation)”.

to or after applying to the court of law or the arbitration court and can be initiated, in particular, per the judge or the arbiter's suggestion. To run the procedure the sides agree upon and pick one or several mediators. Should the sides turn to an organization that carries out operations on securing the conduct of the mediation procedure, such organization can recommend mediator/mediators or appoint them. The procedure per se is set by the agreement on conduct of the mediation procedure. The mediation agreement is made in writing and should contain information on the parties thereto, the subject of the dispute, the mediation procedure implemented, the mediator, as well as the obligations mutually agreed upon, and timelines for their implementation. The meditative agreement the parties arrive at the end of the mediation process should be executed voluntarily and in good faith. In addition, it can be approved as an amicable settlement by the court of law or the arbitration court, should the mediation takes place after the case was brought to the court. As to mediators, they can be both professionals, that is, having a profile higher education and taking a special training course in mediation, and amateurs. Some experts believe that, for instances, lawyers and notaries can handle mediation quite efficiently, for *ex officio* they often resort to amicable settlement and conciliation methods in their work.

Another large block of modifications was formed by *change in the procedure for conclusion of large transactions and non-arm's length transactions*, which was caused by the necessity to prevent siphoning off assets mostly of corporate debtors and corporate bankrupts. In July 2009¹, it was established that a large transaction or a non-arm's length one might be recognized as an invalid one only providing its negative consequences for the company or a shareholder, which should be proved in the court of law. The novelty clearly is a pro-majority one, and it will considerably diminish the number of transactions in question which the court of law renders ineffective.

Plus, the amended legislation specified the list of entities that have interest in effect of transactions and have a possibility to influence their completion; as well, the Board of Directors hence has enjoyed the possibility (along with the general meeting) to approve future transactions.

Lastly, a number of transactions are no longer subject to a special procedure for their conclusion (interest). This novelty concerns:

- a) transactions whose conclusion is binding for the company, per the law;
- b) transactions in which all the participants are interested, which are entered into by an LLC,;
- c) transactions effected by companies consisting of the sole participant who concurrently exercises the functions of the one-man executive body;
- d) relations arising in the course of the assignment to the company of a stake or its share in the company's authorized capital².

Earlier on, in July 2006³, out of the procedure for approval of large transactions and non-arm's length transactions were taken transactions conditioned by the decision on reorganization; as well, the procedure was specified for finding by the Board of Directors of the market

¹ Federal Act of 19.07.2009 № 205-FZ.

² Pp."c" and "d" were adopted in December 2008 with Federal Act of 30.12. 2008 № 312-FZ " On introducing amendments to Section One of the Civil Code of Russian Federation and individual legislative acts of Russian Federation".

³ Federal Act of 27.07.2006 № 146-FZ "On introducing amendments to the Federal Act 'On joint-stock companies".

value of the alienated or purchased assets with regard to such transactions. The modifications concerned joint-stock companies' operations. In July 2009, they were also implemented with regard to LLCs in respect to taking away non-arm's length transactions¹.

It is also worth noting a temporary cancelation of, or limitations put on, the effect of a number of legal provisions, mostly through 1 January 2011 (in the frame of an urgent response to liquidity shortages). In the focus of such a crisis narrowing of the legal environment in the joint-stock area were banks, which faced the following meaningful changes:

- 1) requirements to the procedure for completion of non-arm's length transactions did not encompass the subordinated unsecured loans extended by VEB² and the ones CBR disbursed to Sberbank, which combined stood at Rb. 500 bln., with the term to maturity being 31 December 2019 and the interest rate being 6.5% annualized³;
- 2) in compliance with the CBR decision, the requirement to diminish the company's authorized capital until 1 January 2011 did not encompass banks⁴;
- 3) Requirements to the procedure for exercise of the mandatory offer for sale of equity or other issuable securities by the entity that has purchased 30%-plus of the company's equity (art. 84.2 of Federal Act of 26.12.1995 №208-FZ "On joint-stock companies"⁵) had not concerned until 1 January 2011:
 - Credit organizations, should they acquire property rights for joint-stock companies' equity that form collateral;
 - Third parties that purchased from credit organizations property rights for joint-stock companies equity that formed collateral, including auctioned off ones;⁶
 - Since 20 July 2009, the Federal Act "On joint-stock companies" has been in effect as it pertains to banks in respect to issuance and circulation of issued by banks securities to the extent that it does not contravene Federal Act of 18.07.2009 № 181-FZ "On using public treasuries to raise the banks' capitalization".

¹ Federal Act of 19.07.2009 № 205-FZ.

² - to open-end joint-stock company "Bank VTB" in an amount not in excess of Rb. 200 bln. with the term to maturity being 31 December 2019 and the interest rate being 6.5% annualized (as amended in Federal Act of 27/07.2010 № 206-FZ);

- to open-end joint-stock company "Rosselkhozbank" in an amount not in excess of Rb. 25bln. with the term to maturity being 31 December 2019 and the interest rate being 6.5% annualized (as amended in Federal Act of 27/07.2010 № 206-FZ);

From the date of enactment of Federal Act of 13.10.08 № 173-FZ and through 31 December 2009 <the aforementioned banks> have the right to extend unsecured subordinated credits (loans) to credit organizations, should they comply with the following conditions (as amended in Federal Act of 27.07.2010 № 206-FZ):

- a) In the event the credit organization has the long-term credit scoring not less than the set minimal level as of the date of applying for the credit (loan);
- b) The credit organization received after 1 October 2008 subordinated credits (loans) and (or) amounts to pay the contribution to the said credit organization's authorized capital.

³ P. 2 art. 6 of Federal Act of 27.10.2008 № 173-FZ "On additional measures on support of the financial system of Russian Federation".

⁴ P. 8 art. 7 of Federal Act of 27.10.2008 № 173-FZ "On additional measures on support of the financial system of Russian Federation".

⁵ As amended in Federal Act of 03.11.2010 № 292-FZ "On introducing amendments to art. 84.2 of the Federal Act "on joint-stock companies".

⁶ Federal Act of 30.12.2008 № 306-FZ "On introducing amendments to some legislative acts due to improvement of the procedure for the levy of execution on pledged property".

To what degree the above measures were justifiable one can judge only in the context of the anti-crisis strategy as a whole. That said, the peril of an uncontrolled and opaque redistribution of the largest assets under the said legal framework appears significant.

Yet another direction of development of legislation is formed by systemic novelties that considerably changed *the standing of minority shareholders and creditors to corporations*. This refers to the introduction of mechanisms whose ultimate objective is to lower the level of corporate raiding and limiting possibilities to challenge transactions and decisions made by a company's management bodies.

The milestone development back in June 2009 became enactment of the bill (Federal Act of 03.06.2009 № 115-FZ) that changed the then existing balance of forces within the “shareholders - Board of Directors - company head” triangle. The critical peculiarity and, at the same time, the most profound challenge facing the Russian corporate governance model is the Board having no independence and exercising the will of the controlling shareholder. Meanwhile, other shareholders have no real instruments at hand to influence the company's management.

The new Act *solidified the shareholders' interests* by granting them the right to initiate and terminate the company head (one-man executive body's) powers before an extraordinary shareholder meeting. Such a meeting can be convened by initiative of a shareholder who holds more than 10% of voting shares. The extraordinary meeting at the same time considers the issue of an early termination of the Board members and election of its new composition (sp 6, 7, art. 69 of FA “On joint-stock companies”). Besides, shareholders owning more than 2% of voting shares were granted the right to nominate the candidacy of the company head at the extraordinary shareholder meeting (p. 2 art. 53 of FA “On joint-stock companies”).

Plus, the corporate law saw the introduction therein of the institution of “shareholder agreement” that constitutes an agreement between shareholders, which can obligate the parties to vote in a certain way at the general meeting, buy and sell equity at a certain price or not to sell them until certain circumstances arise, etc. Such an agreement forms the mechanism of coordination of shareholder's will and, in this sense, theoretically, can help regulate corporate conflicts.

Given Russia's peculiarities (a high concentration of equity, a special position held by the government as a shareholder and by companies it controls, a low level of legal culture and corporate governance), though, the mechanism in question can be equally employed for a latent increase in the level of control over corporations' operations by the government, state-controlled banks, public corporations and other large proprietors.

Changes in regulation of the corporate dividend policy adopted in December 2010 (FA of 28.12.2010 № 409-FZ¹) to some extent consolidated the shareholders' influence. The changes provide for introduction of a three-year timeline for realization of the right to appeal to the court of law with the request to pay announced dividends. The company's Charter can extend the timeline up to 5 years.

In addition, it was legislatively set that “the company has no right to grant a preference in respect to payment of dividends to individual owners of shares of the same category (type). The payment of announced dividends by shares of each category (type) shall be effected concurrently to all the owners of shares of a given category”).

¹ Federal Act of 28.12.2010 № 409-FZ “On introducing amendments to individual legislative acts of Russian Federation with regard to payment of dividends”.

As noted above, novelties of the period in question affected rights of creditors to reorganized legal entities. (FA of 30.12.08 № 315-FZ¹). The creditors' rights were de-facto narrowed: while earlier they had a possibility to choose between demanding from the reorganized entity for termination or an early fulfillment of its obligations, presently the termination of obligations and reimbursement of thus arising losses can be possible only in the event of the impossibility to early fulfill the obligations.

That said, even such castrated rights of creditors of reorganized companies are not applicable to creditors to public corporations Rosavtodor², Rosnanotekhnologii³, Rosatom, as well as FPUEs and FPEs whose property complexes are assigned as the RF's contribution to Rosatom⁴ and FSUEs whose assets form the contribution to Rosnanotechnologii and Rosatom.

Now creditors are entitled for demanding from the reorganized company for an early fulfillment of obligations or termination of obligations with the recovery of losses through court action only, providing the reorganized legal entity, its participants or third parties' failure to ensure a sufficient collateralization.

This implies a string of technical novelties which should protect creditors' rights in the event of reorganization, including:

- a) Making an entry on reorganization of the company in the register of legal entities;
- b) The legal entity's obligation to notify tax authorities of reorganization within three days from the moment of taking the decision thereof;
- c) The company's obligation to publish the statement on reorganization;
- d) Additional requirements to the statement of reorganization, including procedures for, and conditions of, laying by creditors of reorganized companies their claims, information of entities that are going to provide collateralization to the creditors, among others (p. 61 Art. 15 of FA "On joint-stock companies).

The requirements may not be applicable to the aforementioned public corporations, except for Rosnanotechnologii.

As to credit organizations, in addition to notifying their creditors of reorganization by posting the respective information on their homepages in the Internet, publication in media or notifying each creditor in writing, they are obligated to disclose information on substantial facts of their financial and economic operations during the whole period of reorganization, including facts and transactions that resulted in an increase or diminishment of the value of their assets by more than 10%; acquisition by an entity of a 5% -more stake in the credit organization, etc.⁵

¹ Art. 2, 3 of Federal Act of 30.12.2008 № 315-FZ "On introducing amendments to the Federal Act "On banks and banking" and some other legislative acts of Russian Federation".

² P. 2 Art. 41 of Federal Act of 17.07. 2009 № 145-FZ "On public company "Rossiyskiye avtomobilnye dorogi" and on introducing amendments to individual legislative acts of Russian Federation".

³ P. 1 Art. 5 of Federal Act of 27.07. 2010 № 211-FZ "On reorganization of the Russian corporation of nanotechnologies".

⁴ P. 10 aArt. 37 and p.2 Art. 41 of Federal Act of 1.12. 2007 № 317-FZ "On public corporation on nuclear power Rosatom".

⁵ For more details, see Art. 23.5 of FA of 2.12.1990 №395-1 "On banks and banking" as amended in FA of 30.12.2008 № 315- FZ "On introducing amendments to the federal Act "on banks and banking" and some other legislative acts of Russian Federation".

The mitigation of the level of protection of creditors' rights continued in December 2009 (FA of 27.12.2009 № 352-FZ¹). Whilst considering lawsuits brought by creditors of companies wherein a decision was made to reduce a company's authorized capital, the court of law was granted the right to reject a claim in the event:

- The creditors' rights are not abused due to reduction in authorized capital;
- Collateralization appears sufficient to ensure a due fulfillment of obligations (Art. 30 of FA "On joint-stock companies").

Such novelties provide significant opportunities for abuse due to the dominating formal approach to consideration of cases by the courts and a low level of development of relationships and control in the property appraisal area.

Meanwhile, the company is obligated to report to tax authorities on the decision to reduce its authorized capital and to publish the information in media. The rights of creditors of companies wherein the decision to reduce the authorized capital was made were regulated in a manner analogous to the regulation of the rights of creditors to the aforementioned reorganized companies.

Plus, the Act has no longer held the obligation to identify the cost of the company's net assets (to present it to the general shareholders meeting) on the basis of the annual balance sheet or results of the financial audit. Instead, the Board of Directors should include in the annual report subject to submission to the general shareholders meeting "indicators that characterize the dynamic of changes in the value of assets and the authorized capital over the three years", "findings of the analysis of causes for, and factors of" such state of affairs, and the list of measures the Board is going to undertake.

All the measures stipulated in the Act may not be applicable to credit organizations founded in the form of joint-stock company.

In July 2009 (FA of 19.07.2009 № 205-FZ²), the company law was enriched by the arsenal of measures aimed at minimizing possibilities for cancelation and challenging of rulings by management bodies of joint-stock companies and encouraging prevention and amicable settlement of corporate conflicts.

Specifically, the procedure for convening an extraordinary shareholder meeting was modified. Now it can be held only through a court proceeding, rather than by the shareholders' initiative (Art. 55 of FA "On joint-stock companies"). As well, the new Act establish solidary responsibility of the company and the registrar for losses caused to the shareholder, with exoneration of the debtor who compensated for losses to another debtor in a volume of ½ of the amount due (p. 4 Art. 44 of FA "On joint-stock companies").

Both the uncertainty with regard to the sphere of the registrar's responsibility and the previous mechanism of holding extraordinary shareholder meetings were sore spots that were actively used in the course of corporate raiding in the 2000s.

As to reduction of possibilities for challenging the company's management bodies' rulings, the following novelties are worth noting:

¹ Federal Act of 27.12.2009 № 352-FZ "On introducing amendments to individual legislative acts of Russian Federation with regard to revision of limitations for economic companies in the course of formation of authorized capital, revision of means of protection of creditors' rights under reduction of authorized capital, changes in requirements to economic companies in the event of authorized capital failing to match the cost of net assets, revision of restrictions associated with the exercise by economic companies of issuance of obligations".

² Federal Act of 19.07.2009 № 205-FZ "On introducing amendments to individual legislative acts of Russian Federation".

- 1) 2-fold contraction (from 6 to 3 months) of the period of appeal of the general shareholders meetings' decisions (p. 4 Art. 44 of FA "On joint-stock companies");
- 2) Imposition of the ban on recovery of the default to a limitation period on claims on annulment of large transactions and non-arm's length ones (p. 6 Art. 79 and p.1 Art 84 of FA "On joint-stock companies"), as well as on claims to recognize the general shareholders meetings' decisions nude/illicit;
- 3) Introduction into the law of grounds for the court to reject a discharge of claims on annulment of large transactions and non-arm's length ones;
- 4) Specification in the law of cases in which the general shareholders meeting and the Board of Directors' rulings have no effect without the verdict rendered by the court of law (p. 10 Art. 49 and p. 8 Art. 68 of the Federal Act "On joint-stock companies"). To all intents, this implies conditions of nullity of decisions made, but if implemented, these provisions can spark greater conflicts between shareholders;
- 5) Encouragement of the joint consideration of disputes on large transactions and non-arm's length ones that involve challenging the general shareholders meeting, the Board of Directors' decisions (p.p. 7,8 Art. 68; p. 3 Art. 70, p. 4 Art. 77 of the Federal Act "On joint-stock companies").

All these measures substantially complicate the return of assets the company sold and stimulate their re-selling from an intermediary to a "*bona fide* purchaser". Meanwhile, the question of the constitutional legitimacy of the clause on the ban on extension of the default to a limitation period remains unanswered.

Besides, the shareholders' rights were extended – they were granted the right to challenge the Board of Directors' ruling in the court of law, provided the decision abused the company or the shareholder's rights and/or legal interests; they also were granted the right to claim, in a judicial proceeding, "coercion of the company" to place the question on the agenda of the general shareholders meeting or to include a nominee in the list of candidacies (p. 6 Art. 53 of FA "On Joint-stock companies").

A logical continuation of the policy aimed at *lowering the level of corporate transparency* became the enactment in October 2010 (FA of 04.10.2010 № 264-FZ¹) of an Act that allows joint-stock companies, following the ruling of their general shareholders meetings, to apply to FSFM for discharge of the obligation to disclose or submit information per the Act on securities (Art. 92.1 of FA "On joint-stock companies"). Such a decision should be passed by the margin of $\frac{3}{4}$ of shareholders' voting, with holders of preferred shares also having the voting authority. The provision came into effect on 1 January 2011.

In 2009-10 *non-for-profit organizations* (NPOs) likewise saw notable changes in the legal regulation of their operations. In July 2009 (FA of 17.07.2009 № 170-FZ²), a simplified reporting procedure was introduced for non-for-profits whose founders (participants, members) are not foreign citizens (organizations) or apatrides. As well, the Ministry of Justice's powers with regard to public registration of NPOs were limited – the Ministry hence has no right to demand for submission of documents other than those stipulated in the Act.

¹ Federal Act of 4.10.2010 № 264-FZ "On introducing amendments to the Federal Act "On market for securities" and individual legislative acts of Russian Federation".

² Federal Act of 4.10.2010 № 264-FZ "On introducing amendments to the Federal Act "On market for securities" and individual legislative acts of Russian Federation".

In April 2010 (FA of 05.04.2010 № 40-FZ¹), the legislator introduced the notion of the “socially oriented non-for-profit organization”. Those are organizations which exercise activity to tackle social problems, development of the civil society, protection of environment, etc. As amended, the Act on NPOs provides for measures of the state support of such organizations, including engaging such NPOs in delivery of supplies, works and services for the government’s and municipal needs; granting the NPOs benefits, including tax ones, etc.

In addition, in December 2010 (FA of 28.12.2010 № 401-FZ² and of 03.11.2010 № 292-FZ³, respectively):

- 1) The circle of transactions recognized as large ones and requiring their completion following a special procedure was slightly broaden;

Under the category of large transactions now fall transactions whose completion is obligatory for the society in compliance with the federal law or other legal acts of RF and settlements by which are made using prices and tariffs set by the Government.

Perhaps, the legislator believes that complicating the procedure for completion of the “obligatory” transactions should strengthen control over them; however, the mechanism of completion of large transactions, together with non-arm’s length ones, has proved the most inefficient one in the effective corporate law, so no positive changes should be anticipated in this regard;

- 2) The area of effect of legal norms on the obligatory offer of the company’s equity (Art. 84.2. of FA “On joint-stock company”) continued to shrink.

The list of cases below constitutes those ones under which one is discharged of the duty to put forward a public offer in the event of buying a 30% stake in the company:

- A) Acquisition of equity as a result of the Government’s contribution with them to the authorized capital of a JSC in which the Government has been or is going to be an owner of more than a 50% stake.
- B) Acquisition of equity with which the Government contributes to the payment of placed by means of closed subscription for supplement shares of JSCs included in the list of backbone corporations and JSCs approved by the RF President.

While these measures can be tagged as anti-crisis ones, they can also be regarded as new ways of solidification of the Government and/or its individual representatives’ position on the market for corporate control.

The novelties of the period between October 2008 and 2010 in the first place *changed the balance of forces within a company by strengthening the shareholders’ positions*, granting them the right to elect/dismiss the company head, the right to early termination of the Board of Directors’ powers, and the right to conclude shareholder agreement, etc. In addition the following agents saw their possibilities be cut substantially:

- Creditors to reorganized companies;
- Creditors to companies that made the decision to diminish their authorized capital;

¹ Federal Act of 05.04.2010 № 40-FZ “On introducing amendments to individual legislative acts of Russian Federation on the matter of support of socially oriented non-for-profit organizations.

² Federal Act of 28.12.2010 № 401-FZ “On introducing amendments to the Federal Act “On electric power sector” and individual legislative acts of Russian Federation”.

³ Federal Act of 03.11.2010 № 292-FZ “On introducing amendments to Art. 84.2 of the Federal Act “On joint-stock companies”.

- Entities intending to challenge large transactions and non-arm's length transactions concluded by joint-stock companies;
- Current and former shareholders of companies consolidated into public corporations and large holdings the Government created recently.

It is shareholders, "old" owners, as well as new ones, including the Government that has bolstered its corporate presence in 2007-08, state-controlled banks which provided loans for assets, including equity, and their affiliated structures, which acquired those assets, that have become beneficiaries resulting from such novelties. Between 2003 and 2009 it was corporations owned by financial structures that most often played the role of buyers of other companies – their share in the aggregate amount of M&A deals accounted for 26% (and 33% of the total amount of funds spent on those)¹.

It can be assumed that the problem of acquisition by the Government (the companies it controls) of new assets was replaced by the problem of obtaining an actual corporate control and negotiation of existing conflicts by more or less legal means. The list of the "victims" of the novelties comprises creditors to Rosnanotechnologii, Rosavtodor, Rosatom, FSUEs and FSIs consolidated into these corporations, as well as management (members of boards of directors and heads of companies, including those consolidated into state-controlled holdings).

It goes without saying, pluses of the novelties are associated with constraining the company management's arbitrariness and strengthening of shareholders' position, introduction of the obligation to hold extraordinary shareholder meetings only through a court proceeding. They will be instrumental for all the parties concerned; however, it is not excluded that once the "new" shareholder changes the "old" management, the legislator's strategy in the corporate regulation area may change once again.

In July 2010, the Federal Act² was promulgated, which established criminal responsibility for:

- Falsification of the Single State Register of Legal Entities or the Register of Securities Owners, particularly for entering into the latter knowingly inaccurate data. Such abuses are punished by the fine amounting from Rb. 100,000 to 300,000 or by deprivation of liberty for the term of up to two years with the fine of up to Rb. 100,000. In the event of falsification of the Single State Register of Legal Entities or the Register of Securities Owners with the use of violence or the threat of its use the punishment is deprivation of liberty for the term between three and seven years and the fine of up to Rb. 500,000;
- falsification of a decision of the general meeting of shareholders (participants) of the economic company or a decision of the Board of Directors (Supervisory Board) of the economic company. Such abuses are punished by the fine amounting from Rb. 100,000 to 500,000 or by deprivation of liberty for the term of up to five years with the fine of between Rb. 100,000 to 300,000. Such a penalty is provided for in the event the falsification was committed by means of intimidation of a company's shareholder, participant in the limited liability company, member of the Board of directors of the economic company to make him/her vote in a certain way or refuse to vote, along with a blackmail or threat to use violence or destroy or to cause damage to one's property;
- entering in single state registers knowingly inaccurate data¹.

¹ Rossiyskaya ekonomika v 2009 g.: tendentsii i perspektivy, M., IEPP, 2010, p. 575.

² Federal Act of 01.07.2010 № 147-FZ "On introducing amendments to the Criminal Code of Russian Federation and Art. 151 of the Criminal-Procedural Code of Russian Federation".

In tandem with the adopted corporate regulation measures, the above novelties can be regarded as quite anti-raiding ones. The regulation of problems in the area of running the shareholder registers, holding extraordinary shareholder meetings may basically block opportunities to try certain ways of seizure of corporate assets, but there remain other means and ways. Besides, the measures in question should have been implemented long ago, for it was in the early 2000s that the respective challenges were really pressing. Retention of the opacity of corporate governance across a number of directions (the problem of conflict of interest, regulation of operations of groups of companies, in particular, in the tax sphere, affiliated entities, profit allocation, to name a few) also gives no grounds to assert there has been any notable progress in this particular sphere.

6.3. Land Use and Land Market in Russia: Situation, Legal Framework, Problems and Outlook

Land use remains such a sector of Russian economy with significant development and improvement capacity – at the expense of private property segment growth including onerous acquisition of land plots from the state; state and municipal revenues growth due to improvements in state lands management; increase in housing provision to citizens, etc.

Efficient comprehensive change in regulation and control of land resources turnover seems to have very low probability in the current environment due to both systemic problems in this sphere and to the scale of issues remaining unresolved for many previous years. However, even if only certain changes are implemented with regards to granting the right of ownership for land plots, expansion of permitted use, etc., they may provide for tangible results and multiplier effect.

6.3.1. Land Titles and Land Plots Turnover Structure

As of January 1 2010, Russian citizens owned 123,190.7 thousand ha (7.205%) of land. 10,286.9 thousand ha (0.602%) was owned by legal entities (*Tables 17 and Table 18*).

Table 17

Russian Federation Lands Profile – by Form of Ownership, thousand ha

	Year	Total area, thousand ha	Owned by private titleholders, thousand ha			Owned by the state and by municipalities, thousand ha	
			Total	including:			
				Owned by individuals	Owned by legal entities		
	1	2	3	4	5	6	7
Russia	2008	1,709,824.2	132,939.7	124,273.7	8,666.0	1,576,884.5	
	2009		133,477.6	123,190.7	10,286.9	1,576,346.6	
Central Federal District	2008	65,020.5	24,488.2	21,988.4	2,499.8	40,532.3	
	2009		24,518.8	21,364.9	3,153.9	40,501.7	
Moscow Region	2008	4,579.9	1,241.5	787.1	454.4	3,338.4	
	2009		1,259.9	765.1	494.8	3,320.0	
Moscow	2008	109.1	2.2	0.1	2.1	106.9	
	2009		2.2	0.1	2.1	106.9	
North-Western Federal District	2008	168,696.8	4,931.8	4,510.8	421.0	163,765.0	
	2009		4,949.6	4,484.4	465.2	163,747.2	
Saint-Petersburg	2008	139.9	23.6	4.7	18.9	116.3	
	2009		24.2	5.3	18.9	115.7	
Southern Federal District (2009)	2008	59,131.5	23,487.7	22,219.3	1,268.4	35,643.8	
	2009		23,821.3	22,370.9	1,450.4	35,310.2	

¹ Gosduma prinyala zakon o borble s reiderstvom.,- Rossiyskaya gazeta, 16.06.10.

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(continued) table 17

1	2	3	4	5	6	7
Southern Federal District (2010)	2008	42,087.6				
	2009		19,205.6	18,048.7	1,156.9	22,882.0
Northern-Caucasus Federal District	2008	17 043.9				
	2009		4 615.7	4 322.2	293.5	12,428.2
Privolzhsky Federal District	2008	103,697.5	35,650.0	33,025.6	2,624.4	68,047.5
	2009		35,783.2	32,553.4	3,229.8	67,914.3
Urals Federal District	2008	181 849.7	9,851.7	9,388.2	463.5	171,998.0
	2009		9,910.4	9,391.0	519.4	171,939.3
Siberian Federal District	2008	514 495.3	32,168.8	30,910.2	1,258.6	482,326.5
	2009		32,122.1	30,818.0	1,304.1	482,373.2
Far-East Federal District	2008	616 932.9	2,361.5	2,231.2	130.3	614,571.4
	2009		2,372.2	2,208.1	164.1	614,560.7
% of total area						
Russia	2008		7.775	7.268	0.507	92.225
	2009		7.807	7.205	0.602	92.193
Central Federal District	2008		37.662	33.818	3.845	62.338
	2009		37.709	32.859	4.851	62.291
Moscow Region	2008		27.108	17.186	9.922	72.892
	2009		27.509	16.706	10.804	72.491
Moscow	2008		2.016	0.092	1.925	97.984
	2009		2.016	0.092	1.925	97.984
North-Western Federal District	2008		2.923	2.674	0.250	97.077
	2009		2.934	2.658	0.276	97.066
Saint-Petersburg	2008		16.869	3.360	13.510	83.131
	2009		17.298	3.788	13.510	82.702
Southern Federal District (2009)	2008		39.721	37.576	2.145	60.279
	2009		40.285	37.832	2.453	59.715
Southern Federal District (2010)	2008					
	2009		45.632	42.884	2.749	54.368
Northern-Caucasus Federal District	2008					
	2009		27.081	25.359	1.722	72.919
Privolzhsky Federal District	2008		34.379	31.848	2.531	65.621
	2009		34.507	31.393	3.115	65.493
Urals Federal District	2008		5.417	5.163	0.255	94.583
	2009		5.450	5.164	0.286	94.550
Siberian Federal District	2008		6.252	6.008	0.245	93.748
	2009		6.243	5.990	0.253	93.757
Far-East Federal District	2008		0.383	0.362	0.021	99.617
	2009		0.385	0.358	0.027	99.615

Source: Federal Service of State Registration, Cadastral Records and Cartography.

The following changes in the land property profile took place in 2009: the total area owned by individual citizens decreased, as well as the area of land in state and municipal ownership; the total area of land owned by legal entities increased respectively – overall by 1,620.9 thousand ha versus the preceding year (see *Table 17*). The share of land owned by individual citizens (percentage to the total area) decreased from 7.268% in 2008 down to 7.205% in 2009. Nevertheless, the total area of privately owned land increased in 2009 by 537.9 thousand ha, i.e. by 0.4% versus 2008.

Overall during the 11-year period 11.1 mln ha of agricultural land were allotted and registered as private, state or municipal property (see *Table 18*).

Table 18

**Land of reorganized agricultural enterprises transferred to individual citizens
with a title for individual share in land**

No.		1998	2009	1998 vs. 2009 (– decrease)
1	Overall area of individual shares in land (mln ha)	115.4	104.3	–11.1
2	Number of citizens holding titles for individual shares in land (mln)	11.8	9.8	–2.0

Source: Federal Service of State Registration, Cadastral Records and Cartography.

In 2009 the number of land plots related transactions between individuals and legal entities in the RF grew by 25.37% versus 2008 (see *Table 19*). Only in Siberian Federal District the decrease made 31.54%.

Table 19

**Number of transactions with land registered as private
property in 2009 (number of agreements, second in line – growth /decrease
of the indicator in % to 2008)**

	Selling land plots by individuals and organizations	Transfer by way of gift	Inheritance	Pledge	Total transac- tions between individuals and legal entities
The Russian Federation	520,209 9.94%	117,776 60.60%	314,556 44.13%	43,921 46.29%	996,462 25.37%
Central Federal District	161,573 6.90%	43,543 80.33%	138,806 77.67%	12,264 126.90%	356,186 37.62%
North-Western Federal District	68,077 237.37%	9,748 44.31%	27,203 74.89%	5,724 28.54%	110,752 135.94%
Southern (combined) Federal District	81,799 13.92%	14,218 43.86%	30,356 11.53%	2,128 –15.22%	128,501 15.34%
Southern (2009) Federal District	42,013	5,822	16,934	1,274	66,043
Northern-Caucasus Fed- eral District (2009)	39,786	8,396	13,422	854	62,458
Privolzhsky Federal District	104,234 22.96%	28,497 96.03%	77,558 7.26%	9,293 43.08%	219,582 23.29%
Urals Federal District	46,421 2.46%	6,633 11.87%	19,494 52.34%	3,416 21.91%	75,964 13.66%
Siberian Federal District	47,283 –48.97%	12,814 12.98%	14,210 36.23%	9,498 18.89%	83,805 –31.54%
Far-East Federal District	10,822 47.56%	2,323 213.07%	6,929 282.40%	1,598 331.89%	21,672 111.27%

Source: Federal Service of State Registration, Cadastral Records and Cartography.

In 2008 selling of land had the leading share in the profile of all transactions associated with land plots (44.19% of total area subject to transactions), but in 2009 the majority of land transactions were transfer by way of gift (56.41%) (*Table 20*). The total area of land plots subject to transactions between individuals and legal entities grew 7.77 times in 2009 (*Table 20*).

Table 20

**Area of privately owned land subject to transactions by Federal Districts
of the Russian Federation in 2009, ha**

	Selling land plots by individuals and organiza- tions	Transfer by way of gift	Inheritance	Pledge	Total transactions between individu- als and legal enti- ties
The Russian Federation	3,159,634.4	10,582,962.53	4,116,337.8	902,674.9	18,761,609.5
Central Federal District	577,856.6	9,481,825.91 ²	1,262,307.1	235,325.9	11,557,315.5
North-Western Federal District	439,585.9	24,262.80	26,357.3	23,432.5	513,638.6
Southern Federal District	487,155.1	107,301.52	29,356.6	25,417.1	649,230.3
Northern-Caucasus Federal District	27,312.3	5,635.76	8,747.3	1,988.0	43,683.4
Privolzhsky Federal District	842,604.57 ¹	821,371.50	863,658.9	451,968.24 ⁴	2,979,603.2
Urals Federal District	394,632.8	28,112.89	144,160.1	15,103.9	582,009.6
Siberian Federal District	385,329.8	113,943.30	1,777,307.68 ³	122,758.1	2,399,338.9
Far-East Federal District	5,157.2	508.85	4,442.8	26,681.3	36,790.1
Private land transactions profile in 2009, %	16.84%	56.41%	21.94%	4.81%	100.00%
Private land transactions profile in 2008, %	44.19%	13.87%	24.69%	17.25%	100.00%
Incremental area in private land transactions in 2009,%	2.96	31.59	6.90	2.17	7.77

¹ including 593.27 thousand ha in Orenburg Region, out of which 581.00 thousand ha was agricultural lands;

² including 9,371.59 thousand ha in Moscow Region;

³ including 1,721.90 thousand ha in Kemerovo Region, out of which 1,433.59 thousand ha were agricultural lands;

⁴ including 241.97 ha in Penza Region, из которых 239.81 ha were agricultural lands.

In total, 350,685 plots of state and municipal land of overall area of 610.74 thousand ha were sold in the Russian Federation in 2009 (see Table 21). The number of sold land plots increased by 57,838 plots versus 2008 (their area was 106.93 thousand ha).

Table 21

Profile of land transactions in the Russian Federation

Types of transactions	Number of transactions, transactions (area, ha)			
	2006	2007	2008	2009
1	2	3	4	5
1. Lease of state and municipal lands, including:	3,737,574	3,628,109	3,677,315	3,514,594
	(104,827,034)	(114,103,370.5)	(114,531,856.7)	(113,081,763.97)
1.1 Transactions closed in the reporting year	522,487	472,732	441,842	410,676
	(5,775,551)	(19,941,450 ¹)	(15,698,127.8)	(26,274,903.12)
2. Selling tenancy rights for state and municipal lands	7,068	13,835	15,684	22,412
	(124,954)	(149,275.9)	(315,888.9)	(326,358.96)
3. Selling state and municipal lands, including:	176,751	233,706	292,847	350,685
	(262,791)	(369,382.7)	(503,813.3)	(610,740.26)
3.1. via tender	10,793	16,337	22,916	41,868
	(57,406)	(138,019.6)	(164,477.7)	(133,028.02)
<i>Total effective transactions with state and municipal lands, including closed in the reporting year</i>	<i>3,921,393</i>	<i>3,875,650</i>	<i>3,985,846</i>	<i>3,887,691</i>
	<i>(105,214,779)</i>	<i>(114,622,029.1)</i>	<i>(115,351,558.9)</i>	<i>(114,018,863.19)</i>
	706,306	720,273	750,373	783,773
	(6,163,296)	(20,460,108.6)	(16,517,830)	(27,212,002.34)
4. Sales and purchase of land by indi- viduals and legal entities	400,075	405,670	473,190	520,209
	(467,686)	(560,285.5)	(1,067,302.6)	(3,159,634.35)
5. Transfer by way of gift	43,437	49,715	73,334	117,776
	(70,355)	(126,596.4)	(335,042.2 ²)	(10,582,962.53)
6. Inheritance	165,847	162,151	218,244	314,556
	(524,352)	(336,091.7)	(596,197.3)	(4,116,337.75)

(continued) table 21

1	2	3	4	5
7. Pledge	14,388 (169,437)	25,907 (198,856)	30,024 (416,637.0)	43,921 (902,674.90)
<i>Total transactions between individuals and legal entities</i>	<i>623,747 (1,231,830)</i>	<i>643,443 (1,221,829.6)</i>	<i>794,792 (2,415,179.1)</i>	<i>996,462 (18,761,609.53³)</i>
<i>Total transactions in the reporting year with account of all effective leases</i>	<i>4,545,140 (106,446,090)</i>	<i>4,519,093 (115,843,858.7)</i>	<i>4,780,638 (117,766,738.0)</i>	<i>4,884,153 (132,780,472.72)</i>
out of them –	1,330,053	1,363,716	1,545,165	1,780,235
closed during the reporting year	(7,395,126)	(21,681,938.2)	(18,933,009.1)	(45,973,611.87)

¹ In 2007 significant areas of agricultural lands occupied mainly by deer pastures were leased in Nenetsky Autonomous District (6,350.8 thousand ha) and in Yamalo-Nenetsky Autonomous District (6,824.0 thousand ha).

² In 2008 significant areas were transferred by way of gift in Orenburg Region – 98,998.5 ha, and in Krasnoyarsk Region – 71,950.2 ha.

³ In 2009 the number of transactions between individuals and legal entities increased significantly: major part of land transferred by way of gift was in Moscow Region – 9,371,592.88 ha; significant areas of inherited land were in Kemerovo Region – 1,721,897.97 ha.

Source: Federal Service of State Registration, Cadastral Records and Cartography.

According to Federal Service of State Registration, Cadastral Records and Cartography¹ in 2009 citizens of Russia bought out 243,000 land plots with total area of 160.37 thousand ha for individual homes construction, for personal subsidiary farming, gardening and animal breeding, including 234,677 land plots with total area of 158.18 thousand ha in residential boroughs. 40,132 plots more were sold to individuals versus 2008; the average area of land plot bought by an individual increased from 0.15 ha up to 0.66 ha.

In 2009 17,041.9 thousand transactions closed by both individuals and legal entities were registered at land auctions. The prices at the auctions were in the great majority of cases higher than when lands were bought out of state and municipal property according to the norms (Table 22).

Table 22

Average prices for state and municipal land plots sold to individuals and legal entities in 2009 (RUR / sq. m), and average prices increment versus the preceding year (%)

Federal Districts	To citizens and their associations for:				To legal entities for using in industrial and other special purposes		To farms and husbandries and to other agricultural organization	
	building individual homes		personal subsidiary farming, gardening and animal breeding		in residential boroughs	outside residential boroughs	in residential boroughs	outside residential boroughs
	in residential boroughs	outside residential boroughs	in residential boroughs	outside residential boroughs				
1	2	3	4	5	6	7	8	9
Russian Federation	58.10	6.39	34.15	4.62	162.57	13.48	3.92	1.44
2009/2008	0.49	0.72	2.86	0.82	3.50	1.94	0.13	1.01
Central Federal District	39.35	3.92	56.88	6.57	963.76	13.66	5.49	1.26
2009/2008	0.54	0.51	3.51	0.76	20.39	0.84	0.08	1.48
North-Western Federal District	125.09	8.21	47.78	4.08	15.11	29.62	0.99	0.94
2009/2008	0.21	0.88	1.15	0.43	0.46	6.03	0.25	0.40

¹ State (National) Report about the status and use of land in the Russian Federation in 2009 – the RF Ministry of Economic Development, Federal Service of State Registration.

RUSSIAN ECONOMY IN 2010

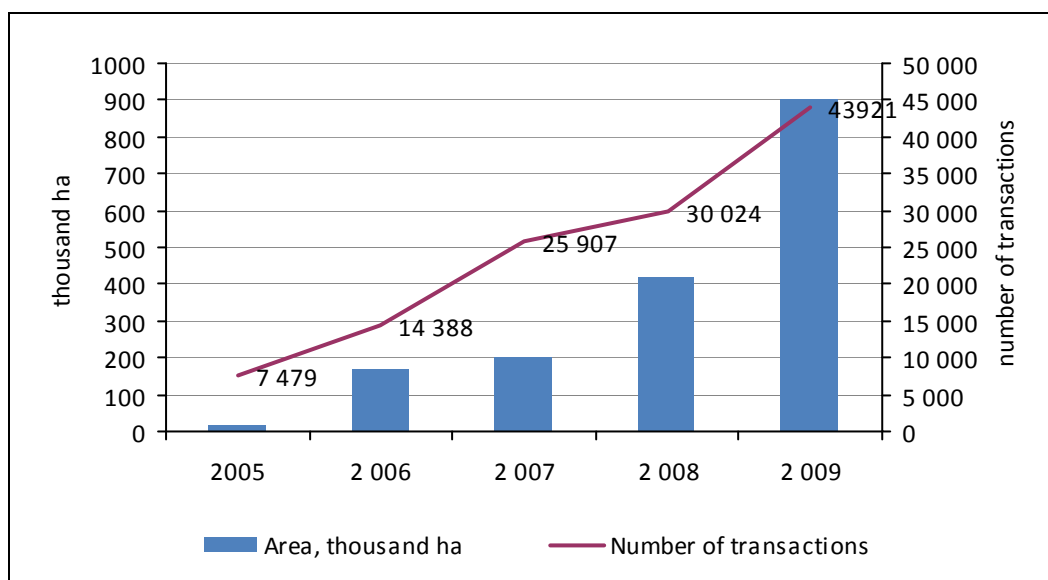
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(continued) table 22

1	2	3	4	5	6	7	8	9
Southern (combined) Federal District	135.76	0.44	121.43	2.76	160.71	10.62	2.27	7.64
2009/2008	1.04	0.00	5.70	1.42	1.89	2.27	0.36	16.26
Southern Federal District	26.49	0.44	16.66	2.59	16.23	8.78	0.93	7.29
2009/2008								
Northern-Caucasus Federal District	109.27	0.00	104.77	0.17	144.48	1.84	1.34	0.35
Privolzhsky Federal District	22.75	18.76	9.53	9.52	32.93	40.05	1.11	0.53
2009/2008	0.96	2.19	1.87	0.98	0.81	12.48	0.21	0.19
Urals Federal District	52.27	2.04	5.35	2.33	44.21	5.53	1.47	0.15
2009/2008	3.15	2.83	4.05	4.31	1.54	4.57	0.78	3.00
Siberia Federal District	38.13	17.72	6.11	5.25	38.81	6.02	0.60	0.86
2009/2008	0.88	43.22	1.20	0.75	0.91	0.93	1.22	0.58
Far-East Federal District	51.45	0.00	26.08	6.43	45.00	2.37	19.38	0.17
2009/2008	4.52	0.00	7.81	64.30	1.85	1.74	193.80	5.67

Source: Federal Service of State Registration, Cadastral Records and Cartography

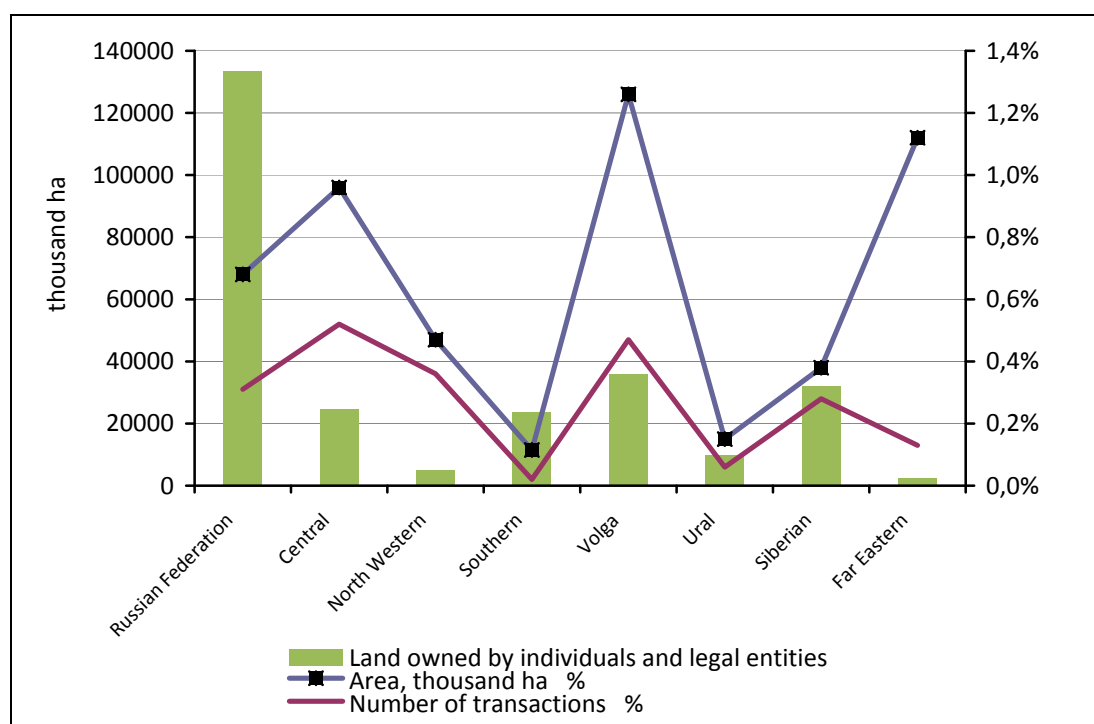
In 2009 the area of land plots at pawn (mortgaged) increased 2.17 times versus 2008, and the number of transactions increased by 31.64% (Fig. 3). The average area of mortgaged land plot increased from 13.9 ha up to 20.56 ha.



Source: Federal Service of State Registration, Cadastral Records and Cartography.

Fig. 3. Dynamics of land mortgage

In 2009 the area of mortgaged land plots in Russia was on the average of 0.68% of the total area of privately owned land (by individuals and legal entities) – compare vs. 0.31% in 2008 (Fig. 4). The majority of land plots mortgaged in 2009 (86.88%) are agricultural lands (85.55% in 2008).



Source: Federal Service of State Registration, Cadastral Records and Cartography

Fig. 4. Land mortgage by Federal Districts

According to Federal Service of State Registration, Cadastral Records and Cartography, in 2010 the number of registry entries with regards to real property and transactions therewith increased by 4%. The Federal Service of State Registration, Cadastral Records and Cartography made 26 mln entries. The number of titles registered as per simplified procedure (“dacha amnesty” program) decreased a little bit versus 2009. 2.125 mln titles were registered under this program, which is about 17% less than in 2009, but 43% more than in 2008. In total 7.121 mln titles were registered under this program starting from 2006.

6.3.2. The Problems of Land Relations in Russia

Speaking about the problems of land relations in Russia it is extremely important to set the system’s “benchmarks” – the key parameters of this sphere and in adjacent spheres having the key impact on absolutely all processes.

Given the huge territory of the country (1,709.8 mln ha), *the amount of land suitable for life-sustaining activities is not that big*. According to expert evaluation, the major portion of land in the country is not suitable for inhabitation and life-sustaining activities, because such lands are located in the regions of the Extreme North and equivalent areas.

In addition the following needs to be taken into account:

- the area of land covered with water and marshes made 225.0 mln ha (13.2% of the total land resources of the Russian Federation) as of January 1 2009¹.
- the area of land covered with woods made 802 mln ha (47% of the total land resources of the Russian Federation);
- the area of low-yielding tundra land made over 10%.

As per the most optimistic estimates, the “good” land share does not exceed 1/3 of the country’s territory. Only 13% of land area of Russia is used for agricultural purposes (plough lands, gardens, hay-fields, pastures). The share of the most valuable land (plough land) makes only 7.7% of the total area of the country. More than half of the plough land (52%) is located in the black soil areas (“chernozem”). About 80% of all farming products of Russia are produced here. And it is the sphere of use and turnover of agricultural land where the biggest problems are experienced.

The value of the most portion of Russian land is extremely small, only 1.9% of territory accounts for 82% of cadastral value of all the lands (the land of residential boroughs). All the other lands have extremely low level of infrastructure development.

With that, *the level of land resources registration and management is extremely poor.* In the vast majority of the country state and municipal lands are *not* delineated between the respective levels of government. By the beginning of 2010 only circa 302 mln ha (i.e. 19.1%) of all the lands being in state and municipal property were delineated. The average annual rate of growth of delineated land made only 1.6% over the last several years. Given such rate, 50 more years will be required to complete delineation of state and municipal lands.

In Russia the procedure of acquisition of titles (buying out land from the state) has inherent contradictions for not delineated land. On one hand, it stipulates for the need to register the state title; on the other hand, it allows for the possibility to dispose the land owned by the state without such registration (paragraph 10 of Article 3 of the Federal Law No.137-FZ “On Enactment of the RF Land Code” of October 25, 2001).

Such regulation allows for voluntary decision-making in the sphere of land disposal and is highly corruption-prone.

The regions seeking for preservation of control over all the land have lawful right to deprive local self-government bodies of the right to dispose of the non-delineated land in the administrative centers of the RF constituent entities. And such lands are of the biggest value.

The State Real Property Cadastre system is not functioning in a robust manner, the plan is to complete it by the end of 2011. The Federal Law “On State Real Property Cadastre”² came into force in March 2008. It stipulates for consolidation of two registration systems: Federal Agency for Real Property Cadastre (“Rosnedvizhimost”) and Bureau of Technical Inventory (BTI). The new cadastre should create the legal framework for state registration of the real property entirety and define the concept of the tax assessment basis as certain percentage of the cadastre value of a land plot. The provision of this Law about setting up a unified federal information system comprising the State Real Property Cadastre and the Unified State Register of Real Property Rights and Transactions Therewith in the electronic format is coming into effect starting from January 1, 2012.

¹ 72.1 mln ha covered with water (rivers, streams, lakes, water reservoirs, ponds, man-made water bodies, irrigation and drainage canals, etc.), 152.9 mln ha covered with marshes.

² Federal Law No.221-FZ of July 24, 2007

The following issues are currently relevant for the state cadastre system functioning¹:

- a) poor quality of government services provision;
- b) lack of electronic document management practices.

The consequence of this – long "lines" and long time required for registration, a big number of intermediaries and additional costs of title registration.

According to E.S. Nabiullina, the RF Minister for Economic Development, the immediate tasks that need to be resolved in this sphere are the following:

On one hand – decreasing the title registration costs for individuals and organizations, as well as reducing the risk of unlawful forfeiture of real property titles;

On the other hand – the possibility of fact and efficient resolution of number of major political issues (affordable housing construction, real estate tax introduction, national projects implementation, construction of facilities for Olympics and APEC, infrastructure projects).

In the situation when the majority of Russian lands lack cadastre documents, the definition of the plot boundaries remains very difficult, and that is reflected in the sphere of land taxation².

Cadastral valuation remains the tool actively applied by the regions to increase budget revenues. In a number of regions the cadastral value of lands occupied by certain facilities – especially in cities and towns with population exceeding 10,000 persons, is evidently a “scarecrow”, meaning it is set to prevent privatization of such land plots. Mainly it pertains to lands occupied by garages and parking lots, multi-storey apartment buildings, educational institutions and organizations. The motivation behind such decisions deserves special attention and analysis.

For example, in Primorsky Region the cadastral value of land occupied by multi-storey apartment buildings in residential boroughs with population exceeding 10,000 persons is more than 9 times higher the cadastral value of land occupied by individual homes (RUR 603.41 per sq. m versus RUR 65.13 per sq. m)³. The cadastral value of land occupied by educational institutions and organizations, garages and parking lots is slightly lower, but still one of the highest in the Region (RUR 597.18 and 566.89 per sq. m respectively). Similar situation may be observed in Khabarovsk and Kamchatka Regions, in Sakha Republic (Yakutia). In Moscow Region the cadastral value of land occupied by multi-storey apartment buildings exceeds the value of land occupied by individual homes more than 10 times (RUR 7,465.55 versus RUR 734.77 per sq. m).

Shares in land remain one of the most important problems. This legal regime of agricultural land use does not provide for ownership/disposal/usage transparency. And 83.2% of all privately owned land falls under shares in land status (circa 110.6 mln ha, i.e. about 6.5% of all the land).

The “weak points” in using shares in land from the agricultural land use regulation standpoint are as follows:

¹ See here and further on: Key point of presentation by E.S. Nabiullina, the RF Minister for Economic Development, on February 12, 2010, in the Russian Government Service Academy with the President of the Russian Federation at the all-Russian conference on the outcomes of activities of the Federal Service of State Registration, Cadastre Records and Cartography - http://www.economy.gov.ru/minrec/press/news/doc20100212_03.

² See details in: E. Apevalova. The Issues of Land Relations and Their Legal Regulation.//Transition Economy. Outline of Economic Policy in Post-Communist Russia. Economic Growth in 2000–2007, M. Delo Publishers, 2008, pp.612–613.

³ Section 228 of the State (National) Report about the status and use of land in the Russian Federation in 2008.

- The right to dispose of shares in land is limited due to the difficulty (in some cases – impossibility) to allocate a separate land plot in lieu of the share in land, without which divestment of land to somebody not being a participant in the share is impossible.
- The fact of a land plot having multiple owners impedes the decision-making on the title and land use.

In reality many owners of shares in land lease them or transfer them in trust, etc. In the current conditions multiple schemes are applied for actual transfer of property rights for shares in land without appropriate registration leading to uncontrolled concentration in the agricultural lands market, violation of rights of owners of shares in land and actual owners of such lands, data about the actual situation with agricultural land use becoming non available for the government, etc.

In May 2008¹ the legislator amended the procedure of land plots allotment in lieu of shares in land within the common title providing for the mechanism of possible agreeing of a location of a portion of land plot subject to allotment in case there is no resolution of the general meeting of the owners of shares in land. According to this new procedure, in case there is no resolution of the general meeting about location of a portion of land plot subject to allotment, the owner of the share willing to separate the land plot shall be entitled for either publishing in the media or for notifying other owners of shares about his/her intention for such separation listing the specific location. In case no objections are received within 30 days, the location of such land plot shall be deemed agreed (paragraphs 3, 4 of Article 13 of the Federal Law “On Turnover of the Agricultural Land”)².

Formally this simplifies the process of separating a land plot in lieu of shares in land for regional authorities and for those capable of implementing this mechanism in accordance with the legislative language. However, poor level of legal culture, lack of organizational and financial capabilities for getting any assistance in exercising their rights will become the critical factors impeding the residents of rural areas in using this right. So in reality this mechanism of agricultural land redistribution in favor of the state means that either major agricultural holding companies and legal entities or intermediaries will become the ones who dispose the unclaimed shares in land.

Poor level of land resources recording and control leads to *abuse and criminal offense in disposal of land plots*. During the period of 2005–2009 many officials were charged with abuse of their authorities: Mayor of Fryazino, Moscow Region (allotment of land plots for construction on a non-tender basis); Mayor of Scherbinka, Moscow Region (abuse of office in the sphere of land plots disposal); Mayor of Togliatti (unlawful disposal of land plots in 1992–2003); Mayor of Tomsk (unlawful allotment of land plots); Mayor of Saratov (unlawful distribution of land plots); Mayor of Volgograd (unlawful allotment of land plots) and others.

The problem of low level of recording and control in the sphere of land use is also a big problem. Given the system of cadastral records the error makes 20%, i.e. 341.96 mln ha out of 1,709.8 mln ha.

¹ Federal Law No.№66-FZ “On Amendments to Certain Legal Acts of the RF and Invalidation of Certain Legal Acts (Clauses) of the RF in Relation with Enactment of Federal Law On State Real Estate Cadastre” of May 13, 2008.

² In addition, an attempt was made at the end of 2008 to decrease unjustified high costs of titles/encumbrances registration for agricultural land plots. Thus, the fee for registration of a share in land was reduced 10 times.

The government practically removed itself from the sphere of territorial development. There is no systematic and planned development of infrastructure (utilities and road construction). Lack of land plots prepared for construction causes the construction costs growth and increase of load on the existing infrastructure. This leads to “pin-point” increase of population density at the same time leaving significant territories undeveloped.

In view of the above, the priority measures to improve land relations would be creating efficient system of state management of land resources meaning changes in the system of recording and controlling the land resources based on assessing the suitability of lands for life-sustaining activities. Valuation of privately owned land should be based not on the total territory of the country, but on the territory suitable for life-sustaining activities. Besides, territories with future development potential should be identified and the required conditions for their development should be created.

6.3.3. Federal and Regional Policy in the Sphere of Land Relations: some specifics

Land regulation in Russia has been under on-going change over the recent years, especially starting from 2006. This was the beginning of the so-called “mini-privatization” and “dacha amnesty”, as well as of cadastral recording and cadastral valuation system, decreasing the prices for land bought-out by industrial enterprises, etc. These new endeavors have started demonstrating some yield fruit by now: new institutions are slowly taking shape, and the privately owned land segment is gradually growing. The demand for government services has remained stable and high in the sphere of land relations, it significantly exceeds the capabilities of the existing organizations – especially, given their current performance. However, the “growth points” described above have very little impact on the overall federal and regional land use policy having formed over the last 20 years, and the quality of government services in this sphere remains very poor.

Segmental development may also be observed in the regulation of land use and land acquisition for various purposes. Active housing construction in 2005–2008 resulted in stricter government control of disposing land plots allotted for construction; mechanisms of selling land plots through auctions were introduced. Special focus on agriculture resulted in various forms of government support to agricultural producers including support in the sphere of land use regulations. Leasing agricultural lands from the state turned out to be the only segment of leasing land where the fees were reduced. Simplifying the turnover of agricultural lands was one of the most important novations of the period in question.

At the same time development of only certain segments of land relations does not serve as a driver for improvements in other segments. For example, it is very easy to bypass the requirement of selling state and municipal lands through auctions (and on pretty lawful grounds!) due to fragmented regulation. There is an RF Government Resolution setting the procedure for such auctions, but it is only selectively observed. Out of 12 land plots sold by the state in 2009 only 1 was sold through an auction.

Such “drop-out” of certain land relations segments from the government attention is followed by insufficient way federal power bodies are working with the regions on implementing the decisions in economics and by their systemic lack of attention towards regional land policies, which in certain cases are quite the opposite to the federal policy, or regions may just ignore the tasks set at the federal level or simply be incapable of implementing them. Regional policy is to a significant extent impeding the activities of local self-government bodies

in the sphere of land use depriving them either of authorities or of funds required for implementation of land-related resolutions. Inconsistency of regulatory framework at different levels of government is another important barrier, and often enough the level of regulation at regional level is not sufficient.

In 2007 the Federal Agency for Real Property Cadastre (“Rosnedvizhimost”) audited 375,027 regulatory acts at the level of the Russian Federation constituents (regional level) and at the local level pertaining to land relations. The audits revealed non-compliance with the federal land legislation in 8,093 acts of regional and local level, and 6,522 recommendations were proposed for bringing them in compliance. Out of them 3,947 acts were brought into compliance, in 2,316 cases materials were sent to supervising agencies for invalidation of the respective regional and local acts. In Nizhny Novgorod Region the Prosecutor’s Office initiated enactment of over 200 acts on land use, in Penza Region – 11 draft plot plans and rules of land use and development¹. However, this activity does not compensate for poor performance of government regulation mechanisms.

Analyzing land privatization laws evidently shows that such privatization is heavily dependent on the regulatory framework of the RF constituents (regional laws and regulations), which provides for the following:

- establishing the norms for land plots allocation for farming, gardening, vegetable production, cattle breeding and construction of summer cottages (dachas);
- defining the prices for agricultural lands;
- granting the right of free privatization of agricultural lands;
- defining the prices of land plots for owners of buildings and facilities;
- defining the initial prices and format of auctions for selling land plots for construction;
- defining the terms of privatization of smaller and medium-size businesses.

The way regional authorities exercise their rights in this sphere influences the trends in land privatization process greatly, especially in the conditions of lack of municipal property.

In reality certain regions are implementing land relations policy based either on setting significant regulatory and administrative barriers and imposing additional tax obligations on land title holders (especially in the construction sphere) making buy-out of land economically unfeasible (e.g., Krasnodar Region in providing land plots for construction; City of Moscow); or on drastic shrinking or complete lack of privatization decision powers of municipal authorities due to undeveloped land regulations at municipal level (the majority of the RF regions).

Zero or close to zero privatization performance for municipal lands is practically a common rule across Russia. Centralization of powers at the regional level allows for any constituent entity of the Russian Federation to unilaterally use its powers for disposal of land or control maintaining of the status-quo. Traditional municipal deficit of municipal budgets is an additional barrier for municipal land ownership development. As a result, there are no adequate mechanisms for allotment of municipal lands and no possibilities for real systematic control.

The need for alignment of federal and regional policies in the sphere of land privatization in terms of shaping the policy, identifying the mechanisms and allocating adequate funds, or acknowledged and agreed refusal from privatization concept in certain regions or segments is

¹ See text of presentation by Yu. Chaika, General Prosecutor of the RF at the extended meeting of the General Prosecutor’s Office Collegiate Body // genproc.gov.ru, February 18, 2008.

the key precondition of effective privatization process. The key issue here is substantiated choice of land policy by the region.

The process of shrinking the area of the common legal framework is going on in the same fragmented manner as land relations development. “Special” authorities were granted to power bodies in Krasnodar and Primorsky Regions with regards to withdrawal of land. Taking into account the growing activity of the Russian Federation in implementing international projects, the number of such “special” procedures is likely to increase. State-owned companies and their managing companies were granted “special” authorities in 2007 allowing them to obtain land plots without participation in any auctions/tenders¹. Considering all the assets currently controlled by such companies, the market segment being put beyond the general regulations is quite significant. Subsoil users received the right to obtain land plots without participation in any auctions/tenders in December 2008².

Exceptions from the common rules are often needed; however, it’s the message dictating such exception which is of special importance here. Like in the case of setting up state corporations, the message is of quasi-state or quasi-public here and does not demonstrate any positive effect, which makes such exceptions look unjustified.

As for privatization of land, there are no clear-cut objectives and baselines set at the federal level, so privatization efficiency needs to be evaluated based on the overall outcomes (amount of land transferred into private ownership). No assessment is performed with regards to the impact of land ownership status transformation on competitiveness of industrial and agricultural companies, on the level of housing prices, on entrepreneurial activity growth, etc.

To be able to effectively implement land privatization program, its objectives need to be clearly set. If the main objective here is to provide housing to the people, then all mechanisms for construction incentives and support should be engaged (transparent and simplified procedure for provision of land for construction, investment into construction and issue of loans, infrastructure development at plots subject to construction, etc.). Land privatization per se will not necessarily provide for more active construction and decrease of housing prices.

If we are to talk about the agricultural complex, the announced intent is to improve efficiency of land use and to give a new spin to their turnover. However, the legal status of unclaimed shares in land and lands of agricultural producers in bankruptcy is not duly regulated. And those are millions of hectares of agricultural lands which are withdrawn from turnover.

The procedure for turnover of shares in land received a new, simpler regulation. However, those are the buyers who benefit, and not all of them are farmers. So the new regulatory framework promotes the buy-out – not sustainable development of rural territories and their residents.

The Land Redistribution Fund created in the 90-ies is another “black hole”. Back in those days the lands of agricultural producers (Soviet kolkhozes [cooperatives of farmers] and sovkhozes [state-owned agricultural enterprises]) were transferred to this Fund. As of January 1, 2008, the Land Redistribution Fund comprised 46.6 mln ha, i.e. 11.5% of agricultural land. New land plots are still being transferred to the Fund at the expense of agricultural producers in bankruptcy, in case the land is not used or is voluntarily rejected, etc. As of January 1, 2009, 15.6 mln ha were registered in cadastre as land in use by manufacturers of commercial agricultural products, at the same time the respective title holders are excluded from the regis-

¹ Federal Law No.240-FZ “On Special Economic Zones in the RF” of October 30, 2007.

² Federal Law No.311-FZ “On Introducing Changes into Certain Legal Acts of the RF” of December 30, 2008.

ters of individuals and legal entities. During 2008 the area of such land grew by 1.3 mln ha versus the preceding year. This group of land comprised 5.5 mln ha of the shares in land and land jointly owned by individuals, as well as 9.9 mln ha of state and municipal land.

Today the federal laws allow government officials (of both federal and regional levels) to fully use their judgment in disposing the lands of the Fund. They have the right to grant this land in someone's ownership for free, which potentially may be used as a source of unlawful income for such officials, decrease the level of revenues into the federal and regional budgets and deteriorate the regulation of the land use sphere.

The unclaimed shares in land currently making 25.6 mln ha still remain a "gray zone". Their owners either have not received certificates of a share in land or have not exercised their right of disposal of the share.

As has already become a tradition over the recent years, new organizations were set up by the government to compensate for the inefficient regulation of the land relations. They are the Fund for Housing Construction Support and Residential Mortgage Agency.

The Fund for Housing Construction Support was created in 2008 with the purpose of developing land plots assigned for housing construction. The Fund's objective is to engage non-used of inefficiently used state-owned land into market turnover (meaning lands assigned to some unitary state enterprises and other government institutions, to Russian Academy of Sciences and agricultural academies). At first the plan was to use the fund for searching such land plots and preparing all the appropriate documentation. The a special Government Commission would review the land plots presented by the Fund and decide either (1) to leave them as federal property or to hand them over to the RF constituent entities under a mandatory condition of connecting to the utilities and selling through an auction during the next three years, or (2) the Fund will develop such plots itself (prepare city planning documents and create infrastructure) with further selling through an auction. Several years ago such scheme could have certain success, but to today its weak points are obvious. And the main of them is low effective demand for land plots assigned for housing construction.

One of the new schemes engaging the Fund for Housing Construction Support stipulates funding of construction by the Residential Mortgage Agency through earmarked loans to the banks. The banks will then issue loans to the developers and provide mortgages to those who buy housing. In this scheme the Fund for Housing Construction Support will perform as a guarantor for selling the housing, and in case such housing will not be in demand at the market, the Fund will buy it out at a distress price of RUR 30,000 per sq. m. The land plots prepared by the Fund (see above) will most likely become part of this scheme. The scale of the Fund and the nature of its activities does not provide for the possibility of qualitative change in the situation of shortage of prepared (from the engineering point of view) land plots for housing construction, because for massive housing construction allotment and engineering preparation of hundreds of thousands hectares per year is required¹.

Summarizing the above it can be said that a whole set of measures is required to improve the efficiency of the current land policy:

- creation of efficient mechanisms for interaction between the federal economic government institutions and regional executive power bodies;

¹ See details in the Annual Report on the Activities by the Fund for Housing Construction Support for 2009 - <http://fondrgs.ru>; Expert No.26, July 6, 2009.

- analysis of regional land policies at the federal level, evaluation of their justification and of their consequences for the regions;
- measures to improve the situation – from invalidation of certain legal acts and holding certain officials liable for offences of competition policy up to initiating criminal law suits;
- change in regulating the activities of Land Redistribution Fund;
- tightening control over buying out agricultural land and some other categories of land.

6.3.4. Lease of State and Municipal Land

Lease-based relations continue to dominate in the sphere of land use, and the situation is not likely to change in the long-term perspective. With that it is especially important for such relations to be stable and mutually beneficial both for the state and for the tenants.

As for the state, we can see that in unstable financial and economic situation in 2009 when effective demand for buying out land from the state fell drastically and budget revenues from privatization and from activities of joint-stock companies with government participation and of unitary municipal enterprises were going down as well, those were the revenues from land tenants (lease fees) that demonstrated growth¹.

It is obvious enough that in volatile and unfavorable economic environment those players who are more mobile and more flexible than the government. So budget revenues from business activities are unlikely to come back to high level until the economy stabilizes. In such conditions fixed budget revenues which are not dependent on companies' performance become especially valuable.

It means that improving the efficiency of state and municipal land resources management is one of the most relevant tasks.

And while discussing the ways to resolve this task it is quite relevant to remember about the problem of Land Redistribution Fund, about contradictions between federal and regional land policies; about the problems of shares in land and of bankrupt agricultural producers who were not excluded from the registers; about the problems of cadastral value of land being the basis for lease payment calculations, etc.

Recent changes of legislation in the sphere of land lease were connected with the changes in distribution of revenues from leasing land between budgets of different levels. These changes have been quite significant over the recent years². Thus, until April 2007 100% of revenues from sale and lease of municipal land plots went into the respective local budget. This became one of the factors impeding delineation of federal and municipal land, because in case of such delineation local budgets would be losing revenues.

In April 2007 the share of revenues in the budgets of settlements and city districts from leasing non-delineated land was reduced down to 50%, which led to shortfall in income in the regions.

Provisions to compensate for such loss were enacted in July 2008³. The law stipulated in favor of local budgets redistribution of no less than 50% of revenues from leasing federal land plots located under the respective local governments jurisdiction and from selling the rights

¹ See details in: G. Malginov, A. Radygin. Privatization Process and Land Relations Status – Economic and Political Situation in Russia, April 2010 - M., Institute of Economy in Transition, p.36.

² Article 62 of the RF Budget Code.

³ Federal Law No.161-FZ “On Housing Construction Support” of July 24, 2008

for leasing such land plots in case the powers to manage and dispose such land were granted to the RF entities and in case the regional legal framework does not stipulate otherwise.

The practice of *regional authorities exercising their powers for leasing land* brings a lot of questions, including questions from prosecutor's agencies revealing numerous violations. According to Yuri Chaika, General Prosecutor of the Russian Federation, "leasing state and municipal property including plots assigned under the right of economic management and the right of operational management with violations of the effective regulations is observed on a mass scale"¹.

For example, it was identified that in the territory of Mordovia Republic federal property (real estate and land plots) were leased based on the directives of the Head of Federal Property Management Agency without any tenders and without report about the site valuation². In Tver Region 87 legal acts of local self-government bodies about regulating agricultural land use and turnover were qualified as contradicting to the federal legislation. Granting land plots with violations of the respective procedure is also one of the key problems in the sphere of land use. As per the results of checks by prosecutors of Kaliningrad Region, 227 breaches of law were identified. In Stavropol Region during similar checks prosecutors introduced 324 representations to officials and companies directors about elimination of laws violations in the sphere of land use.

On top of that, facts about criminal offences – bribes, abuse of powers by the Head of district administration and the Head of Land Resources and Land Use Planning – were revealed in Chelyabinsk and Pskov Regions. In the city of Kislovodsk criminal proceedings were initiated against former Mayor and Vice-Mayor for unlawful allotment of land plots (for bribes)³. However, the overall context of opposing the corruption does not yet allow for qualitative improvement of the situation 70% of bribery offenses are about bribes below RUR 10,000.⁴ That means, the level of anti-corruption fighting is merely "on a household level".

Local self-government bodies often lease land plots for construction on a non-tender basis⁵, such violating the provisions of law from 2005 and onward⁶.

¹ See Report by Yu. Ya. Chaika, General Prosecutor of the RF, at the meeting of the Council of Federation within the Federal Assembly of the RF, April 28, 2010 - <http://genproc.gov.ru/management/appearances/document-33/?print=1>.

² See details at www.genproc.gov.ru.

³ "Land Allotments.- "Expert Online" of August/29, 2008.

⁴ See Report by Yu. Ya. Chaika, General Prosecutor of the RF, at the meeting of the Council of Federation within the Federal Assembly of the RF, April 28, 2010 - <http://genproc.gov.ru/management/appearances/document-33/?print=1>.

⁵ See, for example, Ruling by Higher Arbitration Court of the Russian Federation of September 10, 2008 N 9652/08 on case N A60-32127/2007 about invalidation of Resolution of Yekaterinburg City Mayor; about invalidation of Resolution of Petrozavodsk City local self-government Head; Ruling by Higher Arbitration Court of the Russian Federation of September 1, 2008 N 8498/08 on case N A26-3935/2007; Ruling by Higher Arbitration Court of the Russian Federation of June 23, 2008 N 7697/08 on case N A54-3588/2007C7 about invalidation of Resolution of Ryazan Regional Government about leasing a land plot to LLC "Semeyniy Ochag" for construction of an apartment building; about invalidation of Resolution of Blagoveschensk City Mayor; Ruling by Higher Arbitration Court of the Russian Federation of June 4, 2008 N 6692/08 on case N A04-7170/06-19/548 about invalidation of Resolution of the Head of Voskresensky Raion Municipal Formation of Moscow Region; Ruling by Higher Arbitration Court of the Russian Federation of April 23, 2008 N 4491/08 on case N A41-K2-19501/06, etc.

⁶ For details see: "Land Relations and Real Estate Markets" // Transition Economy. Outline of Economic Policy in Post-Communist Russia in 2000–2007, M., Institute of Economy in Transition, 2008, pp.608–609.

Violations of such kind and criminal offenses in the sphere of land redistribution mean that state/municipal property is transferred not to the most efficient owner and the respective budget is likely to lose some revenues.

In July 2007 the Federal Law “On Small and Medium Size Business Development” was enacted fixing one of the types of property-related support of smaller and medium-size businesses as granting the right to lease state and municipal property (land plots, buildings, non-residential premises, etc.) under privileged terms (p. 1 of Article 18).

According to Andrei Sharov, former Director Government Regulation Department in the RF Ministry of Economic Development, though this new law has been effective for a relatively small period of time, positive outcomes can already be observed. List of properties for lease have been developed in 34 regions comprising in total 29.5 thousands plots with the overall area of 6 mln 215 thousand sq. m. Certain benefits were defined in 50 constituent entities of the RF: in Oryol Region, for example, business men were relieved of lease payments, and in some regions including Moscow, lease rates were fixed at the level of 2008.¹

6.3.5. Legal Framework on Land Issues: 2007–2010

1. In July 2007 Federal Law No.221-FZ “On State Cadastral Records” of July 24, 2007 effected starting from March 2008 stipulated consolidation two registration systems: Federal Agency for Real Property Cadastre (“Rosnedvizhimost”) and Bureau of Technical Inventory (BTI). The State Cadastre System shall be finalized by the end of 2011.

The key issues in acquisition of rights for land plots and land turnover are changes in the procedure for entering a certain land plot into cadastre and cadastral activities. Inefficiency of both mechanisms can materially affect the dynamics of privatization process and land turnover.

2. In 2007–2008 the norms about simplifying the procedure of granting and registering titles for land plots of gardeners, truck-farmers, dacha owners and their associations came into effect receiving the name of “dacha amnesty”. Simplification of the procedure the basis of which was laid back in June 2006 is mainly connected with cancellation of the mechanism of centralized collection of applications, preparation of documents and decision-making about land plots privatization – including for individual use. The legislator introduced another mechanism stipulating for individual acquisition and registration of title for a land plot and a separate mechanism for acquisition and registration titles for land of common use – by non-commercial associations of gardeners, etc.

As the first step the simplified procedure was introduced for the period until January 1, 2010, and then it was prolonged until March 1, 2015.

In addition in 2007–2008 other legislative initiatives targeted at improving the “dacha amnesty” mechanism were undertaken:

1. Simplified procedure of title registration was introduced starting from October 1, 2007 for those who have land plots registered in state cadastre meaning they either have cadastre plan of the land plot no matter how old or – in case there is no such plan – a cadastre number of the land plot.

¹ “Amendments to “minor privatization” law are being discussed in the Council of Federation”, April 8, 2009 - www.arena.irbp.ru.

2. The possibility of simplified registration of titles was stipulated in November 2007¹ for land plots² of citizens having inherited buildings or facilities or received them on other grounds without documents certifying the right for the respective plot³.

3. In May 2008 the period was fixed – until January 1, 2015 – during which no permit will be required for commissioning an individual home or submission of such permit for technical inventory of such home including development and issuance of technical passport.

4. Also in May 2008 changes were introduced into the Land Code⁴ stipulating for simplification of procedure for land plots titles registration by way of replacing the requirement for having the land plot map by the requirement to have cadastral passport for which significantly less data is needed, as well as less efforts and costs. authorities of state power bodies of the RF regions and of local governments were changed:

1) the RF constituent entities were granted the rights to organize and finance actions to prepare the documents required for cadastre registration of such land plots, while the rights of local self-government in this sphere were expanded;

2) the RF constituent entities were granted the right to set the maximum limits for prices, tariffs, rates, etc. for territorial land use planning and surveys with regards to the above mentioned land plots⁵.

According to the General Prosecutor's Office, by the beginning of 2008 almost 50% of the RF constituent entities were not using their right to set the maximum limits for prices, tariffs, rates, etc. for territorial land use planning and surveys⁶.

According to Pavel Krasheninnikov, Chairman of the RF State Duma Committee for Civil, Criminal, Arbitration and Procedural Legislation, 2.5 mln of Russian citizens used the simplified procedure for registering their real estate titles by July 2009. Some experts believe, there are 20 mln more who still need the "dacha amnesty"⁷; however, General Prosecutor's representatives in 2007 claimed there were 30 mln of such citizens.

3. Federal Law No.159-FZ "On Specifics of Divesting Real Property Being State Property of the RF Entities or Municipal Property Leased by Small and Medium-Size Businesses and on Amending Certain Legal Acts of the RF" was enacted in 2008.

The new law introduced the pre-emptive right for small and medium-size businesses to buy-out the leased real property with the possibility of payment by installment at the interest rate equal to 1/3 of the RF Central Bank financing rate for the period until July 1 2010 (later

¹ Federal Law "On Amendments to Separate Legislative Acts of the RF on the Issue of Simplification of Titles for Heirs and Other Citizens" No.268-FZ of November 23, 2007.

² Land plots allocated for household farming, dacha farming and gardening, and for individual homes construction before October 30, 2001.

³ In the case of lack of title-confirming documents certificates of inheritance or another documents may be presented setting or evidencing of Article 25.2 of Federal Law "On State Registration of Real Property Rights and Transactions Therewith" and setting/evidencing the right of an individual – any previous owner of the respective building/facility for this particular land plot.

⁴ Federal Law "On Amendments to Separate Legislative Acts of the RF and Invalidation of Certain Legislative Acts (Clauses) in Relation with Enactment of the Federal Law on State Real Property Cadastre" No.66-FZ of May 13, 2008.

⁵ The period for exercising these powers was initially set until January 1, 2010, and then in July 2009 it was extended until March 1, 2015.

⁶ See Report by Yu. Ya. Chaika, General Prosecutor of the RF, at the meeting of the Council of Federation - <http://genproc.gov.ru>.

⁷ T. Mikhailova "Dacha Amnesty Received a New Term". – Rossiyskaya Gazetta, July 2, 2009.

extended until July 1 2013)¹. The process of land buy-out started under this law received the name of “minor privatization” – similar to the Eastern Europe countries, where such land privatization took place in 80-ies - 90-ies and was the first step in privatization of all the state assets.

In July 2009² amendments were introduced into this Federal Law allowing for expanding the circle of entities entitled to use the pre-emptive right for real property privatization. Thus, the lease term entitling for privatization was decreased from 3 to 2 years; also it became possible to settle the lease payment arrears and arrears in payment of fines imposed for untimely lease payments. Previously it was the fact of being in arrears on lease payments that impeded real property privatization for many small and medium-size businesses.

4. In July 2007 lower rates for land buy-out were set³, the maximum amount not to exceed 20% of the land plot cadastre value – for cities with population over 3 mln, and 2.5% of cadastre value – for land in other locations. These terms for land acquisition relate to commercial companies and individual entrepreneurs should they own buildings and facilities located in such territories (including those erected in the place of the destroyed or demolished ones or those re-constructed), should these buildings/facilities had been previously divested from state/municipal property (p. 2 of Article 2 of Federal Law No.137-FZ “On the RF Land Code Enactment” of October 25, 2001)⁴.

Actually mainly the industrial enterprises were meant here – those which had emerged during the privatization process, as well as entities having later acquired the title for real property of such enterprises. The regulations provide for quite a significant reduction of the buy-out price.

5. In 2010 the Government undertook some measures to resolve the outstanding issues in the sphere of cadastral valuation of land. According to the RF Chamber of Industries and Commerce, unlawful or unjustified valuation was identified in 10 regions of Russia.

In July 2010 amendments were made in land valuation regulations having increased the level of protection of the individual citizens’ and legal entities’ rights in the sphere of cadastral valuation of land.⁵

1) Mandatory insurance was introduced against the liability for causing damage subject to a certain level of cadastral value – in the amount of no less than RUR 30 mln;

¹ The refinancing rate of the Central Bank as of the date of publishing the leased property sale notification.

² Federal Law No.149-FZ “от 17.07.09 г. “On Amendments to the Federal Law “On Specifics of Divesting Real Property Being State Property of the RF Entities or Municipal Property Leased by Small and Medium-Size Businesses and on Amending Certain Legal Acts of the RF” and to certain legal acts of the Russian Federation” of July 17, 2009.

³ Federal Law No.212-FZ “On Amending Legal Acts of the RF with Regards to Clarification of the Terms and Procedure for Acquisition of Titles for Land Plots Being in State or Municipal Property” of July 24, 2007.

⁴ In addition to that Federal Law No.212-FZ “On Specifics of Divesting Real Property Being State Property of the RF Entities or Municipal Property Leased by Small and Medium-Size Businesses and on Amending Certain Legal Acts of the RF” introduce into the RF Land Code (p. 1.2. Article 36) the clause that the sales price for land plots being state or municipal property if bought-out by the owners of buildings and facilities located in the territory of such plots cannot exceed their cadastre value. In addition it was stated that the procedure for defining the price for such land plots and for payment shall be set by the RF Government for the land plots being in federal property, by the RF entities power bodies – for the land plots being the property of the regional government or for which the share has not been set; and by local self-government bodies for lands being in municipal property (p. 1.1 Article 36 of the RF Land Code as amended by Federal Law No.212-FZ of July 24, 2007).

⁵ Federal Law No.167-FZ “On Amendments to the RF Law “On Valuation Activities in the Russian Federation and Certain Legal Acts”” of July 22, 2010.

2) Mandatory expert evaluation of the cadastral valuation report by a self-regulating organization was introduced;

3) Mandatory publishing of cadastral valuation reports was introduced;

4) Individuals and legal entities were granted the right to challenge the identified cadastral value – either in court or in the especially established Commission. With that the individuals/entities disagreeing with the identified cadastral value shall have the right for independent market-based real property valuation.

These changes were long expected and targeted at decreasing the level of arbitrary valuation on behalf of governors and unjustified valuations on behalf of specialized assessors.

The weakest element in all the above novations is the prescribed membership of the Commission for settlement of disputes about the cadastral value: it is dominated by regional officials which significantly increases the risk of unjustified arbitrary decisions. Introducing third-party experts into these Commissions membership could have significantly improved the situation.

The respective similar clause was also introduced into Article 66 of the RF Land Code.

Improving the transparency of all data about state and municipal lands sales and leasing could become an additional safeguard against abuse in land valuation sphere (the best option would be to create a centralized Internet site).

6. The most valuable amendments to legislation on agricultural land turnover were enacted in December 2010.¹ With some minor exceptions they are coming into effect starting from July 1, 2011.

The law provides detailed regulation of the procedure for withdrawal of agricultural land and plots allocated for construction subject to them not being used for the prescribed purposes. Land may be withdrawn from the title holder or from the tenant in case it has not been used for the prescribed purposes during the 3-year period (without account of time required for this land development – up to 2 years, and time falling under the natural calamities period). With regards to plots allocated for construction such period of non-use shall make 5 years.

As for the privately owned land – only court may withdraw it from the title holder. Same may be done by an authorized agency with regards to state-owned and municipally-owned land. Land withdrawal from the title holder may be reinforced in case violations are not eliminated after administrative sanctions. The withdrawn privately owned land plot shall be sold via public auctions. The ex-owner shall be entitled to the proceeds less the auction organization expenses and cadastral activities costs.

The criteria for recognizing the land as not being used for the prescribed purposes should be approved by the Government. According to some experts², almost 50% of agricultural land in Russia has been withdrawn from the turnover, and about half of it is land bought out by investors with speculative purposes. It is the most fertile, conveniently located land with capitalization growth rate of 30–40% per annum.

In addition, the new Law

¹ Federal Law No. “On Amendments into Certain RF Legal Acts to Improve Agricultural Land Turnover” of December 29, 2010.

² Sergei Lisovsky, Senator, co-owner of Mosselprom Group: “Dmitry Medvedev urged us to work on the draft legislation providing for withdrawal privately owned agricultural land not being in use”, November 26, 2010 – [http // www.n-s-k.net](http://www.n-s-k.net).

A) Significantly strengthens administrative liability for non-using agricultural land in the prescribed purposes;

B) Approves the mechanism of recognizing land / shares in land as unclaimed, introduces the procedure for their hand-over to the state by way of judicial procedure;

C) Introduces the procedure for the general meeting of the owners of shares in land;

D) Obliges local self-government bodies to organize such general meetings before July 1, 2013, should they not do it on their own initiative prior to July 1, 2012. Such general meetings shall be authorized to approve the land survey draft, list of title holders, size of shares in land, to provide for cadastral activities for forming land plots and to make decisions on other significant matters;

E) Changes the process of forming Land Re-Distribution Fund;

F) Introduces a series of other changes.

6.3.6. Outcomes and Key Areas of Land Relations Development

Here are the key outcomes of 20 years from the start of land market development in the post-Soviet Russia:

- Land market development started;
- Legal framework created for land titles acquisition;
- Benefits were provided for acquisition of land plots into private ownership (prices decreased for land plots occupied by industrial enterprises; benefits for land buy-out by small and medium-size businesses) and their recording and documentation (“dacha amnesty”);
- Mechanisms improved for implementation of the procedure of land title acquisition – mandatory land auctions;
- Land cadastre and cadastral valuation system formation started, as well as delineation of property rights between the level of governments;
- Some other measures were undertaken.

Nevertheless, a great many problems remain outstanding. A number of systemic factors are acting in Russia, and they are the barriers for unhampered land turnover and are significantly decreasing the effective demand for land and the efficiency of using private property. They are:

1. Property rights are not sufficiently protected by the state by the state due to lack of court independency from the executive power, corruption, poor performance of municipalities, nationalization campaign (including special laws about Sochi Olympics and Asian-Pacific Economic Cooperation Forum);

2. The majority of Russia territory and infrastructure is poorly developed, which really excludes efficient land use and leads to manifold decrease of land use efficiency. 18% of the land value is spread across 98.1% of the country territory. Mainly all the most valuable land is concentrated in populated boroughs;

3. Local self-government and power bodies of the RF entities are poorly developed, they do not provide for efficient decision-making and regulation of land allotment and withdrawal, tax assessment and use of land;

4. The mechanisms of land sale and hand-over into state property are non-transparent due to both corruption and lack of budget funds for preparing land plots for sale; land relations regulation at municipal level is at a very low level;

5. Quasi-property exists in Russia: false legal regime for ownership regulation for the sites which are not real property due to significant limitations of their use and disposal (e.g., shares in land);

6. The institutions providing for land turnover are at the very early stage of their development, which explains the poor quality of government services in the land use sphere and high cost incurred by owners and title holders (land cadastre, cadastral valuation of land, self-regulating organizations of assessors, etc.).

The most dangerous or the most negative factors are as follows:

1. Agricultural land is not used for the intended purposes and is part of semi-legal turnover (shares in land), uncontrolled buy-in. Agricultural land makes 97.0% (128.9 mln ha) of the total privately owned land in Russia, and 83.2% of it is distributed among individuals as shares in land. About 1/5 of officially registered privately owned land is actually the unclaimed shares in land (25.5 mln ha). As of January 1, 2009, agricultural producers were actually using 2,096.2 thousand ha of state-owned and municipally-owned land without any formalization in the appropriate documents.

At the same time it is selling agricultural land that provides for sustainable overall growth of state and municipal land sales. During 2004-2008 the area of agricultural land sold annually by the state grew 46 times (from 8.5 thousand ha up to 391.2 thousand ha).

Such extensive development of private property in land sector mainly at the expense of the most valuable land and continuing weakening of government control in the sphere of agricultural land use has a very strong negative impact due to the following:

- Agricultural land in Russia has limited area and strategic value;
- Agricultural land has a very high share in the total private property of citizens, allowing for high turnover of such land between private owners if supported by efficient legal regulation;
- Gray non-transparent turnover of shares in land and delineation of land plots.

2. Poor level of government regulation and control in the sphere of land resources: agricultural producers in bankruptcy not excluded from official registers (1.5 mln); uncontrolled use and turnover of land from the Re-Distribution Fund (46.6 mln ha or 11.5% of agricultural land as of January 1, 2008); slow progress in land delineation (average annual growth rate was 1.6% in 2006-2008).

3. Land policy is implemented without account of land resources and prospects of their inclusion in land turnover. Thus, only 1/3 of land resources in Russia are favorable for human vital function. Only 13% of land area is used in agriculture (plough land, gardens, hay fields, grass land). As for the most valuable land share – only about 7.7% is plough land, and more than half per cent are in the black soil area. And problems are the biggest in this particular area.

4. Poor level of registration of land titles, the error of State Register data about land transactions makes 20%, this means practically 342 mln ha of land is not registered – more than the territory of Finland (338 mln ha) or Italy (301 mln ha) or Great Britain (244 mln ha).

5. Lack of transparent data about land property and land turnover within the segment of land plots acquired by individuals “for other purposes”. This segment of turnover demonstrates different mechanism of sales-and-purchase transactions, however, the trend is same – more and more agricultural land is bought by legal entities. Thus, 3 times more land plots were purchased “for other purposes” in 2008 than in 2007 (23.8 thousand transactions in 2007;

69.4 thousand transactions in 2008). The area of land plots purchased within this category grew 2 times: 106.6 thousand ha in 2007 and 246.3 thousand ha in 2008).

This category and the structure of land titles require details in this part. It is quite possible that legal entities are thus buying-in land, including agricultural land – in such cases when it is not desirable to legalize the beneficial owner.

Today the level of institutional development, including government institutions, providing for use, turnover and protection of privately owned land excludes the possibility of high-quality services in the segment of big size real property.

At the same time, the level of state land property management is also very low.

In relation to all the above, the optimal scenario looks as follows: in privately owned land segment – using land resources as leverage for resolving the most acute social and economic problems; and in the state-owned land segment – improving government management and control of land allotment and registration, including the unused land into turnover.

With the purposes to improve government policy in the sphere of land privatization the priority measures should be targeted at defining the strategic areas for private land ownership development.

Up till now we could define privatization either as a large-scale change of real property ownership profile, or as a way to increase budget revenues (mainly for regional budgets), or as a way to consolidate real estate. In all of such cases what is sold and to whom practically did not matter. The summarized results are unclear and do not allow for talking about some quality change in the situation or about the improvement of land use efficiency.

It seems that the objective for land privatization should be defined differently. Privatization should be used as an instrument for resolving a specific social and/or economic task. For example, increasing the number of middle class may be selected as an objective – and based in this various methods for its efficient achievement may be defined, the key parameters of the process may be specified, as well the required legal, financial and other tools and the potential costs. Besides, the control over such policy implementation may become more efficient and the required adjustments may be introduced. Given this example, the key areas for privatization could be in individual homes construction and farming development.

The criteria for program implementation efficiency could be: increased provision of housing at the expense of individual construction (maybe – collectively funded), increased revenues from farming sector.

Private farms play a very important role within *the privately owned land segment* (15.9 mln ha of land); as well as *personal subsidiary plots* (7.2 mln ha of land) and *dacha owners associations* (1.2 mln ha of land).

Private title holders are 16 mln families having got their individual subsidiary plots; 14 mln families in gardeningсадоводством; 7 mln families currently building their individual homes; 3 mln families engaged in small farming and 137.7 thousand dacha owners.

Such high engagement of citizens into the process of acquisition of land titles requires the following from the state (if only it has interest in expanding the privatization process):

- create favorable conditions for maintaining and increasing the demand for land plots (provision of utilities under fair and acceptable price at private initiative of citizens; provision of loans for such purposes; simplification of mechanisms for transparency of issuing loans);
- improve the quality of government services in the land sphere;

- develop a set of government actions to enhance each of the mentioned land market segments;
- consider increasing the norms of land allotment in the regions with sufficient lands and expand privately owned land plots;
- create efficient mechanisms for managing the processes of allotment, development and construction on such land plots – both by the state institutions and by self-regulating organizations.

It is quite obvious that such segments of land market as land plots for building individual homes and dacha owners associations are underdeveloped.

The main impediments here are the following:

- A) Inefficient and overcomplicated mechanisms of such land plots allotment;
- B) Underdeveloped infrastructure, high cost of utilities connections, of obtaining construction permits and of commissioning;
- C) Regional land policy in the sphere of building individual homes and setting up dacha owners associations (created only in 56 RF entities);
- D) No right for registration in dacha homes as permanent residency;
- E) Limitations for buildings established for small farms and gardening associations, other unjustified prohibitions for using land plots.

Land privatization for the purpose of building individual homes is a huge factor capable of activating the citizens' demand for land plots. However, land development in this segment is really in embryo state. The share of privately owned land used for this purpose does not exceed 0.05% of total land area (i.e., 0.8 mln ha).

The following factors can provide for significant growth of activity at the land market: substantial household incomes' growth in 2000-s, the amount of loans issued to individuals, high housing deficit (circa 1.6 bln sq. m) and incapability of the government (at least in the mid-term perspective) to resolve this issue (estimated period required is no less than 35 years if the pre-crisis construction growth rate is preserved).

The following will be required for promotion of land privatization with the purposes of building individual homes:

1. Assure creation and development of the system of land plots allotment and acquisition with the purpose of building individual homes, expand opportunities for access to such systems;
2. Assure efficient mechanisms of challenging the results of land auctions and land plots valuation; assure control on behalf of the RF Ministry for Economic Development, RF Ministry of Regional Development, Prosecutor's Office over legal acts adopted at the regional level in the sphere of such land lots allotment;
3. Develop the system of incentives for acquisition of land by citizens beyond the boroughs of residential areas including land in undeveloped territories (e.g., lower interest rate for loans issued to finance construction and utilities connections, longer pay-back period for such loans, reduced / socially acceptable costs for utilities connections, etc.);
4. Develop programs providing for quicker utilities connection (gas, electricity, water, communications, roads) at socially acceptable price for the land plots bought out by citizens for building individual homes. This program should stipulate for provision of services by certain government agencies under public contract terms, the format and terms of which should be defined by the state (best of all – in a federal law), for performing certain work when allocating land plots subject to requests from the title hold-

ers. The number of owners requesting such work should be set at the level providing for the contractor's profitability, on one hand; and excluding the possibility to delay the construction and assure socially acceptable price, on the other hand. Payment by installment and delay in payment under such contracts, as well as the possibility to challenge the cost of services provided under such contracts should also be provided for. In addition, the possibility for selecting contractors via tenders in segments with high competition should be provided for;

5. Consider transformation of certain categories of land plots (except for agricultural land) into land plots designated for building individual homes in cases when increase of their size is possible.

In addition, it is necessary to consider the possibility for increasing the size of land plots allocated to citizens, especially in the regions with vast land resources. The norms of land plots allocated to citizens (6–12 pieces of one hundred square meters, which is a traditional Russian measurement of land) were acceptable in early 1990-ies, however, by the end of 2000-ies they do not match with the level of income and the level of demand on behalf of individual citizens, with medium-level income and higher. Establish an effective system of managerial control and monitoring of activities in the regions with regards to legal framework regulating allotment privatization and mechanisms of land – to exclude the facts of massive violations of citizens' rights, facts of abusing official powers (currently often found in this sphere).

Initially land plots may be leased for building individual homes with the right of further buy-out.

Investment aspect of land privatization should also be revisited, specifically – *privatization of land occupied by enterprises*. The purpose of such privatization should not be consolidation of real property as one single asset, which in practice often turns into buying a land plot with high market value at the underestimated price, which does not have any impact neither on the enterprise growth (micro level), not on the macro-economic development. Privatization of land occupied by enterprises should provide for future development of manufacturing. Land plots should be allocated for buy-out at discounted price to major, medium-size and small enterprises capable of implementing investment projects resulting in their competitiveness growth, cost reduction, growing yields, sales market expansion, etc. (today this practically means shrinking the segment of land plots occupied by enterprises subject to privatization). Otherwise privatization will be senseless for the state.

Besides, land plots designated for gardening private subsidiary farms, etc. may have quite good potential for being in high demand.

Amending legal framework currently providing for intermediaries acquiring land including agricultural land and plots under enterprises is extremely important for efficient land privatization.

The issue of *land property rights (titles) re-registration* is of special importance. Actually we deal here with the already formalized by out-dated rights which will cease to exist in future: permanent (unlimited) use and lifetime ownership with hereditary possession.

It is important that the government policy is targeted at expanding the private property segment, but not by introducing common efficient rules “top down”, but rather by creating the conditions at the ground level (“bottom up”). The costs of such approach are pretty high: for individuals – substantial expenses on land surveying and stock-taking, long period, etc.; for

the government – several years of transition (deregulation) period in the private real property segment.

Poor efficiency of such approach we are now witnessing in the process of re-registration under the “dacha amnesty” process, when registering agencies cannot handle the high demand, the established timeline is unjustifiably long, the prices for land survey services are monopolistically high and not affordable to many citizens, which provokes for growing bribery and abuse.

Efficient re-registration of titles in this segment would mean cardinal change of the approach. Citizens qualified for such re-registration and their heirs should be given a fixed period (e.g., 1 year) to send a request for re-registration of their title (according to the established template) to the State Register Agency (local administration may be an option) territorial branch in the jurisdiction of the land plot location (including sending via e-mail). Government agencies shall keep a special register of such individuals and land plots and issue a special notification about receiving the above described requests.

The State Register agencies should have all the necessary authorities to perform the actions required for re-registration of titles subject to agreement with the individual having requested such re-registration (cadastral valuation and delineation, issuing the required inquiries, etc.) and then the re-registration itself. The applicant shall cover all the required expenses.

The following needs to be developed and approved for this purpose:

- socially acceptable tariffs for all government services in this sphere which should be provided to everyone who would like to use the above described mechanism;
- methodology for the State Register agencies work, for interaction with other bodies and with individuals.

Taking into account the existing practice of land title registration, certain elements of legal relations (may be – for a certain period) maybe withdrawn from under such regulations due to big number of errors and mismatches in title documents. The State will bear all the efforts for further title registration of titles and the individual will cover the costs.

The “pros” of the proposed options are the following:

- significant facilitation of real estate market expansion;
- elimination of acute social problems in the sphere of land title registration;
- decrease of corruption level in real property titles registering agencies;
- decrease the level of social costs of monopolistically high prices for territorial land survey and stock-taking services;
- government capability of creating systems for land surveying and stock-taking which would adequately respond to the economic needs and have socially acceptable prices for their services.

The weak points: limited capabilities of State Register network; possibility for abuse on behalf of citizens; need for additional state funding.

This methodology could be tested in certain regions selected based on high level of effective demand of population and capabilities of territorial agencies of the State Register network.

In a similar way a possibility could be stipulated for legal entities using their land plots under the terms of permanent (unlimited) use: in case such entity does not apply for the land title registration, the lease agreement shall be executed, when the executive agencies draft the required documents and the expenses are covered by the tenant.

In addition, it looks feasible to consider introduction (or using in a wider scale) the installment scheme for buying out the leased land plots. With that, buying out the most valuable (expensive) land should be delayed until their prices go up (currently land plots are significantly underestimated). Today land privatization may be used as a way to get additional income into the budget, but tomorrow it may result in systematic problems, resolution of which may take decades.

6.4. Regulation of competition limiting concerted practices in 2008–2010

Effective Russian anti-monopoly legislation describes the entire diversity of competition limiting concerted practices consequences causing damage to consumers or players in the adjacent markets. According to Article 8 of Law No.135 «"On Protecting Competition"», concerted practices of commodities markets participants shall be include all actions the outcomes of which are in line with the interests of every participant of the market under the following conditions:

- their actions are known to each other in advance;
- these actions are not resulting from the circumstances which have equal impact on all commodities markets participants.

According to Article 11, competition limiting cartels or concerted practices shall be prohibited in case they lead or may potentially lead to:

- 1) establishing or maintaining certain prices, rebates, mark-ups or premiums;
- 2) increasing, reducing or maintaining prices at auctions;
- 3) dividing the commodities market by territories, volume of sales or purchases, range of sold commodities or composition of sellers or buyers (customers);
- 4) economically/technically unjustified refusal to execute contracts with certain sellers or buyers;
- 5) imposing unfavorable terms and conditions in counterparty, or imposing terms and conditions which are not related with the subject of contract;
- 6) economically/technically/in any other way unjustified fixation of prices (tariffs) for one and the same commodity;
- 7) reducing or terminating production of goods which are currently in demand or which have already been procured in the conditions when such goods may be profitably manufactured;
- 8) impeding other economic operators to either enter or exit a certain commodity market;
- 9) establishing professional or other types of associations membership (participation) terms in case such terms lead or may potentially lead to preventing, limiting or eliminating competition.

According to statistical data anti-monopoly agencies in the US, EU and Russia identify not more than several dozens of violations per year. Even a smaller number of violations are terminated after they are contested in courts.

The most effort-intensive stage in the process of identifying the facts of competition limiting concerted practices is the need to provide evidence that all the participants knew about their actions. According to p. 2 of the Resolution No.30 of the RF High Arbitration Court Plenum of June 30, 2008 "On Some Issues Arising in Connection with Arbitration Courts Applying Anti-Monopoly Legislation", which talks about concerted practices, the fact of actions being committed by different market players simultaneously and consistently without any external reasons may be viewed as such evidence. It should be noted that the extent of

consistency and uniformity of actions shall be defined by the respective anti-monopoly agency, and in case its decision is challenged – by the respective Arbitration court.

For example, the judgment of Altaysky Region Arbitration Court confirmed the lawfulness of conclusions made by Altai territorial division of FAS (Federal Anti-Monopoly Service) about the activities of OJSC Rosneft – Altainefteprodukt and OJSC Gazpromneft-Altai constituting a price collusion – on the basis of two criteria: practically simultaneous increase of different grades of gasoline prices by the same value in the territory of Barnaul city from April 3 until May 30, 2009.

In 2008–2010 anti-monopoly agencies of Russia made decisions on such types of violations as coordinating economic activities, impeding entrance to / exit from the market, geographical division of markets, collusion at auctions, price collusion and refusal to act independently by executing exclusivity agreements for supplying products / rendering services.

Table 23

Ascertainment of competition limiting concerted practices in 2008–2010¹

	Participants	Type of violation	Commodity	Type of market	Investigation initiated by	Number of cartel participants
1	2	3	4	5	6	7
2008						
1	LLC Sibneft-Krasnoyarsknefteprodukt, LLC Fortuna Plus, OJSC Krasnoyarsknefteprodukt	price collusion	petroleum products	regional	FAS	3
2	OJSC Oskolneftesnab, LLC Starooskolskaya neftebaza, OJSC Belgorodnefteprodukt	price collusion	petroleum products	regional	FAS	3
3	LLC Kurskobnefteprodukt, LLC Alexiya	price collusion	petroleum products	regional	FAS	2
4	OJSC NK Rosneft – Altainefteprodukt, OJSC Gazpromneft-Altay	price collusion	petroleum products	regional	FAS	2
5	LLC LUKoil-Severo-Zapadneftprodukt, LLC Pskovskaya Toplivnaya Kompaniya, LLC Pskovnefteprodukt	price collusion	petroleum products	regional	FAS	3
6	LLC LUKoil-Nizhnevsknefteprodukt, LLC Gazprom Dobycha Astrakhan	price collusion	petroleum products	regional	FAS	2
7	OJSC Khabarovsknefteprodukt, LLC RN-Vostoknefteprodukt	price collusion	petroleum products	regional	FAS	2
8	CJSC Electron	coordination of economic activities	fiscal registers sales	regional	FAS	1
9	LLC LUKoil-Yugnefteprodukt, OJSC NK Rosneft-Stavropolye, LLC Bashoil-KMV, LLC Stavneft, LLC PKP Stavpromkomplekt	price collusion	petroleum products	regional	FAS	5
10	LLC TV&Radio Company “Luch”, CJSC TV-Service, CJSC RMA Telephone”, Individual Entrepreneur Kakurin A.A.	price collusion	cable TV	regional	FAS	4
11	Federal State Unitary Enterprise Scientific pilot integrated dairy plant named after Vereschagin, CJSC PTK “Severnoye Moloko”, OJSC Sukhonsky Dairy Products	coordination of economic activities	dairy products	regional	FAS	4
12	CJSC Gaspromneft – Kuzbas, OJSC Tomsknefteprodukt	price collusion	petroleum products	regional	FAS	2
13	OJSC SK Eni, LLC Novaya Lizingovaya Kompaniya, CJSC Moscow Commercial Bank Mosprivatbank	coordination of economic activities	leasing services	regional	FAS	4

¹ Systematization of data published at FAS of Russia website at www.fas.gov.ru

Section 6.
Institutional Problems

(continued) table 23

1	2	3	4	5	6	7
14	LLC Rusfinans Bank, OJSC GSK Yugoriya	coordination of economic activities	debt financing	regional	customer	2
15	9 radio-taxi market players	price collusion	radio-taxi	regional	customer	9
16	OJSC Orenburgnefteprodukt, LLC TK Petrol	price collusion	petroleum products	regional	FAS	2
17	LLC UniMilk, CJSC Tandem	coordination of economic activities	dairy products	regional	FAS	2
18	Bank Societe Generale Vostok, OJSC Rosno, LLC Renaissance Strakhovaniye Group, CCJSC Soyuznik	coordination of economic activities	consumer lending	regional	customer	4
19	Retail chains AkBarsTorg, Magnit, Patterson, Perekryostok, Optovik	coordination of economic activities	retail	regional	FAS	5
20	CJSC Refenergo, CJSC Pool-Energo	coordination of economic activities	electric power	regional	FAS	2
21	Bank VTB 24, 12 insurance companies	coordination of economic activities	mortgage lending	national	FAS	13
2009						
1	OJSC Silvinit, OJSC Uralkaliy	price collusion	potassium chloride	national	consumers, power bodies	2
2	OJSC Aviakompaniya Avis-Amur, OJSC Aviakompaniya Vostok	collusion at auction	medical aid aviation	regional	FSB	2
3	LLC Agroremstroy, LLC MonolitStroy, LLC Construction company SMU-30	collusion at auction	metal roofing maintenance	regional	consumers	3
4	8 wholesale companies	collusion at auction	supplying vegetables to educational institutions	regional	regional administration	8
5	IKEA Mos Company	coordination of economic activities	leasing space	regional	consumers	1
6	OJSC Bassol ,LLC Promsol	exclusivity contract	salt	regional	consumers	2
7	Sverdlovsk railway, CJSC Visavi	exclusivity contract	railway cars delivery and cleaning	regional	FAS	2
8	OJSC Izhmash Concern, LLC Deryabin-Oruzhiye	exclusivity contract	non-military weapons	national	FAS	2
9	OJSC Makhachkalinsky Vinzavod, LLC Premium	exclusivity contract	alcoholic products	regional	FAS	2
10	OJSC Center for Rescue and Environmental Operations	coordination of economic activities	servicing hazardous industrial sites	national	consumers	1
11	OJSC Center for Rescue and Environmental Operations, State Institution for Moscow Region Mosobl-pozhspas	market division	servicing hazardous industrial sites	regional	FAS	2
12	CJSC Delta Credit Commercial Bank	coordination of economic activities	mortgage lending	regional	FAS	1
13	OJSC Baltika Brewery and 6 distributors	market division	beer wholesale	regional	FAS	7
14	OJSC Promsvyazbank and 12 insurance companies	coordination of economic activities	debt financing	regional	FAS	13

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(continued) table 23

1	2	3	4	5	6	7
15	CJSC Penzaneftprodukt, LLC LUKoil Nizhnevolzhskneftprodukt	price collusion	petroleum products	regional		2
16	LLC Soda-Chlorat, LLC KhimStandard	market division	potassium chlorate	regional	customer	2
17	OJSC AK Bars Bank, Open Joint-Stock Insurance Company Rossiya	exclusivity contract	auto loan	regional	FAS	2
18	OJSC Electroapparat, LLC Trading House Electroapparat	coordination of economic activities	automatic circuit breaker	national	competitor	2
19	LLC OPUS Trading House	coordination of economic activities	linoleum and floor coating wholesale	national	FAS	1
2010						
1	CJSC TechnoNIKOL, LLC TechnoNIKOL - Construction Systems	market division	construction materials	national	customer	2
2	CJSC Rusperforator, Federal State-Owned Enterprise Permsky Porokhovoy Zavod, Federal State-Owned Enterprise Plant named after Ya. M. Sverdlov, OJSC Promsintez, Federal State Unitary Enterprise Bryansk Chemical Plant named after 50 th October Anniversary, OJSC Kalinovsky Chemical Plant	price collusion	commercial explosives	national	customer	6
3	OJSC Sberbank, Commercial Bank Odinbank (LLC), Federal State Unitary Enterprise Post of Russia, Municipal Unitary Enterprise Information-Computing Center of Odintsovo urban settlement, Odintsovsky Municipality in Moscow Region, Municipal Unitary Enterprise Housing and Utilities Division	coordination of economic activities	payment for services	regional	customer	7
4	LLC KRK-Strakhovaniye, OJSC Alpha Strakhovaniye, OJSC SG MSK, LLC Rosgosstrakh, LLC SG Admiral, LLC Renaissance Strakhovaniye Group, OJSC Russkaya Strakhovaya Kompaniya	coordination of economic activities	Insurance business	national	customer	7
5	Non-State Institution for continuing professional education Business Security School, Non-State Educational Institution STRAZHA	price collusion	security guards certification exams	regional	customer	2
6	LLC Rexam, OJSC Baltika Brewery	coordination of economic activities	aluminum cans	national	customer	2
7	Kotlas poultry farm, Agricultural Service Company Arkhselprom	price collusion	table egg	regional	FAS	2
8	Federal Division of Motor Ways Chernozemye, LLC Road Operating Company No.36	collusion at auction	road construction	regional	customer	2
9	LLC Agrotorg, CJSC Trading House Perekryostok, LLC Real Hypermarket, LLC Lenta, CJSC DIXI-PETERBURG , LLC O'Kay	price collusion	buckwheat groats	regional	FAS	6
10	LLC Echo firm, LLC TD-Holding, LLC RE-SOURCE, LLC Vladimir and Co., LLC Alekon, LLC Samarskaya Niva, LLC AgroMir	price collusion	buckwheat groats	regional	FAS	7
11	Manros-M, OJSC Wim-Bill-Dan branch, CJSC Lyubinsky MKK, OJSC Vita	price collusion	milk	regional	FAS	4
12	OJSC Kyshtym mining and concentrating company, OJSC Polyarny Quartz	exclusivity contract	gangue fractional quartz	regional	FAS	2
13	LLC LUKoil-Yugneftprodukt , OJSC NK Rosneft - Staropoliye	price collusion	petroleum products	regional	FAS	2
14	OJSC SUEK, OJSC Russkiy Ugol, CJSC Stroyservice	price collusion	power-generating coal	regional	customer	3

(continued) table 23

1	2	3	4	5	6	7
15	OJSC AKB ROSBANK, Open Joint-Stock Insurance Company RESO-Guarantiya	coordination of economic activities	mortgage lending	regional	customer	2
16	OJSC Mozyrsol, LLC BPK, CJSC Predpriyatiye MS CJSC TDS, OJSC Upak Group, LLC Grocery, LLC Eurotrust Expo, LLC Gildiya+, LLC SevZapRegionSol SPb, LLC Euroservice Plus	market division	sodium salt	national	FAS	10

Looking at the profile of violations in 2008–2010 the following conclusion may be made: price collusions and coordination of economic activities are the most common violations (*Fig. 5, Table 23*).

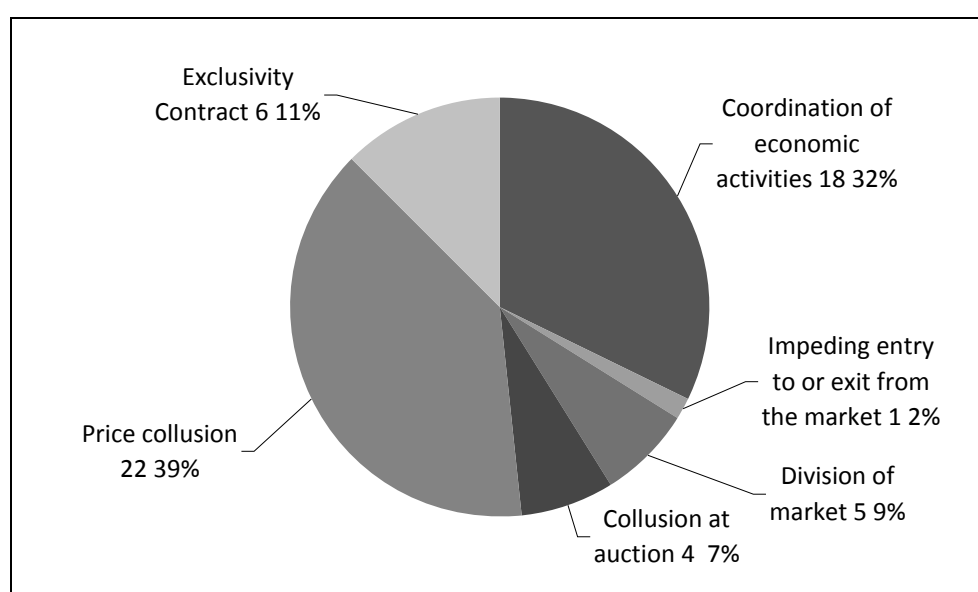


Fig. 5. Identified cases of competition limiting concerted practices in 2008–2010 – by types

Significant increase of concerted practice associated with financial institutions activities coordination was observed in 2010 versus 2008. In 2008 11 price collusions out of the total of 12 were identified based on monitoring petroleum products prices.

Table 24

Competition limiting concerted practices cases by types, 2008–2010

Type of violation	Year		
	2008	2009	2010
Coordination of economic activities	9	5	4
Impeding entry to and exit from the market		1	
Division of the market		3	1
Collusion at auction		3	1
Price collusion	12	2	8
Exclusivity contract		6	1

In the following Table (*Table 25*) the types of concerted practices are analyzed against the spheres of economic activity

Table 25

Congruence between types of concerted practices and spheres of economic activities

Sphere of economic activities \ Types of violations	Coordination of economic activities	Impeding entry to and exit from the market	Division of the market	Collusion at auction	Price collusion	Exclusivity contract
Wholesale and retail	1				2	
Consumer goods	2		1		3	
Industrial manufacturing	1	1	2		2	3
Raw materials market	1		1		13	2
Services to government organizations				4		
Public services	1				3	
Services to business operators	4		1			1
Financial services	7					1

As one can see from the above data, coordination of economic activities cases were identified in all spheres of business, impeding market entry/exit and division of markets are found more often in the sphere of manufacturing. Price collusion was most often identified in raw materials markets which may be associated with the fact that the products in these sectors are more homogeneous and it is easier to prove that change of price is not associated with any external factors. Besides, producers' prices for socially important goods are monitored providing data for identifying price collusion.

Coordination of economic activities is most common type of concerted practices in financial markets associated with limiting the number of insurance companies whose policies are mandatory to have for getting a mortgage, for example.

Most often two entities are recognized as anti-monopoly law offenders committing concerted practices. In particular, most often price collusions of two companies within one regional market are identified (see Table 26 and Fig. 6).

Table 26

Congruence between types of concerted practices and number of offenders

Type of violations \ Number of offenders	Number of offenders					
	1	2	3	4	5	> 5
Coordination of economic activities	5	5		3	2	2
Impeding entry to and exit from the market		1				1
Division of the market		4				1
Collusion at auction		1	1			1
Price collusion		11	4	2	2	4
Exclusivity contract		6				
Total	5	28	5	5	2	9

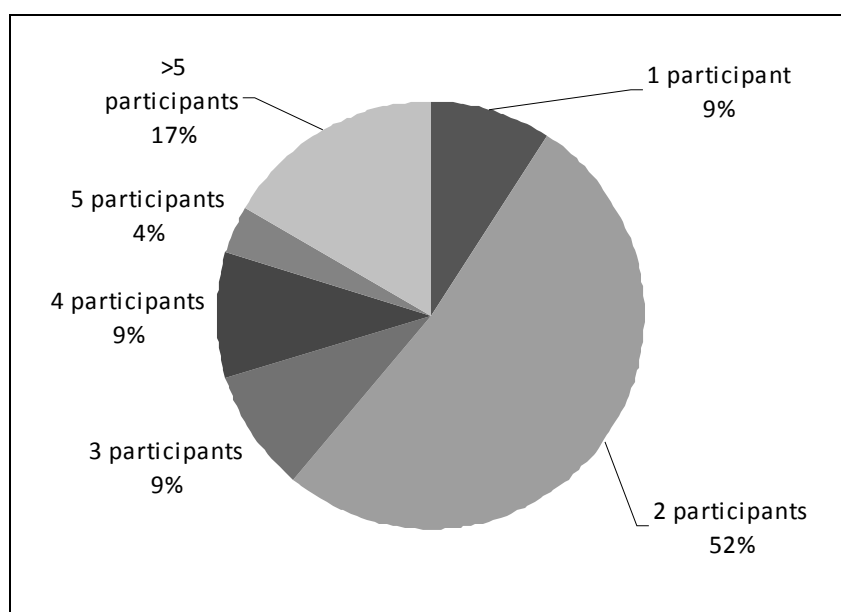


Fig. 6. Identified cases of competition limiting concerted practices – by number of offenders

Federal Anti-Monopoly Service (FAS) is usually initiator of investigation of concerted practices. Concerted practices are most often identified as the result of prices monitoring in case of changes in economic environment or during checks initiated by media publications.

Table 27

Congruence between types of concerted practices and investigations initiators

Investigation initiated by	Investigation initiated by			
	Competitors	Power bodies	Consumers	FAS
Type of violations				
Coordination of economic activities			8	10
Impeding entry to and exit from the market	1			
Division of the market			2	3
Collusion at auction		2	2	
Price collusion		1	4	17
Exclusivity contract			1	5
Total	1	3	17	35

Based on the analysis of completion limiting concerted practices regulation the conclusion can be made that anti-monopoly agencies are especially effective in identifying the following types of concerted actions:

- in regional raw materials markets;
- committed by two market participants;
- expressed in establishing or maintaining the same level of prices;
- identified as the result of monitoring.

The violations profile in 2008–2010 indicates that starting from 2009 the number of violations identified in the national market increased significantly (from 1 case up to 6 cases).

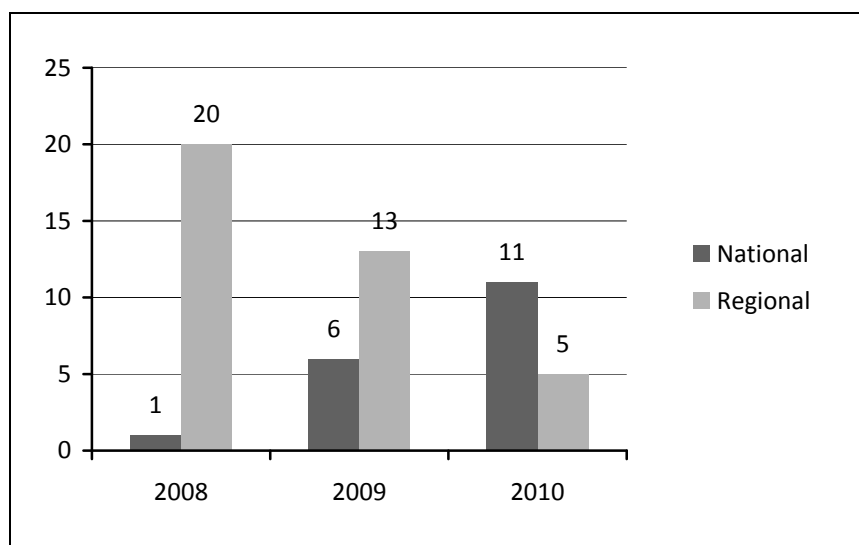


Fig. 7. Concerted practices in the national and regional markets in 2008–2010

Actions by the companies simultaneously raising prices may be qualified as abuse of their dominating position in the market in the form of setting monopolistically high prices. The fact of collective domination must be identified in order to qualify a type of concerted practices violation. Also, pricing mechanisms need to be analyzed in order to prove that the established price exceeds the aggregate amount of costs and revenues required for manufacturing and selling this particular type of goods.

Identification of the market shares of each participant of an anti-competition cartel is not required in order to call them liable. However, the fact of their dominating position in the market needs to be identified in all cases of qualifying collusions at the national market. Thus, FAS issued a resolution determining the fact of OJSC Silvinit and OJSC Uralkaliy setting the monopolistically high price for potassium chloride in the Russian Federation in 2008. For that FAS had to prove the fact of collective domination of these two companies in the national Russian market. OJSC Bassol and LLC Promsol are the only manufacturers of sodium salt in the territory of Russia. FAS resolution on OJSC Electroapparat reads that automatic circuit breakers are innovative proprietary technology of the manufacturer, respectively, the company is a monopolist in the market.

A situation may be possible when concerted practices in the form of supporting prices at certain level are qualified as setting the monopolistically high price. For example, in 2010 FAS issued a resolution of setting monopolistically high prices by OJSC VympelKom, OJSC Megafon, and OJSC MTS in the roaming services market.

According to the effective legislation domination may be determined with regards to one company with a market share exceeding 35% and no more than 3 companies with their total market share collectively making 50%. The Federal State Statistics Service (Rosstat) takes into account economic concentration ratio for material production yields within the Russian Federation borders. With the assumption of the commercial market border being limited with the code of Russian Classification of Production for a certain type of goods, and the geographical borders – by the administrative border of the Russian Federation, the comparison can be made between the shares of the biggest company and three biggest companies.

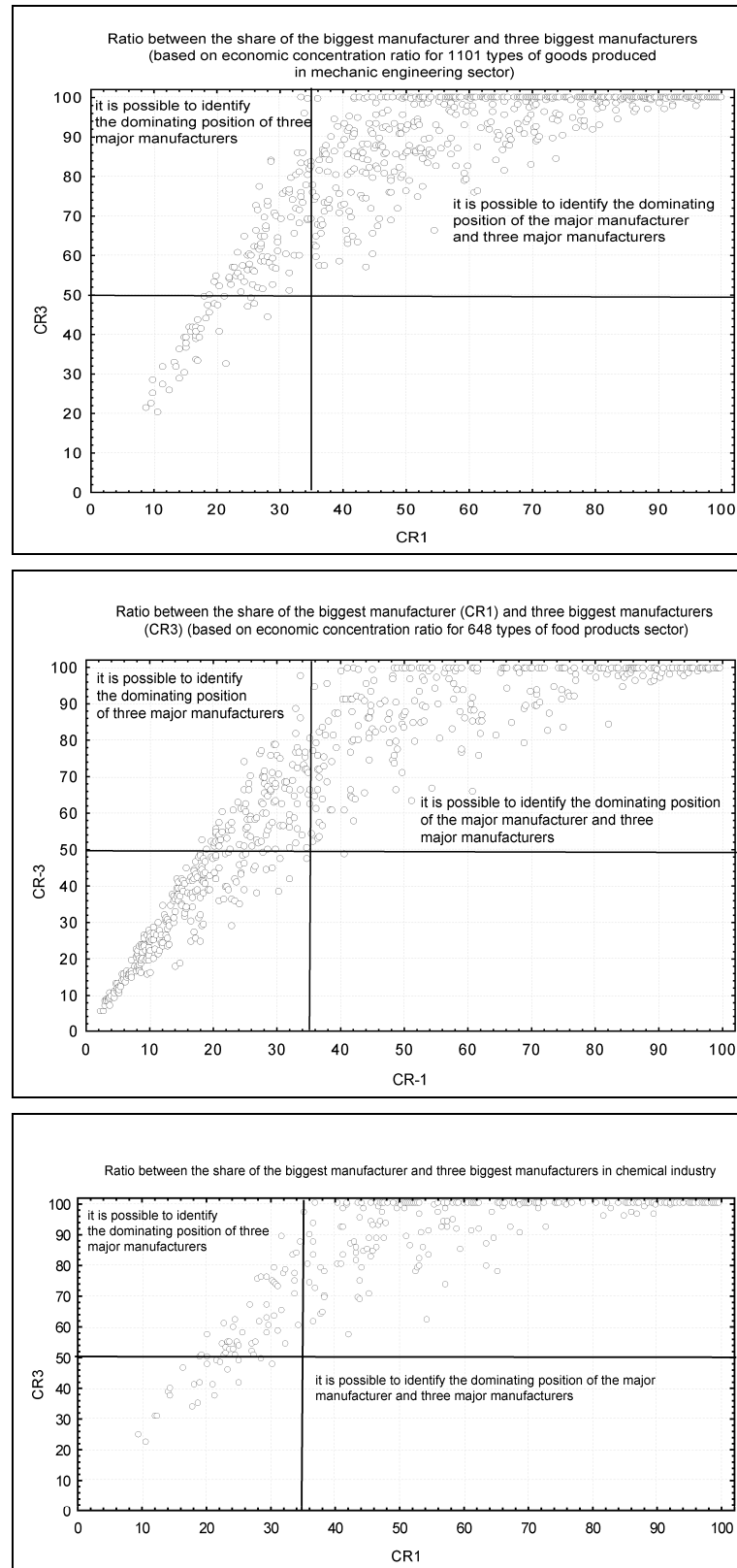


Fig. 8. Ration between the share of the biggest manufacturer and the collective (aggregate) share of three major manufacturers in various sectors

According to Article 5 of the Law on Competition Protection, the company may be recognized as dominating in the market if its market share exceeds 35%, and three companies – if their collective market share exceeds 50%.

As we can see on *Fig. 8*, there are practically no situations when identification of the dominating position is possible for one biggest market player and impossible for three major market players. At the same time, as it is shown for the example of economic concentration of mechanical engineering, chemical and food producers, the dominating position may be identified both for the biggest manufacturer and for three biggest manufacturers of significant number of types of goods in the mentioned sectors.

The key specific feature of identifying a price collusion associated with setting monopolistically high prices in the scenario of collective dominating position is the possibility to prevent the violation before simultaneous increase of prices. The example of such type of price collusion is 2009 Resolution with regards to concerted practices of OJSC Silvinit and OJSC Uralkaliy at the national potassium chloride market – the key feedstock for producing potassium fertilizers and some other products of chemical petroleum sector.

The Resolution about setting the monopolistically high price for potassium chloride with regards to these two companies was issued in 2008.

In 2009 the actions of these two companies on simultaneous increase of prices were qualified as concerted practices limiting the competition. In particular, Moscow City Arbitration Court Ruling says that OJSC Silvinit and OJSC Uralkaliy are profit-generating for both sides, because Q2 2009 20% increase of price for potassium chloride from RUR 3,955 up to RUR 4,750 per ton is in the interests of both market players. Such actions are beneficial for them because such increase of price would lead to increase in their revenues from selling potassium chloride.

The fact of such actions being discussed at meetings at the RF Ministry of Industries and Trade where the representatives of the said compound fertilizers plants were present was regarded as evidence of price increase being known to all the participants in advance.

The fact of the price increase not being justified by calculations based on the production costs analysis and not being caused by economic factors was regarded as evidence of no external factors impact on the price level. Macroeconomic indicators were analyzed with this purpose – such as the customs duties amounts, regulated tariffs, and Rosstat data on producers' price index by types of economic activities in the Russian Federation in 2009.

The most significant factor was that the market participants used different approaches to identifying the price collusion. Thus, actions by OJSC Uralkaliy were in the form of executing supplementary agreement to the supply contract listing the new price, which they had sent to their customers. Actions of the second collusion participant were done by sending a price increase proposal to the customers on behalf of an intermediary company. Thus, in 2009 OJSC Silvinit handed over all the potassium chloride volumes for domestic consumers to LLC Mineral Trading, at the same time the agreement between these two companies did not include and provisions for pricing. However, such actions on behalf of the manufacturer do not release from the liability for pricing when re-selling the product.

So in certain cases when pricing procedures violations were revealed in monopolistic and oligopolistic markets (i.e. markets with infrastructure deficiencies) price collusion cumulative

evidence qualification may be more efficient regulating mechanism versus identifying the facts of setting monopolistically high prices in the environment of collective domination.

About 14% of all concerted practices pertain to coordination of activities in financial markets. In order to reduce dissemination of such violations the RF Government Resolution No.386 “On Permissible Agreements between Credit Institutions and Insurance Companies” was enacted on April 30, 2009. This Resolution contained a list of non-permissible agreements between the financial market players and contributed to a significant reduction of agreements between the financial market players in 2009 versus 2008.

Practically all the violations in 2010 were connected with agreements in the mortgage loans markets. For example, FAS Territorial Division for Komi Republic determined that OJSC AKB ROSBANK and Open Joint-Stock Insurance Company RESO-Guarantiya had entered into an impermissible agreement in the property insurance market for mortgage loans. According to this agreement, the Bank clients were advised in addition to the statutory insurance of the real property subject to acquisition (see Law “On Mortgage (Real Estate Pledge)” was advised to purchase a policy for voluntary life and work capacity insurance. At the same time clients having purchased additional insurance services were offered discounted property insurance tariff.

In 2010 the following changes were introduced into the RF Government Resolution No.386 to reduce the number of anti-monopoly laws violations. These changes also cover mortgage lending markets.

– on December 3 2010 the RF Government enacted Resolution No. 968 “On Amending General Exceptions with Regards to Agreements between Credit Institutions and Insurance Companies” according to which it is allowed to require insurance for the period of mortgage in case it is possible to pay the premium in installments with payments not more frequently than once per year.

Overall the most valuable area of improvement in the concerted practices regulation is amending the effective legislation allowing control/regulate certain markets.

6.5. The Russian Housing Market in 2010: Stagnation and Beginning of the Recovery

Last year, most indices of the country’s social and economic development (the GDP, industrial production and investments in fixed capital) showed positive dynamics. The above factor could not but have an effect on the dynamics of the households’ cash income. According to the preliminary data, in 2010 the households’ real disposable income grew by 4.3% against 2.1% in 2009.

An increase in growth rates of households’ income in a situation where the main macro-economic and financial indices remain stable has contributed to realization of the accumulated earlier delayed solvent demand which had a positive impact on the dynamics of the housing market.

6.5.1. Price Situation on the Secondary Housing Market¹

It is worth remembering the way the dynamics of the prices on the Russian housing market was formed during the crisis. From the end of 2008, the housing prices in rubles and their USD equivalent started to decline. The most critical phase of falling prices lasted till May 2009; after that the RUR prices kept declining but at a slower rate, while by the end of that year they virtually stabilized in most cities. Due to a drop in RUR prices and RUR depreciation, the USD price equivalent decreased a great deal more by May, but then it virtually stabilized as a result of both slowdown of rates of a drop in RUR prices and a somewhat appreciation of the RUR exchange rate which took place simultaneously with insignificant fluctuations within the limits of the band set by the Central Bank of Russia. In general, in 2009 a drop in housing prices was observed nationwide.

In 2010, there was a smooth growth in housing prices in Moscow, while fluctuating stability was typical of most cities of the sample. (*Table. 28*).

Moscow became an undisputable leader as regards the price growth in nominal terms (10%). Also, it is worth mentioning a price increase of over 5% in a group of cities of Siberia and the Urals (Novosibirsk (9.2%), Krasnoyarsk (7.9%), Ufa (7.1%), Omsk (6.2%) and Tyumen (5.3%)), as well as Tver (7.4%). A drop in prices was registered only in Nizhny Novgorod, Stavropol, Ryazan and Shakhty (the Rostov Region), however, it amounted to less than 3%.

In analyzing the price dynamics within the longer period (as compared to December 2007) which included the pre-crisis period, the critical phase of the crisis and the beginning of exit from the crisis, it can be stated that in December 2010 in most cities of the sample nominal prices on the secondary housing market were lower than those which prevailed three years ago. At the same time, as compared to December 2007 in Moscow that index was exceeded by over 26%, while in Shakhty, by 19%; the Moscow Region, by 17.5%; St. Petersburg, by 5.8% and Ulyanovsk, by 3.9%. In Tver, the value of the index in December 2007 was almost the same as that in 2010. The largest drop in prices was registered with the group of cities of Siberia and the Urals: in Izhevsk prices fell by 24%; in Perm, by 21% and in Omsk and Krasnoyarsk, by nearly 20%.

¹ All the calculations have been carried out on the basis of such a monthly data on the average unit weight of the supply price on housing in Russian cities as was provided by RGR certified real-estate analysts S. G. Sternik (OOO «Sternik's Consulting»), A. G. Beketov (All – Moscow and the Moscow Region), S.V. Bobashev, M.A. Bent, GK «The Bulletin of Real Estate» (St. Petersburg), M. A. Khorkov, A. A. Antasyk, G.T. Turashvili (All – RiTz UPN, Yekaterinburg), A. M. Cheremnykh, UK «ASSCO-Stroi» (Izhevsk), A.A. Stepanova SAN «Expert» (Ufa), N. N. Afanansieva, «Adalin-Expertiza Sobstvennosti» (Yaroslavl), S.A. Stasyukevich, «ABI Group» (Vladimit), I. A. Yermolaeva, K.A. Salmina, RID Analytics (Novosibirsk, Kemerovo, Baranaul and Krasnoyarsk), V. M. Troshina, «Information and Analytical Center «BrOK» (Tyumen), A.M. Chumakov, «Titul», G. V. Pivovarova, «Don-NT» (All – Rostov-on-Don), E. D. Epishina, Yu. V. Epishina, GK «Kamskaya Dolina» (All – Perm), V.N. Kaminsky, TITAN (Tver), G.N. Zyryanova, «KuzbassInvestStroi» (Kemerovo), D.A. Stukalov, N. I. Kovalchuk, RK «Sluzhba Nedvizhimosti» (Real Estate Service) (Chelyabinsk), M. A. Repin, «OMEKS» (Omsk), M. Yu. Savina, «Agentstvo Pechati i Informatsii» (Information and Press Agency) (Ryazan), N. A. Yarsina, «Center of Real Estate» (Ulyanovsk), A. V. Trushnikov, «B.I.N.-Expert» (Sterlitamak), A. S. Trofimov, Ilekta Center (Stavropol), G. Yu. Eidlina, «Realty» (Shakhty).

Table 28

**Dynamics of the average unit price of the supply of apartments
on the secondary housing market in the 2007–2010 period**

City (Region)	Thousand RUR/ sq. meters				Index			
	December 2007	December 2008	December 2009	December 2010	December 2008 / December 2007	December 2009/ December 2008	December 2010 / December 2009	December 2010/ December 2007
Moscow	133.38	186.8	153.0	168.5	1.401	0.819	1.10	1.263
St. Petersburg	77.76	101.3	81.1	82.3	1.303	0.801	1.015	1.058
Moscow Region	62.13	91.0	71.5	73.0	1.465	0.786	1.021	1.175
Yekaterinburg	64.1	62.2	53.0	55.5	0.970	0.852	1.047	0.866
Novosibirsk	59.0	59.4	45.5	49.7	1.007	0.766	1.092	0.842
Perm	55.8	58.2	42.4	44.1	1.043	0.729	1.040	0.790
Krasnoyarsk	54.3	57.0	40.3	43.5	1.050	0.707	1.079	0.801
Tyumen	53.7	52.5	43.1	45.4	0.978	0.821	1.053	0.845
Rostov-on-Don	52.0	56.4	48.4	50.5	1.085	0.858	1.043	0.971
Nizhny Novgorod	49.0	59.85	46.37	45.8	1.221	0.775	0.988	0.935
Tver	49.4	62.6	46.1	49.5	1.267	0.736	1.074	1.002
Yaroslavl	46.9	51.6	41.1	42.8	1.100	0.797	1.041	0.913
Kemerovo	45.8	53.0	40.3	40.6	1.157	0.760	1.007	0.886
Izhevsk	45.4	41.7	33.3	34.5	0.919	0.799	1.036	0.760
Chelyabinsk	...	50.5	36.8	37.2	...	0.729	1.011	...
Ufa	45.2	50.2	41.0	43.9	1.111	0.817	1.071	0.971
Vladimir	...	...	36.7	37.5	...	...	1.022	...
Omsk	44.2	40.0	33.4	35.47	0.905	0.835	1.062	0.802
Barnaul	...	39.8	34.4	35.1	...	0.864	1.02	...
Ryazan	36.8	37.4	35.4	34.4	1.016	0.947	0.972	0.935
Stavropol	...	...	33.1	32.4	...	...	0.979	...
Ulyanovsk	30.6	29.9	31.0	31.8	0.977	1.037	1.026	1.039
Sterlitamak (Bashkortostan)	26.3	28.1	22.9	23.7	1.068	0.815	1.035	0.901
Shakhty (Rostov Region)	22.1	31.1	27.0	26.3	1.407	0.868	0.974	1.190

Moscow is still an undisputable leader as regards the level of housing prices. In relation to Moscow, in December 2010 the three main groups could be singled out among the rest of the cities of the sample:

– cities where prices were in the range of from 1/4 to 1/3 of the level of Moscow prices (Yekaterinburg, Rostov-on-Don, Novosibirsk, Tver, Nizhny Novgorod, Tyumen, Perm, Ufa, Krasnoyarsk and Yaroslavl);

– cities where prices were in the range of from 1/5 to 1/4 of the level of Moscow prices (Kemerovo, Vladimir, Chelyabinsk, Omsk, Barnaul, Izhevsk and Ryazan);

– cities where prices amount to less than 1/5 of the level of the Moscow prices (Stavropol, Ulyanovsk, Shakhty and Sterlitamak).

A special place is occupied by St. Petersburg and the Moscow Region where the level of prices as compared to Moscow prices amounted to 0.49 and 0.43, respectively (*Fig. 9*).

Speaking about the dynamics of real housing prices (without the effect of the inflation rate), it is to be reminded that in 2010, as well as in 2009 consumer prices rose by 8.8%. As regards the cities of the sample, the value of the index of real (free of inflation) housing prices (the IGS index)¹ in 2008, 2008, 2010 and the 2008–2010 period as compared to that of December 2007 are shown in *Table 29*.

¹ Calculation of the IGS index is done according to the following formula: $IGS = I_{hp}/I_{cp}$, where I_{hp} is the index of housing prices in rubles, while I_{cp} is the index of consumer prices.

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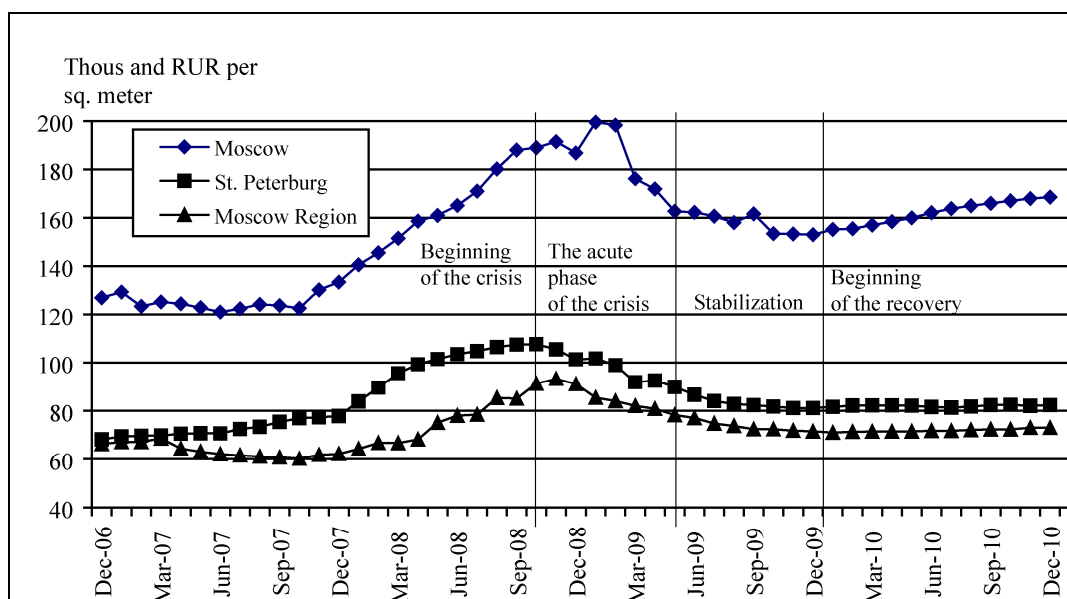


Fig. 9. Dynamics of the average unit price of the supply of housing in metropolitan regions

Table 29

Indices of nominal and real housing prices in the 2007–2010 period

City (Region)	Index of nominal prices				IGS index			
	December 2008 /	December 2009 /	December 2010 /	December 2010/	December 2008 /	December 2009 /	December 2010 /	December 2010 /
	December 2007	December 2008	December 2009	December 2007	December 2007	December 2008	December 2009	December 2007
Moscow	1.401	0.819	1.10	1.263	1.237	0.753	1.01	0.942
St. Petersburg	1.303	0.801	1.015	1.058	1.150	0.736	0.933	0.788
Moscow Region	1.465	0.786	1.021	1.175	1.293	0.722	0.938	0.876
Yekaterinburg	0.970	0.852	1.047	0.866	0.856	0.783	0.962	0.646
Novosibirsk	1.007	0.766	1.092	0.842	0.889	0.704	1.004	0.628
Perm	1.043	0.729	1.040	0.790	0.921	0.670	0.956	0.589
Krasnoyarsk	1.050	0.707	1.079	0.801	0.927	0.650	0.992	0.597
Tyumen	0.978	0.821	1.053	0.845	0.863	0.755	0.968	0.630
Rostov-on-Don	1.085	0.858	1.043	0.971	0.958	0.789	0.959	0.724
Nizhny Novgorod	1.221	0.775	0.988	0.935	1.078	0.712	0.908	0.697
Tver	1.267	0.736	1.074	1.002	1.118	0.676	0.987	0.747
Yaroslavl	1.100	0.797	1.041	0.913	0.971	0.733	0.957	0.681
Kemerovo	1.157	0.760	1.007	0.886	1.021	0.699	0.926	0.661
Izhevsk	0.919	0.799	1.036	0.760	0.811	0.734	0.952	0.567
Chelyabinsk	...	0.729	1.011	...	...	0.670	0.929	...
Ufa	1.111	0.817	1.071	0.971	0.981	0.751	0.984	0.724
Vladimir	...	...	1.022	...	...	...	0.939	...
Omsk	0.905	0.835	1.062	0.802	0.799	0.767	0.976	0.598
Barnaul	...	0.864	1.02	...	...	0.794	0.938	...
Ryazan	1.016	0.947	0.972	0.935	0.897	0.870	0.893	0.697
Stavropol	...	...	0.979	...	...	...	0.9	...
Ulyanovsk	0.977	1.037	1.026	1.039	0.862	0.953	0.943	0.775
Sterlitamak	1.068	0.815	1.035	0.901	0.943	0.749	0.951	0.672
(Bashkortostan)								
Shakhty (Rostov Region)	1.407	0.868	0.974	1.190	1.242	0.798	0.895	0.887

As can be seen from the above data, an insignificant growth in housing prices (around 1%) in real terms took place only in Moscow and Novosibirsk, while in all other cities housing

prices fell to a different extent. The minimum reduction in the IGS index was registered in Krasnoyarsk and Tver, while the maximum one, in Ryazan, Shakhty and Stavropol where real housing prices fell by 10% and more. In Nizhny Novgorod, a similar drop of around 9% was registered.

Also, in all the cities of the sample without an exception, a drop in real housing prices (free of inflation) was registered in the period of the past three years, that is, in the 2008–2010 period. In most cities, such a drop amounted to 20%–40%. The group of metropolitan regions was affected to a lesser extent. In Moscow, the value of the IGS index points to a drop of the mere 6% in real housing prices, while in the Moscow Region, to that of 12.5%. In Shakhty, such a drop amounted to 11.3%. On the contrary, the situation was quite different with the above group of cities of Siberia and the Urals (Omsk, Krasnoyarsk, Perm and Izhevsk) where prices on housing with the inflation rate in the consumer market taken into account fell by 40% and more.

6.5.2. Activities in the residential housing market

Activities in residential housing market started to return back to normal as early as late in 2009, while in 2010 they virtually reached the pre-crisis level. Due to return to the market of both the delayed demand and the delayed supply (investment apartments, banks' collaterals and other), the volume of the supply has largely grown to ensure a deficit-free situation in the housing market.

According to the Rosregister' data, in 2009 the number of purchase and sale transactions with apartments in Moscow amounted to 55,680 which figure was the market's historic minimum in the entire contemporary period. In 2010, the volume of transactions grew by 54% to amount to 85,650, that is, to the 2003 level where the historic maximum was registered (87.500) (*Fig. 10*).

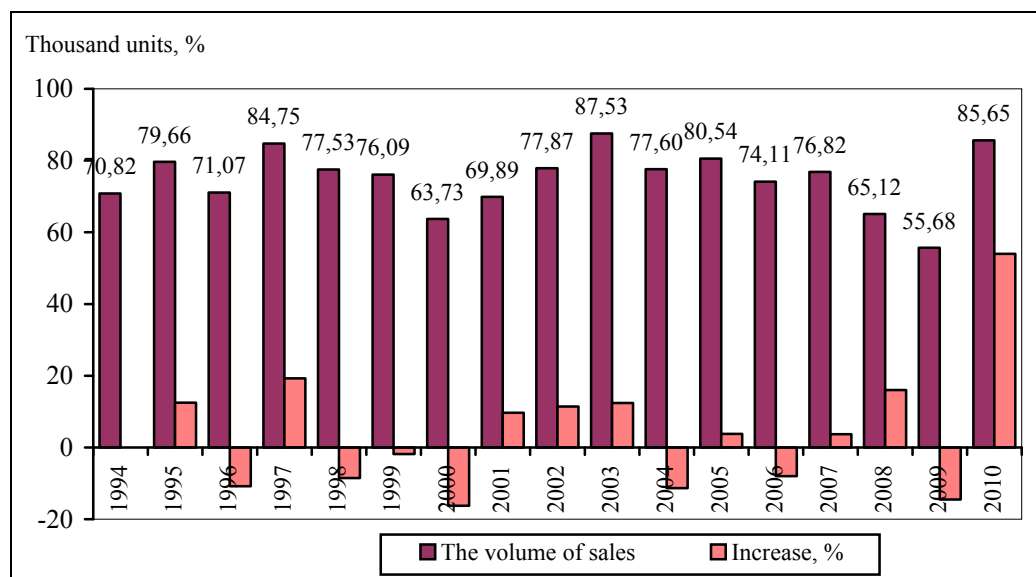


Fig. 10. The annual volume of apartment sales on the Moscow secondary market

The number of mortgage transactions increased from 5,130 in 2009 to 19,800 in 2010 (that is by 286%), while their share in the total number of transactions grew from 9.6% to 23% (*Fig. 11*).

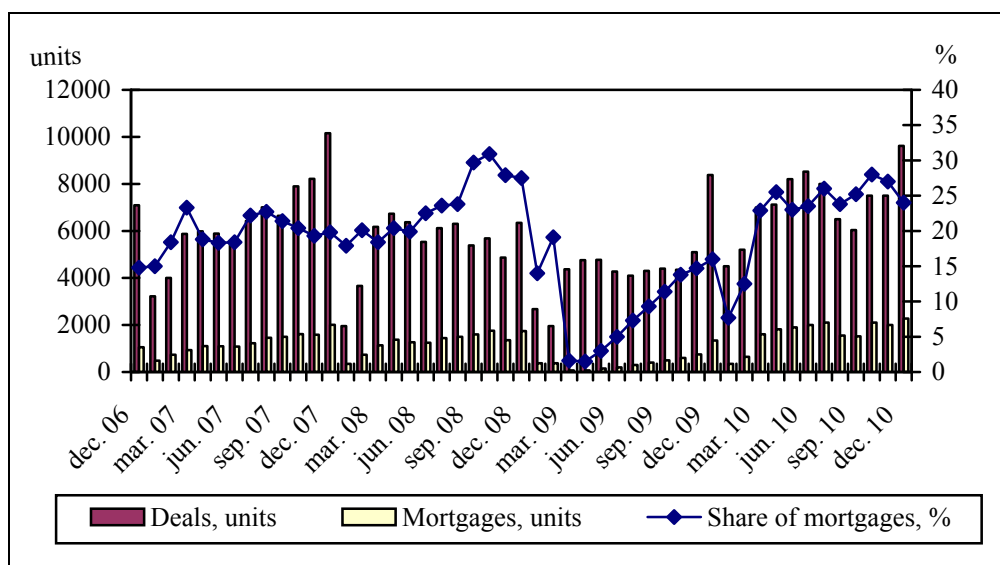


Fig. 11. Turnover dynamics of the housing and mortgages market in Moscow

In Russia, in general, the mortgage lending market grew by 150% to amount to RUR 378.9 billion in 2010. The level of interest rates on RUR mortgage loans extended within a month in December 2010 as compared to October 2010 decreased dramatically from 13.2% to 12.5%. The above value was lower than that in the pre-crisis period of January-October 2008 where the average weighted interest rate on RUR mortgage loans amounted to 12.7% (according to the data of the Agency for Mortgage Housing Lending (OAO AMHL). The total debt of mortgage lending amounted to the record-high level of RUR 1.1 trillion and exceeded the pre-crisis level which factor is evidence of a mortgage boom. In July 2010, AMHL offered its borrowers three new credit products: schemes with a variable interest rate (the budget of RUR 10.5 billion), utilization of the maternal capital (the budget of RUR 6.3 billion) and provision of loans for low-rise housing development¹.

Establishment during the crisis in February 2009 of the Agency for Restructuring of Mortgage Housing Loans (OAO ARMHL), a subsidiary of AMHL may have an important effect on further development of mortgage business.

The above Agency renders support to those borrowers for whom the mortgage housing is the only one they have got and if such housing is not an elite one, either. Also, if the bank makes unacceptable demands to the borrower as regards conditions of restructuring of the loan the latter may apply to ARMHL.

During the economic crisis, the number of mortgage loans in Russia amounted to 1,200,000. According to ARMHL estimates, 9% to 11% of borrowers, that is, about 90,000 persons had problems with meeting their mortgage liabilities. It is noteworthy that in some regions concentration of such borrowers was much higher than the national average. The danger of a crisis situation for the future mortgage lending was made worse by the aggressive policy pursued by creditor-banks.

About one-third of problem borrowers succeeded in solving their problems all alone having received financial support from their friends and relatives, while loans to about 40,000 to 45,000 persons were restructured by banks or with assistance of ARMHL. As regards another

¹ RWAY, Information and Analytical Bulletin, No. 186 (September 2010), p. 60-61.

20,000 persons who failed or were late to take advantage of restructuring programs, the prospects of staying on in mortgage housing is being determined in court.

According to the General Director of ARMHL, the experience related to restructuring of mortgage loans during the crisis showed both high efficiency of mechanisms of pre-trial opinion as regards restructuring of mortgage loans and a lack of willingness by banks to do such work, as well as borrowers' low level of financial literacy. Also, a weak self-regulation of that market revealed itself in a shortage of instruments which could help credit institutions fix their relations with borrowers.

At the same time, the success of ARMHL activities points to the fact that the absolute majority of borrowers who received timely support has resumed to meet their liabilities: 84% of people who were rendered support by the Agency now meet successfully their liabilities. A major factor behind that result was a decrease in the interest rate on newly provided loans by ARMHL to two-thirds of the rate of refinancing of the Central Bank of Russia (earlier the interest rate on loans was equal to that on the main mortgage liability). Such a measure was aimed at easing of the effect related to increase in borrowers' financial burden after the period of support had d up¹.

As the mortgage deals in most cases with the primary market housing of economy-class, the above mechanism is expected to contribute a great deal to recovery of the housing development.

6.5.3. Dynamics of Commissioned Housing Volumes

In 2010, the volumes of commissioning of new housing kept falling though the rates of that process slowed down (3% against 6.7% in 2009). In 2010, the overall number of commissioned housing amounted to 714,100 apartments with the total floorspace of 58.1 million square meters. (*Table. 30*).

Table 30

Commissioning of apartment in Russia in the 1999–2010 period

Year	Million sq. m of floorspace	Growth rates. %	
		To the previous year	to 2000
1999	32.0	104.2	105.6
2000	30.3	94.7	100.0
2001	31.7	104.6	104.6
2002	33.8	106.6	111.5
2003	36.4	107.7	120.1
2004	41.0	112.6	135.3
2005	43.6	106.3	143.9
2006	50.6	116.0	165.7
2007	61.0	120.6	201.3
2008	64.1	104.6	210.6
2009	59.9	93.3	197.4
2010	58.1	97.0	191.7

The source: The Russian Statistics Yearbook. 2007: Statistics Collected Papers./ Rosstat. M.. 2007. p. 507; The Social and Economic Situation in Russia. 2009. M..Rosstat. pp. 86–87. The Social and Economic Situation in Russia. 2010. M.. Rosstat. pp. 86–87. calculations of authors.

Thus, in 2010 the volume of commissioning of new housing kept falling as a result of the investment collapse of the previous years. It is to be noted that as compared to indices of the year 2008 (which indices were the best ones in the 2000s) the drop amounted to less than

¹ Mortgage Lending: Between the Russian Roulette and the Engine of Development. www.opec.ru, March 2, 2011.

10%. The 2010 results turned out to be worse than those of 2007, but notably better than all those of the previous years when implementation of the priority national housing project was in full swing.

The principal difference of the 2010 results was an apparent collapse of the individual housing development. If in 2009 individual housing development smoothed such consequences of the financial and economic crisis as had the most adverse effect on developers' activities by showing a positive dynamic (in 2009 an increase in the volume of commissioning of housing which was built by households at their own expense or with use of borrowed funds amounted to 4.3%) in 2010 individual developers built 11.2% of housing less. It is to be noted that in Russia, in general, the share of individual housing development in the total floorspace of housing built amounted to 43.6% against 47.7% in 2009.

Twenty regions with volumes of commissioning of at least 1 million sq. m accounted for nearly two-thirds of housing commissioned last year. Shown below (*Table 31*) is the group of those regions with differentiation by the rates of growth and decrease in commissioning of housing.

Table 31

Commissioning of housing in Russian regions in 2010 (by the rates of commissioning)

Regions with growth in volumes of housing commissioned	Increase to the same period last year, %	Regions with a decrease in volumes of housing commissioned	Increase to the same period last year, %
Voronezh Region	+18.1	Moscow	-34.5
Novosibirsk Region	+12.2	Chelyabinsk Region	-25.7
Sverdlovsk Region	+10.7	Bashkortostan	-14.7
Krasnodar Territory	+4.2	Tyumen Region	-10.8
Dagestan	+3.7	Moscow region	-8.5
Nizhny Novgorod region	+3.4	Kemerovo Region	-5.7
Stavropol Territory	+2.1		
St. Petersburg	+2.0		
Samara Region	+1.6		
Saratov Region	+1.1		
Leningrad Region	+1.1		
Tatarstan	+0.8		
Belgorod Region	+0.3		
Rostov region	+0.2		

The source: The social and economic situation in Russia. 2010. M. Rossstat. pp. 394–395.

Such growth in volumes of commissioned housing as was registered in most regions stated above can be regarded as a positive factor. The leaders in that respect were the Voronezh Region (18.1%), the Novosibirsk Region (12.2%) and the Sverdlov Region (10.7%), while in other regions including St. Petersburg (where in 2010 a small increase of 2% replaced a dramatic drop of the previous year) the growth did not exceed 5%.

The metropolitan region stands out among regions (with volumes of housing development of at least 1 million square meters) where a drop in volumes of commissioned housing was registered in 2010. In Moscow, that situation has prevailed for three years running with the extent of the drop increasing by 100% and being comparable to that of 2008 (nearly 1/3). In the Moscow Region, a positive dynamic of housing development in 2009 gave way to a drop of 8.5%. The unit weight of the metropolitan region in the aggregate volume of the nationwide housing development amounted to the mere 16.4% of which the Moscow Region accounted for a larger portion (13.3%), while the share of Moscow proper slightly exceeds 3%.

So, as it could be expected such growth in commissioned housing to 3–3.1 million square meters in 2010 (with allocation of 800,000 square meters for implementation of the municipal

housing program) as was expected by the Moscow authorities failed to take place¹ though the volume of housing development (with apartment houses built under the program of the government of Moscow beyond the city borders) amounted to 3,658,500 sq. m or 87.0% to the 2009 figure. However, Moscow proper accounted for less than 50% of that volume (48.4%), while in the previous years the share of housing built beyond its borders was much smaller (approximately 10%–11% in the 2005–2007 period, over 20% in 2008 and over 1/3 in 2009).

Considering the above, it is highly unlikely that the volume of housing development in Moscow will reach the pre-crisis level (about 5 million sq. m) in the 2011–2012 period with relevant consequences for the housing market. The new Moscow authorities have already encountered difficulties in providing housing to households on the waiting list due to a failure by some investors to comply with the terms of their contracts. Also, it seems the priority of the Moscow authorities will be development of transport infrastructure and road building. As regards housing, one may expect reduction in the period of execution of relevant documents and shorter deadlines for securing of approvals at different stages of building.

6.5.4. The Current Situation and the Prospect of Development of Institutional Structure of Housing Development

In the period of over two years since the beginning of the crisis, no such target administrative changes in the money-and-credit system and the banking sector as would be aimed at upgrading of organizational and economic mechanisms (administrative, economic and fiscal) of market regulation of growth in building industry took place. Nor was growth in the volume of the supply on the primary market motivated by means of development of market diversified instruments of project finance of urban planning activities (competitive repayment banking financing, budgetary financing and mortgage monetary financing with use of government guarantees).

As a result of the crises, the new configuration of the structure of the building market is just taking shape.

On the one hand, larger players of the federal level which included mostly Moscow-based operators affiliated with different business-groups and conglomerates kept taking over companies which were local developers at the regional or city level. Such process was encouraged to some extent by state support those players received during the acute stage of the crisis. In particular, the list of economic entities (which was made public by the Ministry of Economic Development of the Russian Federation in spring 2010) which received state support included well-known private business-groups specializing in building and development (SU-155, PIK Group of Companies and Inteko), as well as production of building materials (Glavstroj)². Unfortunately, the data is unavailable as regards the volumes and types of state support those economic entities received which factor actually brings to nought the importance of that information. Also, a question arises to what extent the above information was complete considering involvement of authorities of different levels³. As a result, large players are in position to influence pricing on the property market.

¹ RWAY, Information and Analytical Bulletin, No. 186 (September 2010), pp. 55, 62.

² www.economy.gov.ru, April 12, 2010.

³ During the crisis, in the Moscow Region to complete building of social housing the Bank of Moscow paid RUR 15 billion against guarantees of the Moscow government to ZAO GK SU-155 which apart from that also received RUR 9 billion worth of guarantees of the federal authorities.

On the other hand, due to a complicated financial situation and a large accrued debt¹ building and development companies depend to a great extent on creditors (mostly banks with state participation) which in many cases along with provision of financing take hold of assets which earlier belonged to the above companies through restructuring of their debts.

Late in 2009, VTB received the controlling interest in Sistema-Gals (51.24%) with approval by the Board of Directors of AFK Sistema of the sale of its interest of 27.6% in Sistema-Gals. In autumn 2009, in the course of restructuring of loans for the amount of USD 500 million the bank gained the controlling interest in ZAO GK Don-Stroi whose total debt to VTB amounted, by estimate, to RUR 80 billion. With taking into account the land plots in the Moscow Region which were received by VTB as redemption of the debt of the Unified Industrial Corporation and its own development projects which the bank started earlier, VTB has a good prospect of establishing a powerful unified holding in that area.

A portion of GK Don-Stroi's assets passed to Sberbank, its another creditor (GK Don-Stroi's debt to Sberbank amounted to RUR 20 billion). Since the beginning of the crisis, Sberbank received the total of nearly 2 million sq. m of the already built property as well as that which was under construction from a number of companies, including Capital Group, Keystone Company and Coalco. The Miel Holding is prepared to assign to Sberbank about 20% of its land plots in the Moscow Region as repayment of its debt.

GP PIK may serve as an example of intensive changes in the capital structure.

In April 2009, the controlling interest in the above company was received on a non-cash basis by Nafta Moskva in return for a promise to provide assistance in restructuring of the debt in the amount of RUR 49 billion. The main creditor of GK PIK is Sberbank (RUR 15.84 billion) whose subsidiary Sberbank Capital was granted a mandate to restructuring of PIK's loans. It is not excluded that Sberbank may extend a loan to a buyer of the interest owned by Nafta Moskva, which interest is estimated by the latter at USD 1 billion.

In summer 2010, GK PIK made a decision to issue additional equities in the amount of 20% of the increased capital with VTB Capital selected as the manager of placing. It is to be noted that OOO PIK-Development which is affiliated with the above group was found bankrupt, while the Moscow government prepared a few lawsuits to ZAO PIK-Region for the total amount of RUR 1 billion due to violation by the above company of agreements on building of social housing in the Moscow Region as regards both execution of the title to apartments and failure to build relevant volumes of housing. Taking over by VTB of the Bank of Moscow and possible change of the owner of Inteko's assets (which company repaid the principal debt in 2009) will have a certain effect on establishment of the new structure of development and housing building.²

In June 2010, new amendments to Law No. FZ-214 on Participation in Building of Apartment Houses and Other Real Property Projects By Way of Shared Funding and Amendment of Some Statutory Acts of the Russian Federation were approved. Under the above amendments, all the doubtful schemes of raising of households' funds, except for agreements on shared participation, bonds and housing associations have been banned. Also, developers are exempted from payment of VAT at conclusion of the agreement on participation in building by way of shared funding. By experts' estimates, the above measure contributed to growth in

¹ Late in 2009 and early in 2010, the debt of Don-Stroi was estimated to amount to USD 3 billion, while that of Su-155, Sistema_Gals, GP PIK, Glavstroi and Inteko, to USD 1.48 billion, USD 1.3 billion, USD 1.27 billion, USD 1 billion and USD 0.7 billion, respectively.

² RWAY, Information and Analytical Bulletin, No. 186 (September 2010), pp. 138-143.

the share of new housing (which is built within the frameworks of mechanisms provided for by Federal Law No. FZ-214) in Moscow from 8% to 36%.

In the 2009-2010 period, the Federal Fund for Assistance in Development of Housing Building (FFADHB) which was established in 2008 held only 24 auctions and sold 41 lots, including 10 in Moscow and 10 in the Moscow Region, 9 in Primorski Krai, 4 in the Voronezh Region, 3 in the Tyumen Region, 2 in the Novgorod Region and 2 in the Saratov Region, one in Chuvashia and one in each of the following regions: the Kirov Region, the Chelyabinsk Region, the Kursk Region, the Vologda Region and the Novosibirsk Region. Around 450 ha of land was either sold in ownership or leased¹.

As a result, in Russia, in general, no system changes for the better in the market situation as regards the supply of housing have taken place in the past two years since the beginning of the crisis which fact is confirmed by the following excerpt from the *Housing* federal purpose program that was approved in December 2010:

“Along with weak competition among developers and excessive administrative barriers as regards developers’ access to the housing development market, obtaining of land plots and securing of relevant permits to building, the main problems in the sphere of housing development still consist in a lack of developed land plots with utilities and mechanisms of attraction of private investments and borrowed funds for building and modernization of utilities, as well as prevalence non-transparent and burdensome conditions for developers as regards connection to utilities systems. In most cities, there are no reliable mechanisms of financing and implementation of projects related to provision of land plots with utilities and funds to build projects of social infrastructure which are required for comprehensive development of territories. The banking community lacks the required instruments which could permit financing (at an acceptable level of risk) of projects of development of both utilities and the social infrastructure. Such a situation results in extension of deadlines and growth in the cost of housing development. The existing practice of solving the problems related to development of utilities for housing development purposes and provision of utilities service to the already built projects is based to a greater extent on fixing of fees for connection to utilities and technological connection and fulfillment by developers of technical conditions for connection to such utilities. Such a situation results in growth in the cost of a square meter of housing”².

For the purpose of making housing more affordable, the *Housing* Program is aimed at complementing the activities of commercial developers with those by individual developers and non-profit housing associations. Formation of different schemes of public and private partnership in housing development should involve not only utilization of mechanisms of compensation of expenses related to payment of the interest on loans received from Russian credit institutions for providing land plots with utilities (a pool of projects, including pipelines and heat, gas, power and water supply projects, as well as water disposal and sewage treatment projects within the borders of a municipal entity) for housing development purposes, but also use of mechanisms which support development of the social infrastructure of residential neighborhoods in order to solve the problem comprehensively.

However, mortgage is still a priority mechanism in dealing with the housing problem which fact is confirmed by the new Strategy of Development of Mortgage Housing Lending

¹ www.fondrgs.ru.

² The *Housing* Federal Purpose Program in the 2011-2015 period. The Program was approved by Resolution No. 1050 of December 17, 2010 of the Government of the Russian Federation.

in the Russian Federation till 2030 approved by Resolution No. 1201-r of July 19, 2010 of the Government of the Russian Federation.

As regards the short-term prospect, it is worth mentioning the following aspects.

Until the end of 2011, all the war veterans and military servicemen discharged from service are to be provided with housing. Judging from the President's address to the Federal Assembly of the Russian Federation, it can be expected that the maternal capital will be permitted to be used on a regular basis for repayment of mortgage loans before the child reaches the age of three years old. Also, land plots are expected to be provided for building purposes on a free of charge basis in case of a birth of the third or subsequent child.

A switch-over to provision of land plots for economy-class housing development on the basis of so-called Dutch auctions where the winner is considered that developer which has taken an obligation to sell housing at the maximum low price may be of greater importance.

Such an approach can be found in the Concept of Reduction of the Market Cost of Housing approved by the Ministry of Regional Development in August 2010 which concept recognizes at last (after several years of implementation of the priority national housing project) inevitability of increase in the ultimate housing price for consumers due to holding of land auctions where the winner is that player who has made the highest bid and taken the subsequent burden related to preparation of urban planning documents and land tenure documents due to refusal to do that by municipal authorities.

Introduction of such a scheme which has a potential for prices on economy-class housing to be reduced by 20%-25% requires a thorough selection of buyers because it is expected that such housing is to be bought only by households who are recognized to be in need of better housing conditions or categories of people whom the state has some obligations to with some limitations on disposal of such housing introduced.

Needless to say that specific parameters of the above mechanism and its results could be determined only after the relevant law, as well as numerous amendments to the Urban Planning Code, Land Code, Housing Code, Tax Code and other statutory acts have been approved¹.

6.5.5. The Prospects of Development of the Housing Market

Switching over to evaluation of different scenarios of further development, it is worth mentioning as generalization that stabilization trends which arose (by summer 2009 after the acute phase of the crises had been over) on the secondary housing market in Russia were in line with the dynamics of macroeconomic and financial indices and determined the housing market's entry into the phase of stagnation.

In 2010, the state of depressive stabilization with rates of growth in housing prices lagging behind the inflation rate was typical of most cities' markets. An exception was Moscow and Novosibirsk where growth in prices in nominal terms (9%–10%) ensured a symbolic increase of prices in real terms.

The earlier made forecasts of the dynamics of housing prices in the 2009–2010 period proved to be true. As was expected, in 2010 prices stabilized. Unlike the 1998–1999 crisis where the pricing trend had a U-form, in the current crisis prices were expected to go up in 2011–2012 with the growth in price anticipated to be not that rapid as it was in 2000–2001 (L-form of the trend).

¹ RWAY, Information and Analytical Bulletin, No. 186 (September 2010), pp. 61, 172.

The forecast for the year 2011 and beyond was done on the basis of the pattern in which dependence of the growth rates of prices on those of the average per capita income for different types of the market was taken into account^{1,2}.

The growth rates of households' real income and the expected inflation rate have been taken both from the Mid-Term Forecast of the Social and Economic Development of the Russian Federation in the Year 2011 and the 2012–2013 period³ and relevant regional forecasts. According to the data stated therein, in the mid-term prospect in most regions, except for Perm Territory, the values of indices close to the national average ones⁴ were set⁵.

In 2011, the type of the market in Moscow and Novosibirsk was determined as a developing one, while that in St. Petersburg, the Moscow Region and Vladimir as a stable one in the first half of the year and as a developing one in the second half of that year. In Perm, with lower growth in real income and higher rates of inflation (due to which households are more reluctant to spend their savings) taken into account the type of the market was determined as a stable one.

As a result of calculations, it has been determined that in 2011 the growth in prices in nominal terms will amount to about 15% in Moscow and Novosibirsk, to 6%–10% in the Moscow Region, St. Petersburg and Vladimir and to about 2% in Perm (*Fig. 12*).

It is to be noted that the forecast for the 2011–2013 period calculated on the basis of the above pattern and shown in the Figure is a smooth one. However, the earlier made forecast of higher price volatility remains in force; due to the above factor within 4–6 months monthly growth rates of prices may fluctuate up and down by 1%–2% from the average values and even enter the zone of negative values.

In the secondary market, the volume of sales will remain at the level of pre-crisis values of the 2006–2007 period, while in the primary market it recovers to the 2007 level.

At the same time, it is to be noted that in 2011 the dynamics of macroeconomic indices which is still much dependent on the situation on the global commodities and financial markets may have a great effect on the housing market in Russia.

¹ G.M. Sternik and S.G. Sternik. Typology of Real Property Markets by the Trend to Create Pricing Bubbles - *Property Relations in the Russian Federation* Journal No.8 (95) 2009, pp. 18–28.

² G.M. Sternik Methods of Forecasting Housing Prices Depending on the Type of the Market. – *Property Relations in the Russian Federation* Journal, 2011, No.1, pp. 43–47.

³ The forecast of the social and economic development of the Russian Federation in the year 2011 and the planned 2012–2013 period. - http://www.economy.gov.ru/minec/activity/sections/macro/prognoz/doc20100923_07. Indices of the updated forecast of the social and economic development of the Russian Federation in the 2011–2013 period. - http://www.economy.gov.ru/minec/activity/sections/macro/prognoz/doc20101217_03.

⁴ As regards growth in GDP: 3.2%–4.6% (RF: 3.4%–4.2%), secondary production: 3.4%–4.2% (RF: 3.2%–4.2%), retail sales: 4.5%–6.3% (RF: 4.5%–6.3%), investments in fixed capital from all the sources of financing: 3.5%–4.1% (RF: 8.8%–8.1%), the inflation rate: 6.5%–5.0% (RF: 6.0%–5.0%) and households' real disposable income: 2.9%–4.5% (RF: 3.2%–4.7%).

⁵ Reference conditions for formation of the scenarios of economic development of Perm Territory in the period until the year 2012 (the main scenario conditions). – <http://www.gorodperm.ru>. Those conditions provide for slower growth rates of households' real income (2%) and higher inflation rate at the regional level (12.5%).

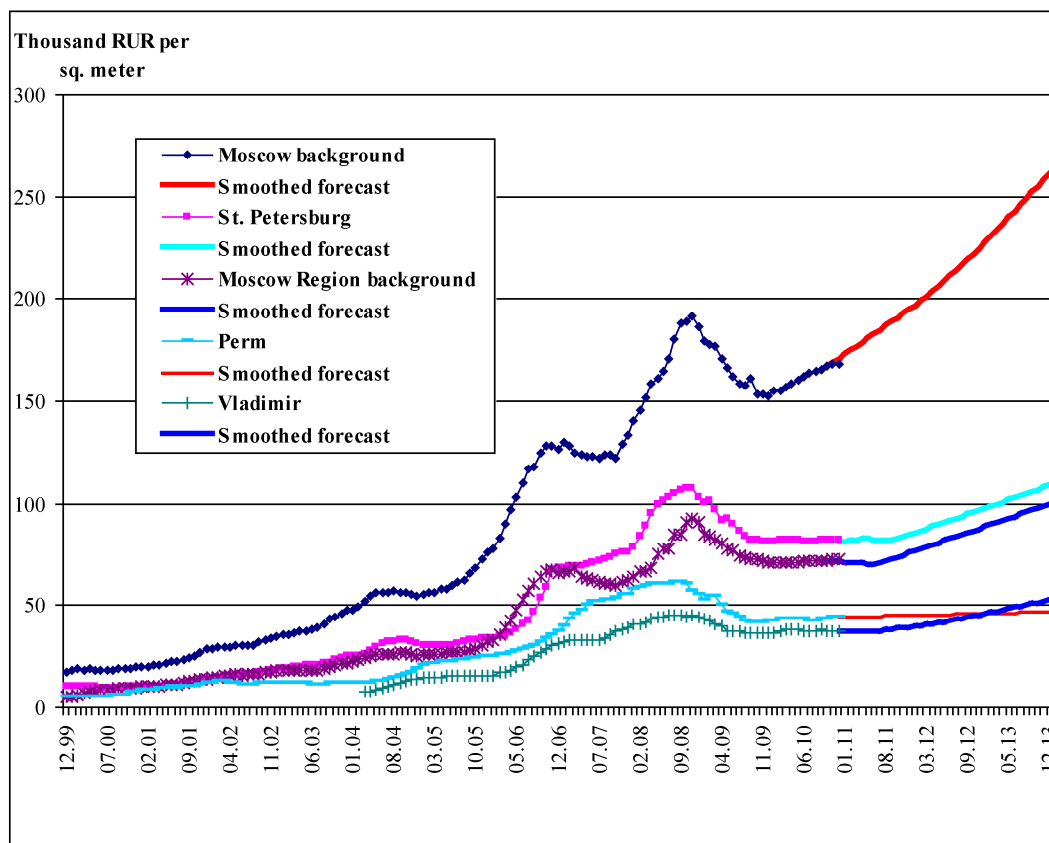
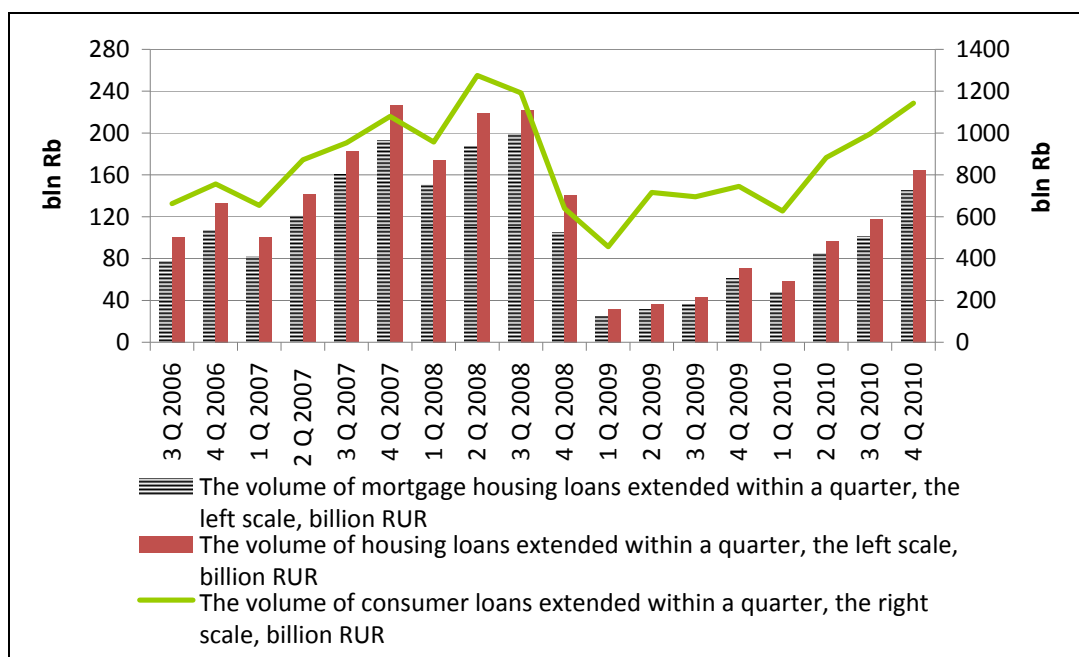


Fig. 12. The forecast of RUR prices of the supply on the secondary market in some cities of Russia.

If late in 2010, the outflow of capital from the private sector (it mostly fell on the 4th quarter and was somewhat smaller as compared to that of 2009) was a negative factor for the Russian economy, the dramatic growth in global prices on oil due to developments in the Middle East creates a basis for a more rapid recovery of the Russian property market. An additional factor behind the above suggestion may be the upcoming political cycle of the 2011–2012 period with the prospect of growth in budget expenditure and incomes of certain groups of households. However, the authorities' efforts to prevent a new pricing bubble on the property market make a repetition of the scenario of the mortgage-oil growth of the 2005-2007 period highly unlikely.

6.5.6. Housing Lending

According to the data of the Central Bank of Russia, 301,035 mortgage housing loans (MHL) for the total amount of RUR 378, 933 million were extended in 2010 with the outstanding debt of RUR 1,127,834 million as of January 1, 2011. The volume of mortgage housing loans extended in 2010 amounted to 58% of the total volume of loans extended in 2007 and exceeded by 148% the volume of loans extended in 2008. On the contrary, as of January 1, 2011 the outstanding debt on mortgage housing loans already exceeded that as of January 1, 2008 and January 1, 2009. In 2010, the volume of extended housing loans (HL) amounted to RUR 437,030 million or 395,515 loans with the outstanding debt of RUR 1,295,006 million as of January 1, 2011.

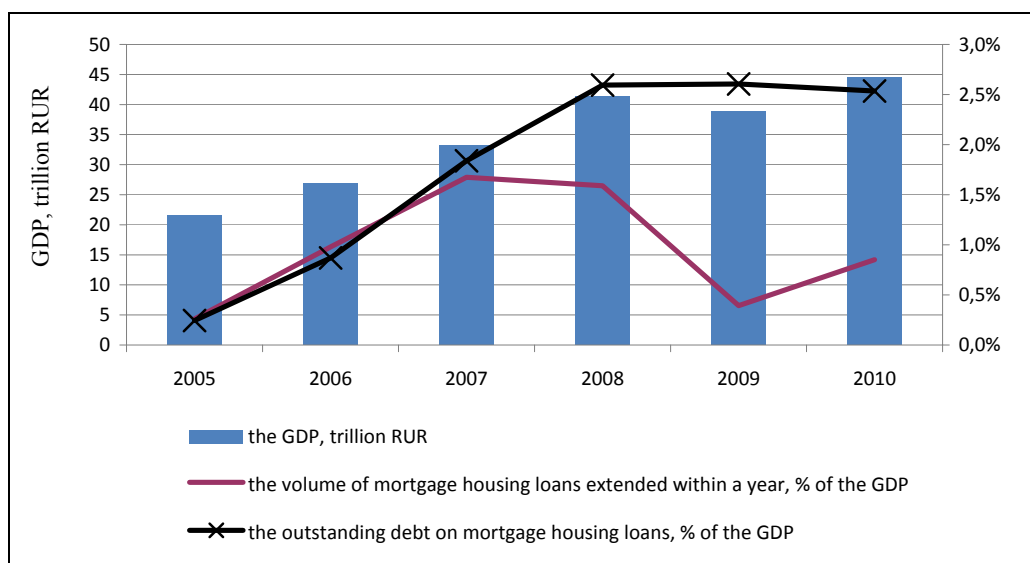


The source: the data of the Central Bank of Russia.

Fig. 13. Dynamics of the rate of extension of loans to individuals within a quarter

In 2010, the volume of the extended mortgage housing loans amounted 0.85% of the annual value of GDP against 1.59% in 2008. (Fig. 14). As of January 2011, the debt on mortgage housing loans amounted to 2.53% of the 2010 GDP which figure is somewhat less than the relevant value (2.59%) in 2008.

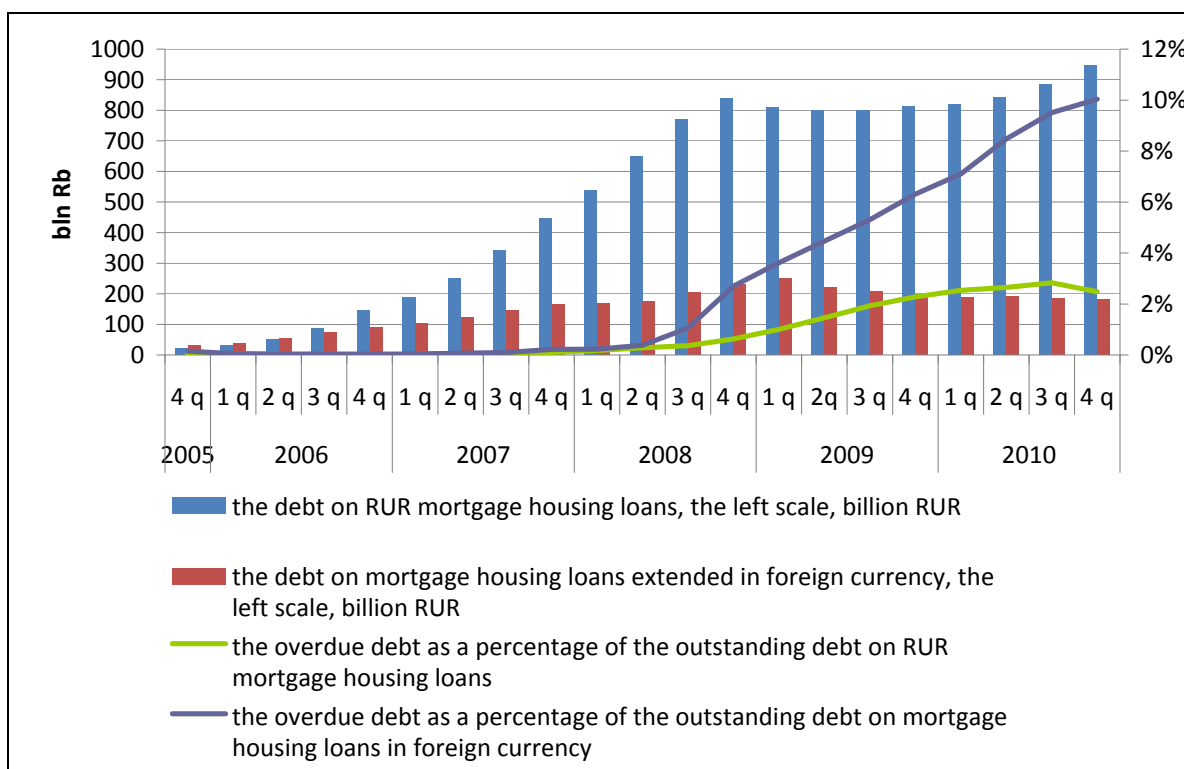
According to the data of the Federal Service of State Registration, Cadastre and Cartography, the number of residential premises encumbered with mortgage and registered in the Unified Register of Titles in 2010 amounted to 733,090.



The Source: The Rosstat data.

Fig. 14. Dynamics of the mortgage housing lending, % of the GDP

In 2010, there was a sustained growth in outstanding debt on RUR mortgage housing loans (*Fig. 15*). At the same time, in the 4th quarter 2010 the share of the overdue debt in the outstanding debt on RUR mortgage housing loans decreased from 2.83% in the 3rd quarter to 2.48% in the 4th quarter. It is to be noted that in December 2010, the value of the overdue debt decreased somewhat from RUR 26.1 billion to RUR 23.5 billion. On the contrary, in the 3rd and the 4th quarter 2010, the outstanding debt on mortgage housing loans in foreign currency decreased from RUR 192.4 billion to RUR 179.9 billion, while the share of the overdue debt in the outstanding debt in foreign currency rose from 6.31% (RUR 12.5 billion) late in the 4th quarter 2009 to 10.4% (RUR 18.0 billion) late in the 4th quarter 2010. (*Fig. 15*).



The source: the data of the Central Bank of Russia.

Fig. 15. Dynamics of the outstanding debt and the overdue debt on mortgage housing loans

In 2010, both the value of the outstanding debt on mortgage housing loans without overdue payments and its share in the total amount of the debt increased (*Table 32*). A positive factor is a decrease in the share of the debt on the defaulted mortgage housing loans with payments overdue for over 180 days in the total amount of the debt to 5.11% by the end of 2010. (*Table 32*).

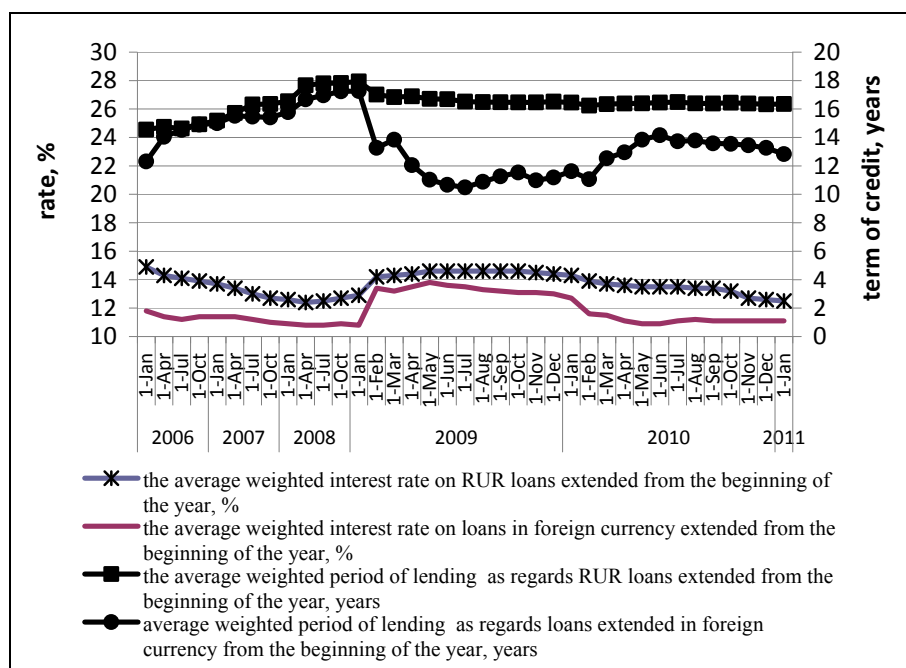
Throughout 2010, the average weighted interest rate on RUR mortgage housing loans extended since the beginning of the year decreased from 14.3% to 12.5% (*Fig. 16*), while that on mortgage housing loans in foreign currency extended from the beginning of the year, fell in the first half of 2010 from 12.7% to 11.1% and remained virtually unchanged till the end of the year.

Table 32

Grouping of the debt on mortgage housing loans by the period of delay in payments

	The total amount of the debt on mortgage housing loans	including:							
		Without overdue payments		With payments overdue for 1 to 90 days		With payments overdue for 91 to 180 days		With payments overdue for over 180 days	
		In million RUR	% of the total amount of the debt	In million RUR	% of the total amount of the debt	In million RUR	% of the total amount of the debt	In million RUR	% of the total amount of the debt
2010									
Feb 01	1 008 450	864 947	85.77	73 516	7.29%	17 648	1.75	52 339	5.19
Mar. 01	1 005 629	859 411	85.46	75 221	7.48%	17 699	1.76	53 298	5.3
Apr. 01	1 006 838	858 532	85.27	76 922	7.64%	17 720	1.76	53 664	5.33
May 01	1 013 685	867 308	85.56	74 709	7.37%	19 767	1.95	51 901	5.12
June 01	1 025 020	874 137	85.28	76 159	7.43%	18 860	1.84	55 864	5.45
July 01	1 033 813	883 910	85.5	76 502	7.40%	16 024	1.55	57 377	5.55
Aug. 01	1 042 163	900 012	86.36	68 574	6.58%	15 737	1.51	57 840	5.55
Sept. 01	1 055 983	905 400	85.74	74 975	7.10%	14 467	1.37	61 141	5.79
Oct. 01	1 069 618	916 342	85.67	77 119	7.21%	14 012	1.31	62 145	5.81
Nov. 01	1 086 204	941 847	86.71	67 671	6.23%	14 555	1.34	62 131	5.72
Dec. 01	1 105 023	953 524	86.29	74 700	6.76%	14 365	1.3	62 434	5.65
2011									
Jan. 01	1 127 834	990 578	87.83	66 767	5.92%	12 857	1.14	57 632	5.11

The source: the data of the Central Bank of Russia.

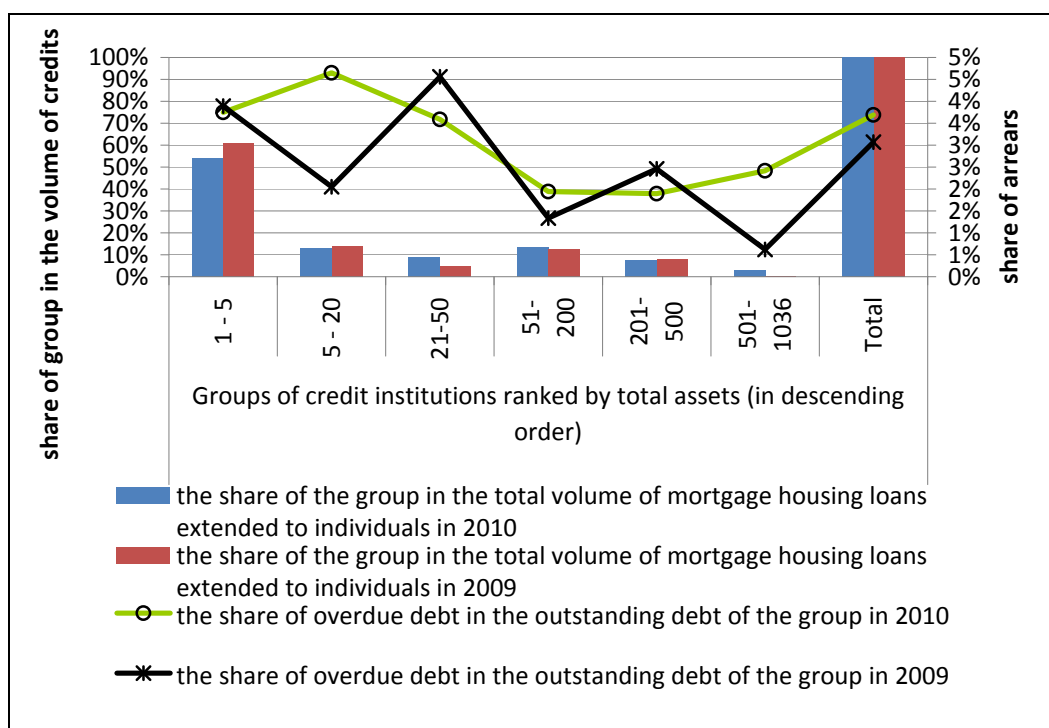


The source: the data of the Central Bank of Russia.

Fig. 16. The average weighted data on mortgage housing loans in RUR and foreign currency extended from the beginning of the year

The average weighted period of lending as regards RUR mortgage housing loans extended since the beginning of the year varied throughout 2010 between 16.5 and 16.2 years, while that regarding mortgage housing loans in foreign currency extended since the beginning of the year initially rose from 11.1 to 14.2 years and then fell to 12.8 years (Fig. 16).

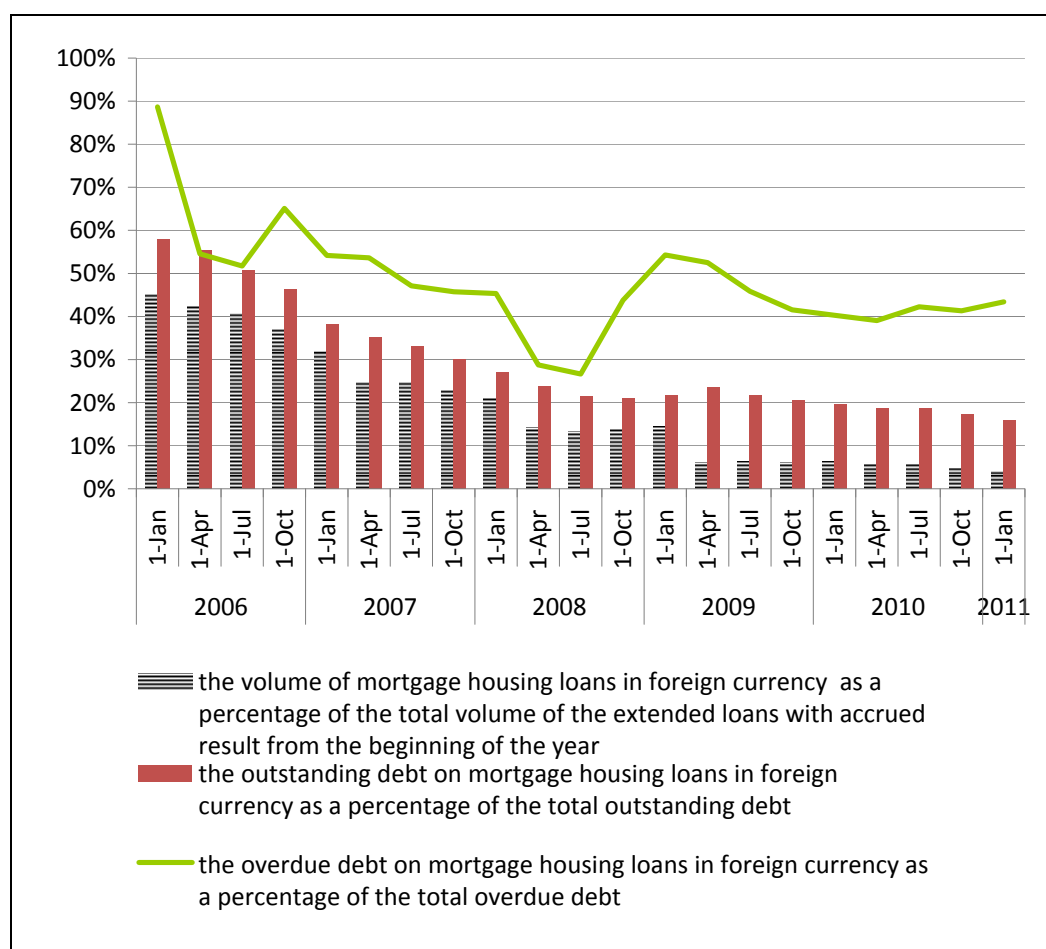
In 2009, a significant increase of up to 60.82% in the share of five credit institutions with the largest assets in the total volume of mortgage housing loans extended that year gave way to a drop in the above value to 54.18% in 2010 and a redistribution of volumes between other groups (Fig. 17). If in 2009 the largest share of the overdue debt was registered with the third group (4.56%), in 2010 it was the second group whose portfolio of mortgage housing loans was of a higher risk (4,65%).



The source: the data of the Central Bank of Russia.

Fig. 17. Dynamics of the volumes of extended mortgage housing loans and the overdue debt by the group of credit institutions ranged by the size of assets

In 2010, the share of foreign currency mortgage housing loans in the volume of mortgage housing loans extended during a quarter and that in the volume of the outstanding MHL debt kept decreasing (Fig. 18) from 6.25% in the 4th quarter 2009 to 4.03% in the 4th quarter 2010 and from 19.6% in the 4th quarter 2009 to 15.95% in the 4th quarter 2010, respectively. However, a decrease in the share of the overdue debt on mortgage housing loans in foreign currency in the total volume of the overdue debt in the beginning of the year (39.06%) was replaced by growth by the end of that year (43.42%).



The source: the data of the Central Bank of Russia.

Fig. 18. The ratio of RUR mortgage housing loans to mortgage housing loans in foreign currency

In the three quarters of 2010, AMHL refinanced 34,167,000 mortgage loans for the total amount of RUR 37.1 billion, which figure is equivalent to 18.2% in quantitative terms and 15.8% cash terms of the total number mortgage loans extended in that period.

In 2008, the share of AMHL on the market of refinancing of mortgage housing loans amounted to 26.69%, while in 2009, to 35.78%. In the first half of 2010, AMHL dominated on the market of refinancing; AMHL accounted for 75.53% of that market.

According to AMHL's data, as of December 2010 the minimum average rate on the refinanced AMHL loans which complied with the relevant AMHL standards amounted to 10.85% in the Privolzhsky Federal District, while the maximum one to 11.42% in the North Caucasian Federal District (Table 33). The average weighted term of the refinanced AMHL loans varied by the federal district from 16.2 years to 19.3 years. The average amount of the mortgage loan refinanced by AMHL amounts to RUR 1,011,000.

Table 33

**Individual indices of the mortgage housing market by the federal district
as of December 1, 2010.***

	Russia	Central Federal District	North-Western Federal District	Southern Federal District	North Caucasian Federal District	Privolzhsky Federal District	Ural Federal District	Siberian Federal District	Far Eastern Federal District
The number of refinanced loans (units)	36 423	4 315	3 766	1 413	379	12 486	4 379	8 367	1 318
Loans refinanced by AMHL, million RUR**	36 824.8	4 938.5	4 258.0	1 615.3	452.3	11 409.2	4 423.8	8 099.9	1 627.8
Average weighted term of the loans refinanced by AMHL, years**	16.8	17.3	16.2	17.3	19.3	17.2	16.3	16.2	16.8
Average interest rate on loans refinanced by AMHL, %**	10.99	11.18	10.89	11.13	11.42	10.85	11.30	10.90	11.24

* accrued from the beginning of the year

** on standard AMHL products

The source: OAO AMHL.

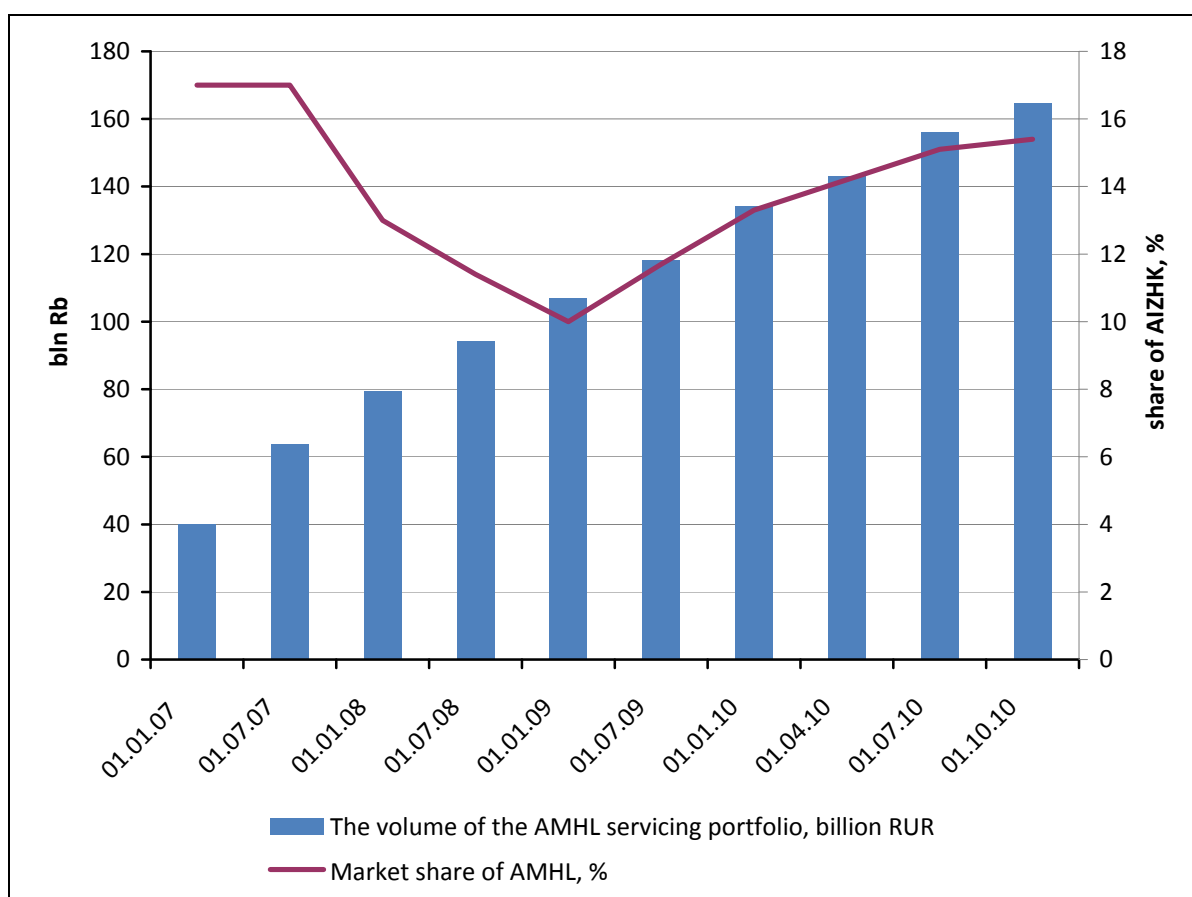
After a drop in the volumes of mortgage housing lending and refinancing in 2008, the minimum share of the loans refinanced by AMHL in the total volume of MHL debt was registered late in 2008. From that moment, the share of AMHL kept growing in the 3rd quarter 2010 and amounted to 15.4% (Fig. 19).

As of November 1, 2010, AMHL refinanced 4119 mortgage loans extended under the *Military Mortgage* program for the total amount of about RUR 8 billion, as well as 828 loans with utilization of the maternal capital for the total amount of over RUR 936 million.

Early in 2011, the President signed the law which permitted all the women who had got the second child (regardless of the fact whether the child reached the age of three years old) to utilize the maternal capital for repayment of the mortgage loan. Furthermore, under the new law households with children will have an opportunity to use the maternal capital to repay mortgage loans received both before and after December 31, 2010.

As seen from the Strategy of Development of Mortgage Housing Lending in the Russian Federation till 2030, solution of the housing problem is still related to mortgage. Mortgage is considered as an instrument which regulates real-estate prices and has the following parameters:

- loans are extended for the period of up to 30 years;
- the interest rate is fixed at the level of the consumer price index plus 2-3%;
- the down payment is to be made in the amount of at least 30% (in case of absence of mortgage insurance);
- the share of loans with mortgage insurance and the down payment of 10% should not exceed 1/5;
- the procedure for repayment of loans should provide for use of flexible schemes of debt management.



The source: the Rusipoteka's data.

Fig. 19. The share of loans refinanced by AMHL in the total volume of MHL debt

The quantitative parameters of the Strategy suggest that after the mortgage market has got through the following three stages - recovery to the pre-crisis level (2010–2012), complete recovery and attainment of sustained growth rates (2013–2020) and full market saturation (2021–2030) – mortgage will be affordable to 60% of Russian households (17% in 2009) with the mortgage loan debt amounting to 15.5% of the GDP. The main obstacles in implementation of the above strategy are both the shortage of financial resources for mortgage and actual volumes of commissioning of housing. Suffice to say that with 90 million square meters of housing in 2015 (the above value was stated in the *Housing* federal purpose program) it will be necessary to increase by more than 50% the volume of commissioning of housing as compared to the existing one, however, even that will be far short of the target, that is, commissioning of 1 sq. m per capita annually in Russia.

6.6. The Military Economy and Military Reform in Russia

From the financial perspective, the year of 2010 started with a unusually early (of 12/04/2009) notification of the national military organization's chief controllers of such a critical development as "the 2010 budget obligation limits", which, in principle, allowed all the military departments a timely delivery of respective obligations to recipients of budget funds. However, like in the previous years, the planned volumes and timelines once again were not met, plans altered momentarily, while prices of military products were on the up-swing.

The "power" ministries and the respective military leadership failed to exercise a due control over the last year's military-economic processes. This ascertainment is particularly true, as far as the Ministry of Defense is concerned, which was half-way towards completion of its reorganization, while running, at the same time, transition of the Armed Forces (AF) of Russian Federation to some "new look". The document on the new look has not ever been made available for the at-large public's review and comments, while views on it it have been changing constantly through the end of the year. Meanwhile, a string of official legal documents was adopted and promulgated, including, first and foremost, the new Military Doctrine of RF¹, which builds on individual provisions of the Strategy of National Security of RF², and engendered a number of the national military structure (MS) leadership representatives' statements in the media. The Commander-in- Chief and other participants in the meeting of the Collegiums of the Ministry of Defense held on 5 March assessed progress en route to the new look and specified annual objectives. Specifically, Mr. N. Makarov the Head of the Staff Quarters, asserted that, "now as many as 85 brigades have been formed. All of them are in the state of permanent combat readiness... They are fully manned, equipped with arms and military hardware"³. However, it was futile an attempt to ensure a "full" manning of the brigades and to sustain it through the end of the year, as there were no young men ready for conscription and willing to serve in the army. By the end of the year, it became clear that the brigades would not be fully manned in the years to come, either. Mr. Makarov's also produced an inaccurate ascertainment of economic aspects of the process: "The best option is to have a genuine draft-based army. But the state so far has not been in a position to afford such a financial burden..."⁴

The biggest changes occurred in the highest echelon of military brass. The number of military-administrative districts was reduced from recent 6 to 4 ones and the respective number of operative strategic commands (OSKs) was established ahead of pre-set timelines. Concomitant with the processes were relocations of organizational structures, which involved costs of relocation and provision of service and support. However, it is a waste of time to look for the respective figures in the federal budget, as the information is classified, while the budget classification remains imperfect.

A notable development for AF became completion of the reforming of reduced units and transition of all others under the "permanent combat readiness" category, which implied transition of the bulk of AF from the division-based structure to the brigade-based one, which

¹ Decree of the RF President of 05.02.2010 and the Military Doctrine of RF approved with it//Nezavisimoye voyennoye obozreniye. 2010. 12-18 February (№05).

² Decree of the RF President of 12.05.2009 and the Strategy of National Security of RF approved with it//Krasnaya zvezda. 2009. 2-26 May (№ 88).

³ *Ibid.*

⁴ *Ibid.*

suggests a greater mobility. The changes resulted in “extra” officers with no housing who found themselves “out of service”. There have been no unambiguously positive comments on the brigade-based structure. Meanwhile, being the most mobile branch of troops, the Airborne Forces has retained the division-based structure. But critical comments on the novelty are often hushed.

Yet more dangerous is the fact that the year of 2010 saw continuous disinformation of the civil society and the military, including the supreme level of the military and political command. To cite a particular example that implies far-reaching consequences, suffice it to mention a statement that the ratio of the AF support and training costs to their development costs, or more precisely, development of arms and military hardware, in RF allegedly does not quadruple with records posted by most modern states. Several years ago, when Russia would spend nearly 30% of the national defense budget on equipping its AF with arms and military hardware (AMH), Mr. Yu. Baluyevsky, the then-head of the Staff Quarters reckoned¹: “The whole world is following the pattern: some 60 per cent is spent on procurement of arms and R&D, while some 30-40 per cent - on money allowance and matters associated with the material provision and military training of armed forces”. The statement disclosed the rationale behind the RF Security Council’s decision of 25 June 2005. It became known later that at the time the Security Council set a task of “changing the ratio of the ongoing support and technical equipping of the Armed Forces towards the latter and to hit the level of 50:50 by 2011 and further the one of 30:70 in favor of technical equipping – by 2015”².

Meanwhile, the level of costs of development and procurement of arms worldwide was: in the US – 36.2% of the nation’s overall defense expenditures, in UK – 30.4%, France – 36.2%, and Germany – 24.2%³. In other words, there is rock-solid evidence that Russia was no maverick in this respect, as far as leading military nations are concerned. They have not boosted the share of spending on arms ever since, either. For example, between 2005 and 2010, the US spent, on a year-on-year basis, 62.1%, 64.2%, 61.7%, 58.6%, 63.1% of the nation’s total defense spending. An RF Ministry of Defense’s periodical regularly updates on these data⁴, but the military bosses and red tape ignore even domestic analysts’ materials.

The declared total “optimal” number of the AF staff accounts for 1 mln., of whom 150,000 are officers, while another 150,000 are sergeants and contracted specialists. Hence the need to man 700,000- plus positions with conscripts. That, in our view, became a consequence of the original erratic ascertainment that entailed a misconception of Russia being short of funds to transit to a draft-based army. Therefore, the policy setback implied “revisiting” conscription, which means both restrictions of some of the military’s rights and freedoms and an exceptionally low level of money allowance due (MA). An earlier IET research, which included a survey on conscription-aged residents⁵, evidenced that a 1.2 average nationwide salary would

¹ Rossiyskaya Gazeta. 2005. 1 November (№245). URL: <http://www.rg.ru/2005/11/01/baluyevsky.html>

² Comments of the Defense and Security Committee of the Federation Council on Federal Act “On the Federal Budget for 2011 and the planned period of 2012 and 2013”. №3.5-07/1681 of 30.11.2010.

³ For objective information, including transparency of military spending, see Reports by the UN Secretary-General №№ A/59/192 и A/60/159, 2004

⁴ Korotcheko V. Project voennogo byudgeta SSHA na 2010 finansovy god//Zarubezhnoye voyennoye obozreniye. 2009. № 11

⁵ Reforma systemy komplektovaniya voennoy organizatsii Rossii ryadovym i mladshim komandnym sostavom / Pod red. Ye.T. Gaidara i V.I.Tsybala. Nauchnye trudy № 39P. M.: IEPP, 2002; Problemy i praktika perekhoda voyennoy organizatsii Rossii na novuyu system komplektovaniya./ Pod red. Ye.T. Gaidara i V.I.Tsybala. Nauchnye trudy: Working papers # 75P. Moscow, IET, 2004.

suffice to attract new draftees; instead, the conscripted military are paid an amount 40-fold smaller than that. The approach conflicts with most of citizenry's interests, but it suits two main groupings: army jobsters and around-the-army fixers, who make money on 1) the citizens' fear of the army and desire to dodge conscription; and 2) on kickbacks and other embezzlement schemes in the course of allocation, under the smokescreen of secrecy, of huge funds on R&D works and arms procurements.

6.6.1. The Army Recruitment Problem

Last year, as many as 700,000 young men born in 1992 reached the conscription age. For reference, in the early -1990 the birth rate in RF plummeted more than twice vis-à-vis the 1980s, hence the number of future conscripts will fall short of making up even the 2010 figures and will account for slightly over 600,000. Given past records, 1/3 of them will be discarded due to health problems. Plus, Russian universities will shortly offer some 1m tuition opportunities (with roughly a half of them targeting young men), so practically every masculine higher school graduate can enroll to the university and enjoy a conscription deferment. The situation is further aggravated by many Russians' willingness, to reside and work overseas, while retaining the RF passport.

Hence, today, it is mostly those who used to enjoy deferments earlier who form the bulk of the conscription reserve (CR), with ex-students dominating the group. That is why the number of university-educated conscripts is on the upsurge: in the spring 2009, they accounted for 31,000 (out of the total of 305,500 conscripts), in the autumn of 2009 – 43,000 (271,000), in the spring of 2010 – 45,000 (270,600), and in the autumn of 2010 – 44,000 (278,800).

The conscription reserve, which the head of the State Operational Mobilization Department has recently estimated at the level of 3 mln, should exhaust within next two or three years. The above data allow assessing both current challenges to, and meager future opportunities for, filling in 700,000 positions with conscripts; as well the exercise can shed some light on magnitude of the corruption potential the system engenders.

Let us start with economic incentives potential bribe-givers may have. With the average nationwide monthly salary currently in the region of Rb. 19,000, while in service, the conscript can “earn” a miserable Rb. 500 a month, plus another Rb. 3,000 (cash equivalent of other kinds of military allowance combined). Hence, what the conscript and his family loose annually is: $(19 - 0.5 - 3) * 12 = \text{Rb.}186,000$. The total loss of all the conscripts' families combined will make up astounding Rb. 130 bln. Let us note that in the past, when the bulk of conscripts was formed by fresh higher school graduates, the IET calculations assumed their salaries would account, on average, for just 70% of the average salary nationwide. This adjustment can now be dumped, as we see the tendency to compulsory recruitment of fresh university graduates to the army. It goes without saying, this material factor (alongside the fear of hazing) pushes prospective conscripts and their parents to check out conscription exemption “services”.

Now, let us depict interests of those who “facilitate” that under and beyond the legal framework. The past years' record shows there are 1.4 mln. conscription notifications sent out annually. That is to say, they fail to cover (due to various reasons, including corruption) 3-1.4 mln.=1.6 mln. young men of conscription age. Consequently, provided only a half out of 1.4 mln. of recipients of conscription notifications is actually enlisted, it means that the other half of them, i.e. 0.7 mln., will be exempted from conscription because of some reasons (possibly, corruption-based ones), too. So, the number of individuals who have dodged the annual con-

scription campaign will total 1.6 mln.+07 mln.= 2.3 mln. The Military Prosecutor's office, INDEM foundation and media reports estimate the costs of conscription exemption "services" rendered by medics, lawyers and staff at military commissariats within the range from Rb. 300,000-more in megapolises to 30,000 in regions¹.

Assuming the amount of the bribe per each given conscription dodger averages Rb. 60,000, the criminogenic capacity in the area can very roughly account for 2.3 mln. * Rb.60,000 = Rb.138 bln. The figure is way greater than budget expenditures required for transition to draft, which by the IET estimates, do not exceed Rb. 90 bln, or less than 1% of the 2010 defense budget (Rb. 1,276 bln.)². Meanwhile, the annual increase in defense spending accounts for some 20%, but all the funds are spent on procurements and R&D.

So, while saving on a decent pay service to draftees, the government de-facto withdraws the same amount from budgets of conscripts' families, which form the most disenfranchised fraction of the society. At the same time, while resorting to the illegal "services", other citizens are stripped of an amount roughly matching the one needed to transit to the draft system.

From the military perspective, such a policy can engender the following outcomes: on request of the Defense Committee of the State Duma, the Head Department of Military Training (HDMT) of AF RF (outgoing letter ref. № 533.3.1211 of 16.09. 2002) unveiled expert comments in this respect. Proceeding from the model "professional" (ie. basing on at least a five-year military training program) soldier's combat capacity (which equivalents 1), after 6 months of military service and training the respective index accounts for 0.1 and after 12 months in service – 0.3. As a reminder, while drawing its comparisons across different nations' military capacity, the UN experts disregarded troops in service for less than half a year.

Notwithstanding the above HDMT's assessments and failing to officially produce their own, the present military leadership argue that 2-3 months is a period sufficient to train a modern soldier.

While commenting on results of the spring stage of conscription, the SOMD head asserted that "<C> enlisted between April and May, already in June the soldiers took part in "Vostok-2010" strategic exercise and performed not that bad"³. However, there exists absolutely polar evidence: "While gearing up for the exercise, a simple decision was made – that is, against any law, to halt dismissal of conscripts by deploying any qualified soldiers just to prepare training areas, rather than to even partake in the future exercise"⁴. Assurances of a "credible level of military training" were also been shrugged off by the current head of HDMT and Troop Service⁵: "there is a question no one so far has produced a clear answer to: how to make a qualified troop out of a conscript in the span of one year?". He also added that without modern training capacities, this is an unrealistic objective in principle. AF RF have no such training capacities, nor the troops' military efficiency matters at the end of their service- rather, they are needed earlier than that. At this juncture, commanders of military units and detachments are doomed to a constant renewal of their troops (while some of them are booties,

¹ Web-page of the RF Ministry of Interior, 27.10.2010: <http://mvdrf.ru/news/49341>. - Access date 07.02.2011.

² Report of the Federal Treasury on execution of the federal budget of RF: http://www.roskazna.ru/store/reports_file571.xls. – Access date 9.02.2011.

³ Aleksandrov A. Itogi pryzyvnoy kampanii // Krannaya zvezda. 2010. 27 July (№ 133); 28 July–3 August (№ 134).

⁴ Goltz A. Gotovim pushechnoye myaso // Voенno-promyshlenny kuryer. 10–16 November (№44).

⁵ Evnevich V. Lazer v rukakh soldata // Voенno-promyshlenny kuryer. 2010. 4–10 August (№ 30).

others are getting ready for dismissal), which makes it hard to arrange a normal military training.

Giving such troops even the most cutting-edge weapons will not save their commanders' day, as soldiers would have no time to master them, nor would they appreciate any incentives to take care of them. So an army, wherein the bulk of troops are in service just for one year, is and will be unlikely to ensure a due combat efficiency. And it is not accidental then that the chief commander of Airborne Forces was compelled to form 5 "primary engagement" battalions and man them solely with draftees. Meanwhile, other Airborne Forces' units are manned with conscripts, which effectively make them look like and operate as training attachments.

Perhaps this very approach might be worth legitimizing, but legislators ruled otherwise. They were at pains to urgently amend an act in compliance with which "rookies" can be deployed on combat missions after 3 months in service, rather than after 6, as the document stated earlier. The head of SOMD used to accentuate that if the length of service would be reduced to 1 year, conscripts would fill positions that "do not determine the armed forces' combat efficiency". Now it means that AF comprises 70% of such positions. Plus, strictly speaking, such a category of positions has not ever been identified in legal terms, and its arbitrary usage appears illicit.

Meanwhile, both RF and other countries are confronted with an urgent imperative of answering a more general question as to what the ultimate objective of conscription is. For Russians, the answer should be built on requirements set by the Strategy of National Security of RF until 2020. The document emphasizes that military threats form just a fraction of a general list of threats to Russia and the nation should get ready to counter them all. In all fairness, life has already made us face the challenge of a non-traditional deployment of individuals recruited from the civic sector to ensure the national security. Specifically, last summer, during the period of wildfires, as many as 8,500 - 10,000 troops and some 1,000 units of specialized military hardware were deployed to fight the fires on a daily basis¹. Art. 59 of the RF Constitution does not suggest that the citizen's duty to defend the Motherland implies only repelling an invasion. That is why all the RF citizenry should be trained to exercise their constitutional duty. If conscription is retained to serve that purpose, it should be reduced chiefly to a short-term but practical survival course. Having completed the initial phase, only the best and the brightest should be picked and offered to voluntary stay in service for a handsome allowance and lucrative preferences. That is the way professionals in the key security areas should be recruited, otherwise the level of safety of military service and the one of military efficiency of most of troops would remain low².

The problem, which aggravated in 2010, concerns junior commanders, who are represented overseas by the institution of warrant officers and sergeants. Experts are unanimous: "Modern ways of fighting war are determined not by generals –to a significant extent they depend upon command which sergeants demonstrate on the tactical level"³.

Until recently, Russia has had too many officers and the national equivalent to the US CWO, who were supposed to exercise control over privates, but in fact could and did nothing in this respect. These positions were slashed, with reference made to other countries, mostly the US's, army wherein the officers/soldiers ratio allegedly was 1:16. Meanwhile, our reform-

¹ Tikhonov A. Ne chislom, a umeniyem//Kransya zvezda. 2010. 17 August (№148).

² Litovkin V. Opyat prizyv, opyat problem//Nezavisimoye voyennoye obozreniye. 2010. 9–15 April (№13).

³ McDermot R. Armiya nachinayetsya s serzhanta// Voенno-promyshlenny kuryer. 2010. 14-20 April (№ 14).

ers lost sight of the much-needed category of warrant officers and did not give thought to well-trained sergeants, either. As a result, our new staff and military service system was doomed to failure: there are no such qualified sergeants in AF as yet - their training has just kicked off and its pace is too low. Hence no hope for the reign of law and order in military barracks.

That a special category of military counselors will be up to the job seems quite problematic, too. Such officers will be assigned to every unit with the number of troops over 75, which suggests there will be 10,000 such counselors in AF, plus 20,000-strong MP and priests. The Ministry of Defense will surely rake up some cash on their subsistence and transition to new uniforms (some Rb. 25 bln.), and on travel subsidies to parents to see their conscripted sons to their stationing locations (the number of concerned parents was over 10,000 at the heyday of the autumn conscription campaign), but not on transition to draft.

Equally critical was another challenge Russia faced last year – namely, training the renewed officer corps. As the Soviet legacy, the military universities network proved excessive and so did the number of military university graduates, who struggled to find a position in AF. As a temporary solution, they were offered to fill in sergeants' positions, with all their perks untouched. A considerable part of them opted for an early retirement, though, and it is highly unlikely already retired and now retiring officers will be provided with long-promised housing and decent pensions.

6.6.2. Problems of Design, Production and Supplies of Arms

The inadequate closeness of “power” agencies and absence of the civilian control add to the dire situation with supplies to the military.

From the economic perspective, an analysis should encapsulate all the list of items of military supplies (IMS), including both an extensive set of items earlier supplied to AF via the logistic arm and weaponry and military hardware (WMH), which used to be supplied via the Head of the Inventory Service. Today, these structures have been reorganized, consolidated and fell under the “non-military” part of the MOD's new structures. Those include the inventory system of the Strategic Nuclear Forces (SNF), by which Russia still maintains a rough parity with the US, and Non-Nuclear Forces (NNF), by which Russia catastrophically fell behind its major rival. In addition, those are strategic reconnaissance, communications, navigation and space control systems (SCS), missile attack warning system (MAWS) of the anti-ballistic and airspace defense (ABD and ASD).

Tactical weapons on theaters of war (TW), or in, a new interpretation, – on operational avenues of strategic command authorities - were traditionally considered the second critical group of IMS.

The third critical group of IMS is formed by means of military power projection from one theater of war to another. Given the time factor, the group comprises military airlift (MA) and the respective means of provision of its functioning.

Meanwhile, there exists an increasing need for developing the fourth group of IMS that secure operations of the AF command authority, various units and attachments, as well as solitary troops, with account of means of automated cut-through command and control, information collection and control, and conduct of “information wars”.

All these groups should have been expected to post some military-economic progress in 2010, for the volume of funding earmarked under the State Defense Order (SDO) was greater than in the previous years. But the actual capacity of the military-industrial complex that in

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principle operates to meet demand of both domestic, as well as overseas customers, was not factored in.

The above is evidenced by open data collected from domestic media, fragmented public statements by representatives of the RF military and political command authority, and references of the international Institute of Strategic Studies. The *Table* below (*Table 34*) characterizes the dynamic of main IMS of the first group.

Table 34

Dynamic of Equipping AF with Main Models of Strategic Arms

IMS group	Model	Quantity in 2008	Quantity in 2009 r.	Quantity in 2010 r.	Dynamic 08–09	Dynamic 09–10	Notes
Strategic NS with MC BM In the Navy (Northern, Pacific arms)	(Delta III, RSM-50)	6	6	5	0	-1	Reduction appropriate
	(Delta IV, RSM-54)	4	4	4	0	0	Unchanged
	(Delta IV, RSM-52)	2	2	2	0	0	Unchanged
	Tayfoon	2	2	2+1 (re-serve)	0	0	Unchanged
	Pp. 955 (MC «Bulava»)	1	1+2 (under construction)	1+2 (under construction)	0	0	Failure to develop MC, NC were not passed into service. Overspending 12 units in service. The combat capacity of the NS grouping is down
NS- total with MS BM SB	15 with 252 BM SB	15 c 252 BM SB	14 c 236 BM SB	0	-1	-16	
Missile Complexes of SRF Silo-based/mobile	PC-20 (SS-18)	80	75	68	-5	-7	Partial use of old MC to launch SA, particularly for commercial purposes. profit= ?
	PC-12M(SS-25)	254	201	180	-53	-21	The military capacity of new BM is on the rise, but fails to compensate for the retirement of old ones
	PC-18 (SS-19)	126	100	72	-26	-28	Production and supplies in progress
	Topol-M (SS-27) silo-based / mobile	48	54	50 /15	+6	+11	The general military capacity of SRF is intact
	PC-24	0	0	?	0	+?	
Long-range aircraft (the 37 th Air Force wing)	MC with warheads (WH), total (BF)	508 with 1600 WH	430 with 1605 WH	430 with 1605 WH	-78	0	
	Tu-160	15	16	16	+1	0	Strengthened
	Tu-95MC6 (H6)	32	32	32	0	0	Unchanged
	Tu-95MC16(H16)	32	32	31	0	-1	Weakened
Missile Attack Warning means; MC BMD	Aircraft with cruise missiles	79 with 884 ALCM	80 with 900 ALCM	79 with 856 ALCM	+1	-1	SNF military capacity is down, but NNF capacity is on the rise
	KA CIIPH			5			
Airspace Force	PJC CIIPH	10	10	9	0	-1	Reduction in the number, but modernization
	SH-11	36	32	32	-4	0	Weakened
	SH-08	64	68	68	+4	0	Approximate balance
	C-300ПМУ (SA-10)	----	1900	1900	0	0	Inclusion in the strategic BMD is inappropriate
Airspace Force	C-400/Triumpf	?	64	64	0	0	Inclusion in the strategic BMD is inappropriate
	Spacecraft (SC); launch and control means	No quantitative data on SC, except for some dual use ones (GLONASS)			---	---	Positive effect thanks to dual-use means and commercial launches

Source: The Military Balance. London: IISS, 2008–2010.

From the military-economic standpoint, it is important to consider effects from budget investments in this group of weapons and to examine the extent to which the declared plans were implemented. To this end, suffice it to analyze quantitative data on composition of means over the past three years. As evidenced by *Table 34* (whose columns of dynamics of volumes of funds are quite illustrative), with all the huge funding pouring in, the effects were negligible, if not negative.

The military capacity of offensive arms, particularly, the naval component, was on decline. The idea to unify all Russian ballistic missiles proved a failure. *Bulava*, a naval version of the unified design, is not ready for passing into service, while three nuclear submarines, which

had been supposed to be equipped with *Bulava* were launched armless. As a reminder, the Constructor General of *Bulava* and the previous Defense Minister kept assuring the submarines equipped with these missiles were long to pass into service.

Production of new ground-launched missiles failed to compensate for retirement of old ones. Hence, our most powerful component of the strategic triad weakened, too. Plus, in the aftermath of the noted “unification” it was found out that all the variants of missiles, including the tactical “Iscandar”, should be produced by one and the same plant in the town of Votkinsk, whose capacity fall short of meeting the planned aggregate volume of output.

The Air Force, too, saw no rise in its military capacity. The growth in the number of bombers, which (as the military strategists reckoned) should have resulted in a rhythmic modernization of the 15 existing aircraft and production of another 15 next-gen ones by 2012, was put at jeopardy. The number of cruise missiles with nuclear warheads did not soar, either (judging indirect characteristics of the balance of forces)¹. As to non-nuclear variants of equipping the missiles (for the purposes of NNF), foreign references additionally inform just of equipping them with GPS/GLONASS-controlled targeting devices. Notably, foreign publications cite GPS on the first place as a more advanced and precise system, as it might be this year that GLONASS might match the desirable precision characteristics.

The foreign reference materials refer to the destructive role played by some Russian experts’ assurances that the domestic ADMS under the AA defense could shoot down ballistic missiles. That C-300 and C-400 can target short- and midrange ballistic missiles does not make any difference to the national AA defense, as the threat they pose is negligible. Since 2008 foreign sources have begun attributing our complexes, which earlier fell under the category of ADMS, to AA defense, and Russia proved the most equipped with strategic anti-missile systems country worldwide. Judging the outcomes of the November NATO Summit, the Europeans do not consider our ADMS as a prospective element of the European AA system.

It is most likely that the “joint” Russia-NATO AA defense will be limited with exchange of information of a missile attack, while Europe will become home to strategic silo-based components developed on the basis of offensive complexes Minuteman-2 (and that is what the US wanted). Numerous experts, including the late Dr. Yegor Gaidar, Director of the IET, cited the military and political danger stemming from this destabilizing move and raised their objections both in Russia and in the US.

The data on dynamics of other IMS does not appear encouraging, either. As noted above, with the rise of SCAs and the need to project troops from one direction to another, the focus of attention should be on equipping Russian Air Force with military cargo aircraft and helicopters, and, perhaps, some other means of urgent transportation, which are not there as yet. Joint declarations by the Russian and Ukrainian military leadership on renewal (after some modernization) of the cooperative production of a uniquely efficient Antonov-124 and a smaller Antonov-70 seem inspiring, albeit they were made before, too. The past efforts resulted in their rejection by representatives of Russia’s MIC and even those of the Russian Air Force, who were reluctant to “share” with “foreigners” prospective lucrative receipts and possibilities for their private use. Overall, in 2010, the Air Force received 4 combat aircraft, but lost 6 other ones in accidents.

¹ The Military Balance. London: IISS, 2008–2010.

The military-economic conclusion by the first three groups of IMS is evident: despite an increasingly growing volume of spending, there has been no adequate surge in the number of modern weaponry across the groups in question.

The situation with the fourth group, which is designated for cyberwar, is yet gloomier. Without much details, let us note that the modern soldier is, as a rule, equipped with protected communication and data transmission/receipt, and positioning and navigation gear; infra-red and laser target capture devices; and, if need be, outside arms, friend-or-foe devices, and many other gadgets, which he can control using a backpack PC. That is why the main reason behind the voluntary recruitment to, and professionalization of, such armies is the need to bring all the soldier's respective skills to perfection.

Unfortunately, Russia's AF have found themselves in a completely polar situation, with troops having no access to even the most primitive means of communications. The greatest "achievement" so far became the permission to privates to use cell phones they buy for themselves – a great economy of scale, indeed, in the eyes of those keen to retain a "cheap" conscription-based army. It seems that they train cannonfodder, rather than a modern army. Nonetheless, the Minister of Defense is confident that, "in 2010, a new military composition of the Army and Navy was created, the military command and control system, the ones for logistics and supplies and military training underwent a fundamental change"¹.

However, there exist other assessments. In the logistics and supplies sphere, the 2010 level of economic crimes was up by 10% compared with the prior year and worth a total of Rb. 2 bln.-plus,² while kickbacks in the state defense area hit 40%. The Defense Minister was bold in characterizing the situation: When I Came to the Ministry of Defense, frankly, I was flabbergasted by the volume of thievery, and that sensation is till with me. Financial debauchery and impunity of the people whom no one ever audited"³.

6.6.3. The Military-Fiscal Policy and the Problem of Openness

Once the peak of the economic crisis was over, the level of stability of the financial and economic planning on the federal level rose substantially. While the 2009 federal budget underwent 7 modifications, the last year's one was modified only twice: in July and October⁴. Between the moment the RF President approved the first version⁵ of the federal budget and the moment of adoption of the third one⁶ appropriations under section 02 «National Defense» rose from Rb. 1,257 bln to 1,278 bln., or by 1.7%, with a 3.7% general increase in federal spending over the period in question. On a year-on-year basis the appropriations in question plunged by 2.9% in real terms⁷, along with a 0.2p.p. contraction in their volume relative to GDP – down to 2.87% of GDP .

¹ The Military Balance. London: IISS, 2008–2010.

² Kostyukova I. Korruptsiya v oborone//Vzglyad. 2010. 19 November. URL: [http:// vz.ru/politics/2010/11/19/448506.html/](http://vz.ru/politics/2010/11/19/448506.html/)

³ Pavlikova O., Ukolov. R. Korruptsia atakuet // Profil. 2010. 29 November (№ 44).

⁴ The April changes per Federal Act № 71-FZ of 4 May 2010 г. practically did not affect the expenditure part of the budget.

⁵ On the federal budget for 2010 and the planned period of 2011 and 2012: Federal Act № 308-FZ: passed by the State Duma on 24 October 2009.

⁶ On introduction of amendments to the Federal Act «On the federal budget for 2010 and the planned period of 2011 and 2012»: Federal Act № 278-FZ: passed by the State Duma on 21 October 2010.

⁷ With the use of the index- GDP deflator (the first Rosstat's estimate for 2010 – 110.3%).

The level of secrecy of the 2010 federal budget expenditure slightly reduced compared with the previous year (*Table 35*), despite the Rb. 28, 268 bln.-worth increase in secret appropriations due to the double adjustment of the budget. Secret appropriations disappeared from expenditure sub-section 0704 «Secondary vocational training», but were still retained in sub-sections 0701 «Preschool education», 0801 «Culture» and 0908 «Physical culture and sport». The proportion of secret appropriations in sections 04 «National economy» and 05 «Housing and utilities» continued to rise, with the respective annual increase rate in the latter section exceeding 12 p.p.

Table 35

**Proportion of Secret Appropriations in the Federal Budget Expenditures
in 2003–2010, as %**

Code and name of the Section (sub-section) that comprises secret expenditures	2004 .	2005 .	2006.	2007 .	2008 .	2009.	2010
1	2	3	4	5	6	7	8
The federal budget expenditures, total	9.73	9.83	11.33	11.80	10.33	11.92	10.42
0100 GENERAL PUBLIC ADMINISTRATION ISSUES	n/a ¹	n/a	3.67	6.28	5.52	8.66	4.75
0108 International relations and international cooperation	31.88	18.04	–	0.01	< 0.01	3.66	–
0109 The state material reserve	97.73	93.33	82.86	89.23	92.18	90.17	85.08
0110 Fundamental research	–	–	2.13	1.22	1.12	0.97	0.32
0114 Other general public administration issues	n/a	n/a	0.05	0.72	0.28	4.42	1.05
0200 NATIONAL DEFENSE	37.22	38.40	42.06	42.77	45.33	46.14	45.74
0201 The Armed Forces of RF	35.39	36.11	33.07	35.59	37.11	39.04	38.36
0204 Mobilization preparation of the economy	100.0	100.0	100.0	100.0	100.0	100.0	100.0
0205 Preparation for and participation in provision of the collective security and peacekeeping activities	–	–	100.0	100.0	100.0	–	–
0206 Nuclear arms complex	100.0	100.0	100.0	100.0	100.0	100.0	100.0
0207 Implementation of international obligations in the sphere of military-technical cooperation	100.0	41.05	45.22	46.90	50.65	100.0	100.0
0208 Applied research in the area of national defense	n/a	n/a	98.37	93.94	93.69	93.20	91.32
0209 Other issues in the national defense area	n/a	n/a	2.49	8.79	24.38	29.21	41.19
0300 NATIONAL SECURITY AND LAW ENFORCEMENT	23.33	20.79	28.52	31.64	31.07	31.84	31.94
0302 Interior Ministry bodies	3.40	3.01	4.76	6.31	5.16	4.97	4.27
0303 Interior Ministry troops	13.21	11.10	11.76	10.31	9.80	10.25	8.26
0306 Security bodies	100.00	98.91	97.80	95.49	97.31	99.05	97.07
0307 Border Guard bodies	19.73	22.88	100.00	98.97	97.62	100.00	98.61
0309 Population and territory protection from emergency situations of natural and technogenetics situation, civil defense	43.69	41.74	59.02	62.39	50.65	51.39	50.48
0313 Applied research in the area of national security and law enforcement activity	n/a	n/a	73.95	66.41	64.43	75.49	92.09
0314 Other matters in the area of national security and law enforcement activity	n/a	n/a	8.26	50.71	39.95	56.32	67.82
0400 NATIONAL ECONOMY	n/a	n/a	0.05	0.02	0.44	0.64	1.56
0411 Applied economic research	n/a	n/a	–	–	5.23	5.84	5.61
0412 Other matters in the national economy area	n/a	n/a	0.12	0.06	< 0.01	0.31	4.47
0500 HOUSING AND UTILITIES SECTOR	n/a	n/a	–	3.42	0.85	6.96	19.26
0501 Housing	n/a	n/a	–	4.22	5.69	15.97	20.79
0700 EDUCATION	–	–	2.76	2.69	2.39	2.55	3.59
0701 Preschool education	–	–	2.03	2.17	2.44	2.48	3.91
0702 General education	–	–	1.51	1.91	2.14	2.00	3.45
0704 Secondary vocational training	–	–	1.06	1.03	1.02	0.86	–
0705 Professional training and retraining	–	–	16.85	15.78	17.22	1.80	9.40
0706 University and post-graduate professional education	–	–	3.15	2.93	2.53	3.08	4.08
0709 Other matters in the sphere of education	–	–	0.30	0.33	0.28	0.29	0.61

¹ Not applicable due the change of the structure of the budget classification.

(continued) table 35

1	2	3	4	5	6	7	8
0800 CULTURE, MOTION PICTURE INDUSTRY, MASS MEDIA	–	–	0.17	0.17	0.21	0.17	<i>0.17</i>
0801 Culture	–	–	0.14	0.10	0.16	0.10	<i>0.09</i>
0804 Periodical media and publishing	–	–	13.46	7.45	2.57	2.62	<i>3.59</i>
0806 Other matters in the sphere of culture, motion picture industry and mass media	–	–	0.02	0.15	–	–	–
0900 HEALTH CARE, PHYSICAL CULTURE AND SPORTS	–	–	4.30	3.99	2.57	4.14	<i>3.01</i>
0901 Stationary medical assistance	–	–	5.61	4.66	2.94	3.24	<i>2.41</i>
0902 Outpatient medical assistance	n/a	n/a	n/a	n/a	n/a	13.94	<i>3.75</i>
0905 Rehabilitation	n/a	n/a	n/a	n/a	n/a	14.07	<i>10.73</i>
0907 Sanatorium-epidemiological well-being	n/a	n/a	n/a	n/a	n/a	2.09	<i>0.64</i>
0908 Physical culture and sports	–	–	0.28	0.26	0.24	0.42	<i>0.62</i>
0910 Other matters in the sphere of health care, physical culture and sports	–	–	–	–	–	1.74	<i>1.01</i>
1000 SOCIAL POLICY	–	–	–	–	–	0.01	–
1003 Social security of the population	–	–	–	–	–	0.02	–
1100 INTERBUDGETARY TRANSFERS	–	–	–	–	0.16	–	–
1101 Subsidies to budgets of the RF Subjects and municipal entities	–	–	–	–	0.50	–	–

Source: the IET calculations by the 2003-2010 federal budget data (the 2003-2007 data have been adjusted to the respective sections and subsections of the budget classification that took effect as of January 2008). Estimates made on the basis of Federal Act № 185-FZ of 23.07.2010 are given in italics.

The lowering of the transparency rate of the federal budget over the past three years makes it possible to estimate it only using complementary sources. In this particular case, we used materials of a Ministry of Finance's memorandum to the bill. The document enable us to restore a structure of expenditures across sections and subsections of the classification for the previous, July, variant of the federal budget Act¹, and a conclusion of the Committee of Defense and Security of the Federation Council on the October version of the bill². This way of data aggregation undoubtedly affects the accuracy of the estimates.

Absolute and relative values of main components of direct military appropriations of RF in the federal budget and their change relative to the final variant of the 2010 federal budget Act are given in Table 36 (the re-calculation into the 2009 prices was made with the use of the Rosstat's first estimate of the index-deflator of GDP for 2010³).

Table 36

Direct Military Appropriations in the Federal Budget on Section 02 «National Defense»

Section and subsections	2010, as Rb mln / the same in the 2009 prices	Change 2010/2009 as Rb. mln./ increase as %	Allocated proportion, as % / change vs. 2009, as p.p.	
			In the 2010 federal budget	In GDP
1	2	3	4	5
NATIONAL DEFENSE	<u>1 278 027</u>	<u>-34 184</u>	<u>12,46</u>	<u>2,87</u>
	1 158 682	-2,87	0,34	-0,20
The Armed Forces of the Russian Federation	<u>959 563</u>	<u>-17 959</u>	<u>9,36</u>	<u>2,16</u>
	869 958	-2,02	0,34	-0,13
Mobilization and out-base training	<u>2 607</u>	<u>-1 260</u>	<u>0,03</u>	<u>0,01</u>
	2 363	-34,78	-0,01	–

¹On introduction of amendments to the Federal Act «On the federal budget for 2009 and the planned period of 2010 and 2011»: Federal Act № 185-FZ: passed by the State Duma on 07 July 2010.

² Conclusion of the Defense and Security Committee of the Federation Council № 3.5-07/1466 of 26 October 2010.

³ On production and use of the gross domestic product (GDP) for 2010. M.: Rosstat, 31 January 2011. See: http://www.gks.ru/bgd/free/B04_03/IssWWW.exe/Stg/d01/17vvp31.htm.

(continued) table 36

1	2	3	4	5
Mobilization preparation of the economy	4 895	1 057	0,05	0,01
	4 438	31,27	0,01	–
Preparation for and contribution to provision of collective security and peacekeeping operations	11 087	9 788	0,11	0,02
	10 051	3 713,09	0,11	0,02
Nuclear weapons complex	18 755	–2 077	0,18	0,04
	17 003	–10,89	–0,01	–0,01
Implementation of international obligations in the military-technical cooperation area	4 210	–638	0,04	0,01
	3 817	–14,32	–0,01	–
Applied research in the national defense area	148 680	–28 100	1,45	0,33
	134 797	–17,25	–0,20	–0,09
Other issues in the national defense area	128 229	5 004	1,25	0,29
	116 255	4,50	0,12	–

Source: the IEP calculations

Military appropriations out of other sections of the federal budget are presented in *Table 37* (with estimates made on the basis of the July version of the federal budget Act given in italics). It should be noted that rather an impromptu novelty in the form of Rb. 2bln. that popped up in the summer in Section 01 “General public administration matters» “on construction of new production capacities of JSC “Concern PVO “Almaz-Antey” on manufacturing perspective next-gen ADMS”¹ is not presented in the *Table*, albeit it was factored into subsequent calculations.

Appropriations on housing construction by the Ministry of Defense by Section 02 “National defense” increased by 37% in real terms on a year-on-year basis, and by another 34% - by Section 05 “The Housing and utility”, which nonetheless, did not ensure attainment of the declared goal of provision of the military with permanent housing by 2010. The federal budget appropriations on the so called housing certificates increased by 54% (see *Table 37*), and the ones on the mortgage system for the military – by 47%.

Table 37

Direct and Indirect Military Expenditures across Other Sections of the Federal Budget

Name of subsection Or nature of appropriations	2010, as Rb mln / the same in the 2009 prices	Change 2010/2009 as Rb. mln./ increase as %	Allocated proportion, as % / change vs. 2009, as p.p.	
			In the 2010 federal budget	In GDP
1	2	3	4	5
In Section 03 «National security and law enforcement activity»				
Law enforcement forces	66 433	2 578	0,65	0,15
	60 230	4,47	0,06	–
Security agencies	201 507	2 936	1,96	0,45
	182 691	1,63	0,14	–0,01
The border guard structures	77 427	–9 937	0,75	0,17
	70 196	–12,40	–0,06	–0,03
<i>The RF MES forces and civil defense</i>	46 140	323	0,45	0,10
	41 831	0,78	0,03	–
In Section «National economy»				
Organization of the alternative civil service	6	–1	<0,01	<0,01
	5	–9,34	–	–
Subsidies to transportation organizations that exercise procurements of motor vehicles for completion of the mobile component of motor columns.	1 069	–112	0,01	<0,01
	970	–10,33	–	–
Subsidies to the functioning of the Russia-NATO coordination center	55	–30	<0,01	<0,01
	50	–37,65	–	–

¹ Memorandum of the RF Ministry of Finance to bill № 389589-5, submitted to the State Duma on 11 June 2010, p 40.

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(continued) table 37

1	2	3	4	5
Construction of special and military objects	<u>21</u>	<u>-2</u>	<u><0,01</u>	<u><0,01</u>
	19	-9,34	-	-
<i>FTP «Industrial utilization of weaponry and military hardware (2005–2010)»</i>	<u>15 131</u>	<u>9 401</u>	<u>0,15</u>	<u>0,03</u>
	13 718	217,75	0,10	0,02
<i>Subsidies to “Rostekhnologii” public corporation</i>	<u>36</u>	<u>-12</u>	<u><0,01</u>	<u><0,01</u>
	33	-27,24	-	-
Realization of public functions associated with provision of the national defense	<u>3 544</u>	<u>-497</u>	<u>0,03</u>	<u>0,01</u>
	3 213	-13,39	-	-
<i>Contributions to authorized capital and subsidies to organizations of the defense and industrial complex</i>	<u>23 185</u>	<u>-20 402</u>	<u>0,23</u>	<u>0,05</u>
	21 020	-49,25	-0,19	-0,05
<i>Classified expenditures</i>	<u>22 282</u>	<u>9 546</u>	<u>0,22</u>	<u>0,05</u>
	20 201	89,59	0,11	0,02
In Section 05 «Housing and Utilities Sector»				
<i>FTP «Industrial utilization of weaponry and military hardware (2005–2010)»</i>	<u>1 418</u>	<u>-880</u>	<u>0,01</u>	<u>=</u>
	1 286	-40,63	-0,01	-
<i>Provision of the military with the departmental and permanent housing</i>	<u>125 916</u>	<u>29 531</u>	<u>1,23</u>	<u>0,28</u>
	114 158	34,90	0,37	0,06
<i>Classified expenditures</i>	<u>35 708</u>	<u>18 028</u>	<u>0,35</u>	<u>0,08</u>
	32 374	125,67	0,20	0,04
In Section 07 «Education»				
The RF Defense Ministry’s expenditures	<u>44 511</u>	<u>-1 961</u>	<u>0,43</u>	<u>0,10</u>
	40 355	-4,63	-	-0,01
<i>Classified expenditures</i>	<u>14 576</u>	<u>952</u>	<u>0,14</u>	<u>0,03</u>
	13 215	7,76	0,02	-
In Section 08 «Culture, motion picture industry, mass media»				
The RF Defense Ministry’s expenditures	<u>4 893</u>	<u>903</u>	<u>0,05</u>	<u>0,01</u>
	4 436	25,57	0,01	-
<i>Classified expenditures</i>	<u>207</u>	<u>-13</u>	<u><0,01</u>	<u><0,01</u>
	188	-6,54	-	-
In Section 09 «Health Care, Physical Culture and Sports»				
The RF Defense Ministry’s expenditures	<u>33 339</u>	<u>-837</u>	<u>0,33</u>	<u>0,07</u>
	30 226	-2,70	0,01	-0,01
<i>Classified expenditures</i>	<u>10 186</u>	<u>-2 655</u>	<u>0,10</u>	<u>0,02</u>
	9 235	-22,33	-0,02	-0,01
In Section 10 «Social Policy»				
<i>The RF Defense Ministry’s pension plans</i>	<u>125 908</u>	<u>-1 487</u>	<u>1,23</u>	<u>0,28</u>
	114 151	-1,29	0,05	-0,02
<i>The FSB pension plans</i>	<u>18 956</u>	<u>-368</u>	<u>0,18</u>	<u>0,04</u>
	17 185	-2,10	-0,01	-
<i>Procurement of housing for the retired and designated for retirement military</i>	<u>18 048</u>	<u>5 765</u>	<u>0,18</u>	<u>0,04</u>
	16 363	54,39	0,07	0,01
<i>Complementary monthly material allowance to the disabled due to the military injures</i>	<u>396</u>	<u>-14</u>	<u><0,01</u>	<u><0,01</u>
	359	-3,65	-	-
<i>Provision for conduct of refurbishment of individual housing owned by the families of military that have lost the breadwinner</i>	<u>401</u>	<u>47</u>	<u><0,01</u>	<u><0,01</u>
	363	14,74	-	-
<i>Compensations to family members of the deceased military</i>	<u>975</u>	<u>-596</u>	<u>0,01</u>	<u><0,01</u>
	884	-40,28	-0,01	-
<i>Relief and compensations to the military, individuals equaled to them, and those dismissed from their ranks</i>	<u>11 226</u>	<u>-2 175</u>	<u>0,11</u>	<u>0,03</u>
	10 178	-17,61	-0,02	-0,01
<i>Social support and rehabilitation of disabled because of military actions and combat trauma</i>	<u>71</u>	<u>-42</u>	<u><0,00</u>	<u><0,00</u>
	64	-39,40	-	-
In Section 11 «Interbudgetary transfers»				
<i>Subsidies to CATEs’ budgets</i>	<u>8 876</u>	<u>-3 490</u>	<u>0,09</u>	<u>0,02</u>
	8 047	-30,25	-0,03	-0,01
<i>Development of, and support to the CATEs’ social and engineering infrastructure</i>	<u>2 690</u>	<u>-2 974</u>	<u>0,03</u>	<u>0,01</u>
	2 439	-54,94	-0,03	-0,01
<i>Running the primary military and conscription records in territories with no military commissariats in place</i>	<u>1 998</u>	<u>-255</u>	<u>0,02</u>	<u><0,01</u>
	1 812	-12,33	-	-

(continued) table 37

1	2	3	4	5
One-time allowance to a conscript's pregnant wife and the monthly allowance for a conscript's child	<u>1 977</u>	<u>715</u>	<u>0,02</u>	<u><0,01</u>
	1 792	66,40	0,02	-
Residents relocation from CATE	<u>527</u>	<u>-840</u>	<u>0,01</u>	<u><0,01</u>
	478	-63,74	-0,01	-
Material security for specialists of the nuclear-arms complex of RF	<u>4 165</u>	<u>473</u>	<u>0,04</u>	<u>0,01</u>
	3 776	14,32	0,01	-
Complementary monthly material security for disabled due to the military injury	<u>645</u>	<u>-70</u>	<u>0,01</u>	<u><0,01</u>
	585	-10,67	-	-

Source: the IEP calculations.

Appropriations on the military personnel of the Ministry of Defense in real terms practically remained unchanged (with no raises in money allowance and pensions to the military in 2010), while out of Rb. 283 bln. earmarked to the Ministry of Defense in compliance with the federal budget Act on money allowances to the military as much as Rb. 22,894 bln. was saved across all 12 target expenditure items, or thrice as big as the prior year's figure (Rb. 7, 637 bln.). That is to say, the expenditure item "Military personnel" continues seeing a surplus whose existence cannot be ascribed to the quality of planning.

The target expenditure item "Military training" was crossed out from the 2010 budget classification. Appropriations for fuel and lubricants rose by 7% in real terms, but failed to compensate for the accelerated price rise for diesel fuel and jet fuel, all the more so, as by the end of the year the MoD had saved Rb. 8,105 bln. (16.5% of the earmarked amount) under the target expenditure item "Payment for, and storage of, special fuel and fuel and lubricants". The actual cut-backs on procurements of fuel and lubricants still failed to notably improve military training indicators in the Army and Navy compared with the prior year, when MOD had to cover a substantial fraction of its needs at the expense of its own inventories. The Ministry's actual spending on food supplies was up by 31.5% on a year-on-year basis, while those on material support dwindled again – this time by 16%.

The 2010 appropriations on military pensions in nominal terms were increased by 8.9% vs. the prior year, which can be ascribed just to the rise in the cohort of military pensioners due to cuts in the officer corps and liquidation of the institution of senior warrant officers. The MoD managed to save as much as Rb. 658 mln. on the target expenditure item "Pension provision".

The 2010 direct military appropriations (*Table 38*) calculated according to the UN military expenditure standard accounted for 4.5% of the nation's GDP, while, having been factored into appropriations associated with the past military activity (military pensions, utilization of chemical weapons, etc.), they hit 5.0% of Russia's GDP.

Execution of the 2010 federal budget with regard to military expenditures did not display any drastic differences vs. the 2009 figures. Specifically, the Federal Treasury reports evidence a Rb 3,113 bln.-worth excess of the limit of expenditures by the consolidate budget quarterly breakdown over appropriations by section 02 "National defense" earmarked in compliance with the effective budget Act, which was noted since February. The said excess hit its peak in November (Rb. 15,863 bln.) and subsequently slid to 10,711 bln. by the end of the year. While assessing the executive branch's discretionary powers, a benchmark reference point is stipulated in part 1 Art. 24 of the 2010 federal budget Act, which capped an increase in military appropriations at the expense of above-the-plan budget revenues in the frame of the consolidate budget quarterly breakdown with Rb. 8,879 bln. Consequently, by results of 2010, section 02 "National defense" posted savings worth a total of Rb. 1,546 bln., though 14,833 bln. was overspent on subsection 0201 "Armed Forces of RF" and another Rb. 4, 418

bln. was overspent on subsection 0208 “Applied research in the defense area”, and both amounts were compensated for by savings across other subsections of section 02 “National defense”. In addition, a substantial reallocation of budget funds occurred in the MoD’s budgets wherein savings on just fuel and lubricants (in other words, on military training) and money allowance to the military accounted for Rb. 31 bln. One can only guess on what the saved funds were spent.

Table 38

Aggregate Indicators of the Federal Budget Military Expenditures and Other Associated Expenditures

Expenditure	Amount of appropriations, as Rb. mln	Proportion of appropriations, as % / its change vs 2009 r., as p.p.	
		In the 2009 federal budget	In GDP
Overall direct military appropriations	2 020 637	19,70 1,09	4,54 -0,18
Aggregate direct and indirect military appropriations related to the current and past military activity	2 204 479	21,49 1,18	4,95 -0,20
Aggregate appropriations across sections “National defense” and “National security and law enforcement activity”	2 366 702	23,08 0,57	5,32 -0,39

Source: the IET calculations

The situation with the savings and overspending deserves a greater attention, for the aforementioned spare expenditures on the MoD’s military personnel proved substantially greater than figures the Federal Treasury references to in its federal budget execution reports. Table 39 gives a better idea of the size of spare amounts and cushions between the military budgets and reports on its execution. The Table was compiled on the basis of the data Russian Federation supplies annually by results of execution of military expenditures to the UN Secretary-General.

Table 39

Unallocated Appropriations in RF Expenditures on the Military Personnel in 2000–2009, as Rb. Mln.

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
22 465	37 291	40 692	61 743	61 850	53 629	78 188	88 399	113 259	127 685

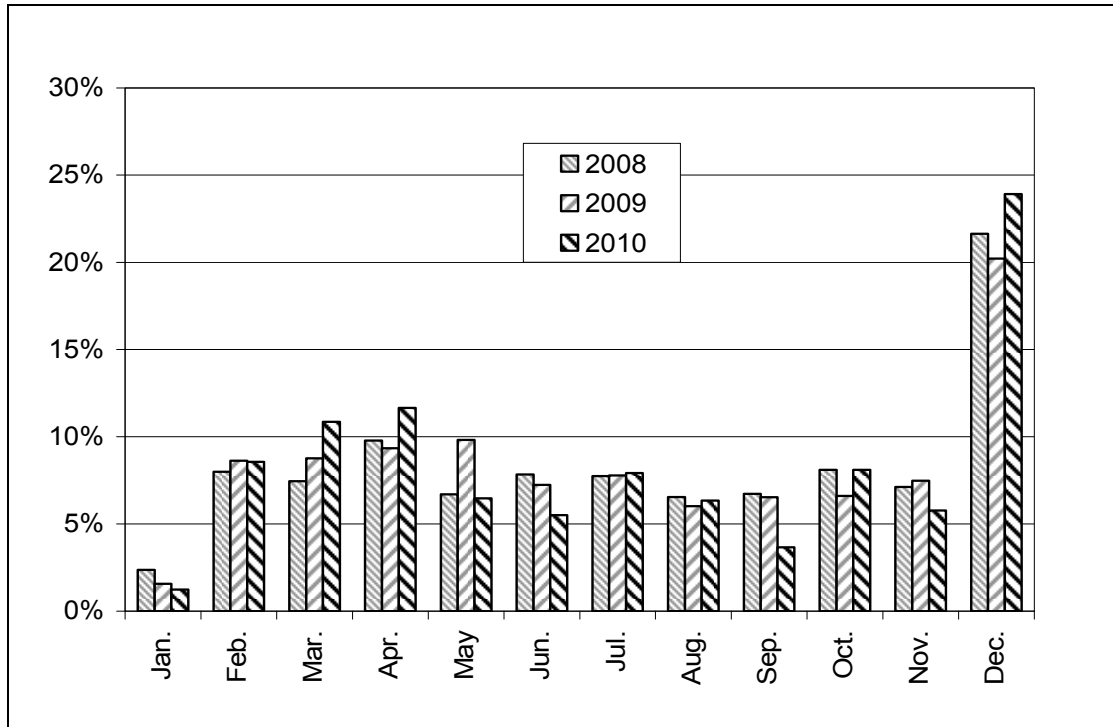
Source: Objective information on military issues, including transparency of military expenditures: Reports by the UN Secretary-General, 2001–2010.

The aforementioned “unallocated appropriations” accounted for between 9 and 17% of the section “National defense” (or 0.25–0.47% of GDP) and proved many-fold greater than, for example, expenditures on the notorious 2004–2007 Federal Target Program¹, on transition to draft so ingloriously failed by MoD as its customer and coordinator. Reasons behind, and the sense of, such a stubborn demonstration of the failure to allocate quite a sizable fraction of the nation’s military spending are of course mind-boggling.

The monthly dynamic of execution of expenditures across the largest subsections of the section “National defense” between 2008 and 2010 is presented in Fig. 20–22. It is quite visible that the trend to contraction of the “budget overhang” accumulating by the end of the year, which manifested itself in 2009, the next year remained only in the R&D spending. Mean-

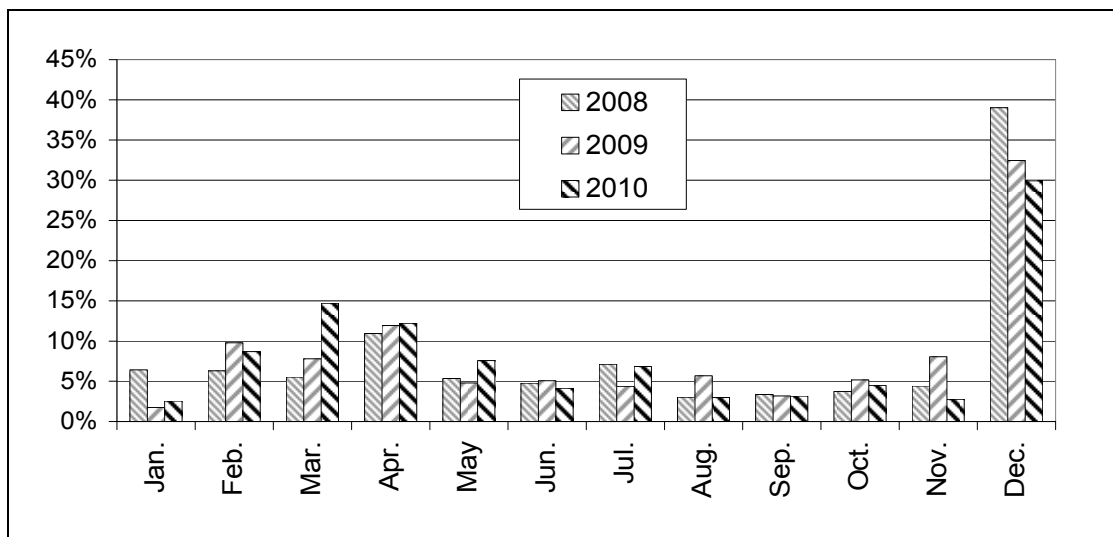
¹ According to the Federal Treasury, the Government spent on this FTP as much as Rb 84,377 (See: URL: <http://fcp.economy.gov.ru/cgi-bin/cis/fcp.cgi/Fcp/ViewFcp/View/2007/166/> . Access date: 10.02.2011).

while, the two-month deadline for conclusion of contracts in the beginning of the year is not met, while the peak of making advance payments shifts to March and April.



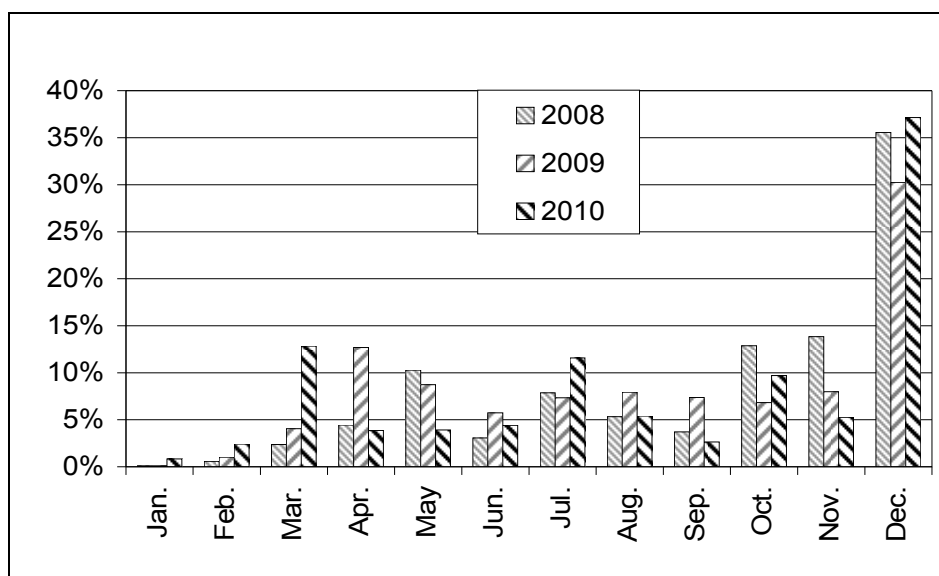
Source: the IET calculations basing on the Federal Treasury data.

Fig. 20. Execution of the Federal Budget Expenditures by Sub-Section 0201 «The Armed Forces of the Russian Federation» in 2008–2010



Source: the IET calculations basing on the Federal Treasury data

Fig. 21. Execution of the Federal Budget Expenditures by Sub-Section 0207 «Applied research in the area of national defense» in 2008–2009



Source: the IET calculations basing on the Federal Treasury data.

Fig. 22. Execution of the Federal Budget Expenditures by Section 0208 «Other Matters in the Area of National Defense» in 2008–2010

Table 40 evidences that long-standing trends continue to persist in the Federation Subjects' military expenditures – the ones on mobilization and out-of-army training generally do not exceed the amount of transfers from the federal budget on exercising the primary military registration. (See Table 37).

Table 40

Military Expenditures of the Consolidated Budgets of the Federation Subjects in 2004–2010, as Rb. mln*

Name of the sub-section of the expenditure classification	2003	2004	2005	2006	2007	2008	2009	2010
The Armed Forces of the Russian Federation	=	=	=	3,5	0,5	0,3	=	=
Modernization of the Armed Forces of the Russian Federation and military establishments	=	=	=	=	=	1,0	=	=
Mobilization and out-of-army training	13,1	=	65,6	899,3	1 351,9	1 797,9	2 116,0	2 003,7
Mobilization preparation of the economy**	449,7	532,4	485,4	708,3	861,2	1 137,2	1 045,4	1 298,4
Other matters in the national defense area	=	=	109,6	32,8	5,5	0,7	4,4	<0,1
Ministry of Interior forces	14,6	12,4	9,9	3,5	1,0	0,3	=	=
Security agencies	3,7	6,7	0,3	16,5	0,1	0,0	60,0	<0,1
Border Guard bodies	=	=	0,1	=	=	=	=	=
Population and territory protection from emergency situations of natural and technogenetics situations, civil defense	6 511,0	7 968,2	11 184,6	15 636,4	19 118,4	23 895,8	23 865,0	27 218,0
	6 244,1	7 281,3	10 958,9	14 367,0	18 292,6	21 456,7	21 712,6	25 527,4

*numerator – as allocated, common denominator – as eramarked.

** had not been included in the section “National defense” until 2005.

Source: the Federal Treasury.

Table 41 presents Russia's military expenditures over the period of 1999–2010. To avoid double count the data do not comprise the ones presented in *Table 40*.

Table 41

Key indicators of the RF military expenditure in 1999-2010

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
1	2	3	4	5	6	7	8	9	10	11	12	13
1. In nominal terms (in current prices), as Rb.blm												
Execution of the federal budget expenditures by Section "National Defense" in the current budget classification ^a	115,6	191,7	247,7	295,4	355,7	430,0	581,1	681,8	831,9	1 040,8	1 188,2	1 276,5
The federal budget appropriations by Section "National Defense":	93,7	209,4	214,7	284,2	354,9	427,4	578,4	686,1	839,1	1 031,6	1 192,9	1 278,0
in the current budget classification												
placed into other sections of the budget classification ^b	–	–	–	–	–	–	44,3	77,7	91,3	126,5	202,4	270,8
In a comparable budget classification	93,7	209,4	214,7	284,2	354,9	427,4	622,6	763,9	930,4	1 158,1	1 395,3	1 548,8
Military expenditures, the UN data ^c	–	202,6	294,4	325,9	447,0	499,0	665,0	822,1	850,2	1 127,2	1 176,4	–
Overall direct military appropriations ^d	128,9	270,4	283,4	357,7	464,2	552,7	770,3	1 003,9	1 214,4	1 502,8	1 832,5	2 020,6
Direct and indirect military appropriations associated with the current and past military activity, combined ^e	144,0	304,6	329,6	460,1	602,3	638,8	855,1	1 090,4	1 375,6	1 645,4	1 999,5	2 204,5
2. In real terms (in the 2009 prices)^f, as Rb. blm												
Execution of the federal budget expenditures by Section "National Defense" in the current budget classification	1 051,4	1 123,6	1 090,7	1 106,8	1 092,5	1 126,9	1 253,2	1 174,4	1 230,9	1 298,6	1 409,2	1 276,5
The federal budget appropriations by Section "National Defense":	952,3	1 227,5	945,3	1 063,9	1 090,1	1 120,0	1 229,3	1 181,9	1 240,6	1 287,0	1 414,7	1 278,0
in the current budget classification												
placed into other sections of the budget classification	–	–	–	–	–	–	94,1	133,9	135,0	157,8	240,1	270,8
In a comparable budget classification	852,3	1 227,5	945,3	1 063,9	1 090,1	1 120,0	1 323,4	1 315,7	1 375,6	1 444,9	1 654,8	1 548,8
Military expenditures, the UN data	–	1 187,6	1 296,4	1 220,3	1 373,0	1 307,6	1 413,4	1 416,0	1 257,0	1 406,3	1 395,3	–
Overall direct military appropriations	1 172,4	1 584,9	1 247,8	1 339,1	1 425,8	1 448,4	1 637,3	1 729,2	1 795,4	1 875,1	2 173,3	2 020,6
Direct and indirect military appropriations associated with the current and past military activity, combined	1 309,9	1 785,4	1 451,2	1 722,9	1 849,9	1 674,2	1 817,6	1 878,1	2 033,7	2 052,9	2 371,4	2 204,5
3. In real terms (in the 1999 prices)^f, as Rb. blm												
Execution of the federal budget expenditures by Section "National Defense" in the current budget classification	115,6	123,5	119,9	121,6	120,1	123,9	135,8	129,1	135,2	142,8	154,9	140,3
The federal budget appropriations by Section "National Defense":	93,7	135,0	103,9	117,0	119,8	123,1	135,2	129,9	136,4	141,5	155,5	140,5
in the current budget classification												
placed into other sections of the budget classification	–	–	–	–	–	–	10,3	14,7	14,8	17,4	26,4	29,8
In a comparable budget classification	93,7	135,0	103,9	117,0	119,8	123,1	145,5	144,7	151,2	158,9	181,9	170,3

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(continued) table 41

	1	2	3	4	5	6	7	8	9	10	11	12	13
Military expenditures, the UN data	–	130,6	142,5	134,2	151,0	143,8	155,4	155,7	138,2	154,6	153,4	–	
Overall direct military appropriations	128,9	174,3	137,2	147,2	156,8	159,2	180,0	190,1	197,4	206,1	238,9	222,2	
Direct and indirect military appropriations associated with the current and past military activity, combined	144,0	196,3	159,5	189,4	203,4	184,1	199,8	206,5	223,6	225,7	260,7	242,4	
4. Military burden on the economy, as % of GDP													
Execution of the federal budget expenditures by Section "National Defense" in the current budget classification	2,40	2,62	2,77	2,73	2,69	2,53	2,69	2,53	2,50	2,52	3,06	2,87	
The federal budget appropriations by Section "National Defense":	1,94	2,87	2,40	2,63	2,69	2,51	2,68	2,55	2,52	2,50	3,07	2,87	
in the current budget classification	–	–	–	–	–	–	0,20	0,29	0,27	0,31	0,52	0,61	
placed into other sections of the budget classification	–	–	–	–	–	–	0,20	0,29	0,27	0,31	0,52	0,61	
In a comparable budget classification	1,94	2,87	2,40	2,63	2,69	2,51	2,88	2,84	2,80	2,81	3,60	3,48	
Military expenditures, the UN data	–	2,77	3,29	3,01	3,38	2,93	3,08	3,05	2,56	2,73	3,03	–	
Overall direct military appropriations	2,67	3,70	3,17	3,31	3,51	3,25	3,56	3,73	3,65	3,64	4,72	4,54	
Direct and indirect military appropriations associated with the current and past military activity, combined	2,99	4,17	3,69	4,25	4,56	3,75	3,96	4,05	4,14	3,99	5,15	4,95	
5. By purchasing power parity (in current prices), as USD bln .													
Execution of the federal budget expenditures by Section "National Defense" in the current budget classification	21,9	26,8	30,2	31,9	34,2	36,2	45,6	48,0	52,9	57,1	64,4	64,3	
The federal budget appropriations by Section "National Defense":	17,7	29,3	26,2	30,7	34,1	35,9	45,4	48,3	53,4	56,6	64,7	64,4	
in the current budget classification	–	–	–	–	–	–	3,5	5,5	5,8	6,9	11,0	13,6	
placed into other sections of the budget classification	–	–	–	–	–	–	3,5	5,5	5,8	6,9	11,0	13,6	
In a comparable budget classification	17,7	29,3	26,2	30,7	34,1	35,9	48,9	53,8	59,2	63,6	75,6	78,0	
Military expenditures, the UN data	–	28,3	35,9	35,2	42,9	42,0	52,2	57,9	54,1	61,9	63,8	–	
Overall direct military appropriations	24,4	37,8	34,6	38,6	44,6	46,5	60,5	70,7	77,2	82,5	99,3	101,7	
Direct and indirect military appropriations associated with the current and past military activity, combined	27,2	42,6	40,2	49,6	57,9	53,7	67,1	76,8	87,5	90,3	108,4	111,0	
For reference													
GDP deflator, as % to the prior year	172,5	137,6	116,5	115,5	113,8	120,3	119,3	115,2	113,8	117,9	102,0	110,3	
Public administration final consumption expenditure deflator ^g , as % to the prior year	140,1	155,2	133,1	117,6	121,9	117,2	123,3	123,4	116,5	118,5	105,2	118,6	
Purchasing power parity ^h , as Rb/USD	5,29	7,15	8,19	9,27	10,41	11,89	12,74	14,20	15,72	18,22	18,45	19,86	

^a For 2010 – the Federal Treasury preliminary data on execution of the federal budget.

^b The Defense Ministry expenditures and secret expenditures by sections 04–09 and 11 of the federal budget in 2005–2010.

^c The RF Government did not submit the 1999 data to the UN; the 2010 data will be submitted in 2011, inclusive of expenditures on the Ministry of Interior forces, the Board Guard and civil defense,

^d Including on the Ministry of Interior forces, the Board Guard, civil defense, and other elements of the military organization

^e Inclusive of pensions due to the military.

^f Deflated by means of the public administration final consumption expenditure deflator.

^{g,h} For 2010 - as estimated by the IET.

Sources: the 1999–2010 federal acts on federal budget and its execution; *Natsionalnye scheta Rossii v 1997–2009 godakh:* Stat. sb./Rosstat. M., 2005–2010; *Obyektivnayay informatsiya po voennym voprosam, vklyuchaya transparentnost voennykh raskhodov. Doklady Generalnogo Sekretarya OON 2001–2010;* Rosstat; the Federal Treasury.

6.6.4. Conclusions and Recommendations

Launched with benevolent intentions but designed in private, the transition of Russia's AF to the "new look" produced controversial outcomes: cuts in the excessive number of officers and volume of assets and diminishment of the government's obligations with regard to provision of housing to the military, on the one hand, and a great number of grievous failures, on the other. The central drawback is negligence of needs of the bulk of the military and even more so – of the civil society's. The rising number of economic crimes is a perfect proof of flaws in the transformation of MoD and AF RF. Behind the crimes are numerous factors and the abundant disinformation in particular, whose roots are in bureaucracy, and rarely does the Commander-in-Chief conceive of it as lies. The most recent evidence of crudity was the decision to create the national airspace defense and, accordingly, to increase the number of officers in AF RF by 70,000¹.

The remedy lies only in frankness, openness of plans, transparency of budgeting and the budget classification (to be maintained according to the UN standards and the civilized nations' experience), control over public spending and the so called "extrabudgetary" revenues and expenditures. Public control over military spending is critical.

The recommendation is not new, but ignoring it now is pregnant with not just continuation of the past deficiencies, but irreparable consequences. The country is unlikely to be saved by brave assurances and orders the President gave at a recent meeting of the AF leadership: "All the planned measures...on reforming should be most thoroughly calculated and secured logistically. To this end, the military budget was adjusted and control over spending was organized. I draw attention of all the leadership of the Ministry of Defense: all these processes should be completed in coordination with other government structures, so that we will have here an absolute accuracy"².

In 2011, the military spending increase by 20% vs. the 2010 figures, with the increment spent on weaponry for the army. But new arms will be given to untrained and forced to service troops. None of the military leadership has bothered even to entertain the idea of reallocating a tiny fraction of the said 20% increase to ensure a voluntary, draft-based recruitment to AF RF. No one cared to better train troops, improve their military skills and combat efficiency. Corruption interests prevailed, and that became a major threat to Russia's national security.

¹ Mokhov V. *Vopros gosudarstvennoy vazhnosti*//Krasnaya zvezda. 2011. 3 February (№17).

² Telmanov D. *Serdyukov prodolzhit voennuyu reform s absolutnoy tochnostyu*// GZT.ru. 11.2010. – URL: <http://www.gzt.ru/topnews/politics/-serdyukov-prodolzhit-voennuyu-reformu-s-/336314.html>. Access date: 10.02.2011.

6.7. The Year of 2010 – Completion of the Municipal Counter-Reform

When compared with 2009, the last year did not bring anything new into processes in the municipal self-governance area. Dr. Emil Markwart, President of the European Club of Experts on Local Self Government and one of prominent experts in this area, wittily labeled the processes “centralization, vertikalization and partyzation” of local self-governance¹. His words are proved by the following last year’s processes:

- Inclusion in the law on local self-governance of amendments that provide for a possibility not to establish a local administration in a settlement, which is the administrative center of a municipal district, while the municipal district administration may exercise the respective functions;
- Conducted by regional administrations, the “managerial revolution” has been unfolding in cities and municipal districts in many RF Subjects. The ultimate objective of the revolution became abolition of direct mayoral elections and introduction of the institution of city managers;
- “modernization” of the electoral system aimed at the increase of the nationwide parties’ role in local elections.

6.7.1. Consolidated Administrations of the Municipal District and the District Center²

In the spring of 2010, the Legislative Assembly of Leningrad oblast submitted to the State Duma a legislative initiative which allowed one to establish a consolidated administration for a municipal district and a settlement that forms its administrative center. The authors of the initiative believe that would reduce administrative costs and lower the level of uncertainty of residents of municipal district centers about which administration they should appeal to in order to solve their problems.

Originally, this legislative initiative was blocked and failed to mobilize the expert community³ and a number of federal structures’ support. More specifically, the Legal Department of the State Duma⁴ submitted its negative comments to the profile State Duma Committee for self-governance: the Legal Department fairly believed that, had the bill in question been passed, it would have cast a doubt upon the possibility of implementation of the principles underpinning the local self-governance bodies’ independence, transparency and accountability. The RF Government did not render its support to the bill, either. The State Duma Committee for self-governance first considered the bill at its meeting on 2 June 2010. Having

¹ Markwart E. Vse mestnoye samoupravili po vertikali. Ot vyborov merov tozhe reshili otkazatsya// Ё-Online. 27.12.2010 – URL: <http://kommersant.ru/doc.aspx?DocsID=1564980&print=true>. Access date: 26.01.2011.

² This problem was discussed in a greater detail in the IET’s monthly reports. See: Starodubrovskaya I., Mironova N. Novaya initsiativa po ogranicheniyu prav poseleniy ustanovlena: nadolgo li? // Rossiyskaya ekonomika v 2010 godu: tendentsii i perspektivy. Ezhemesyachy obzor. M., IET, 2010; Starodubrovskaya I., Mironova N. Predstavleniya o mestnom samoupravlenii Evropy i Rossii raskhodyatsya vse dalshe// Rossiyskaya ekonomika v 2010 godu: tendentsii i perspektivy. Ezhemesyachy obzor. M., IET, November 2010.

³ Motyakova O. “K voporsu o vozmozhnosti obyedineniya rayonnoy i gorodskoy administratsii//Munitsipalnyaa vlast, № 2 (March-April) 2010, pp. 14-15. An appeal by the European club of experts in local self-governance to Y. Mildon, head of the Congress of Local and Regional Authorities of the Council of Europe.

⁴ The drafting of the document was commissioned by the State Duma Council of 9 February 2010 (Minutes № 175, p. 28).

found “legal uncertainties” and contradictions to Russia’s international obligations therein, the Committee recommended MPs to decline the bill. However, in the mid-summer the Committee’s opinion reversed at 180 degrees, and on 7 July 2010 the amendment to the federal Act № 131-FZ, which foresees that in the event no local administration is to be established in an urban municipal entity, its mandate has to be assigned to the district administration, was passed by the State Duma in the first reading.

While preparing the amendment for the second reading, the scope of the amendment’s effect was broaden - the possibility to establish consolidated administrations was likewise foreseen for both urban settlements and any other settlements that form administrative centers of municipal districts. Meanwhile, the MPs dumped the idea of a meticulous regulation of consolidation procedures and left the problem of setting concrete mechanisms of interaction between the municipal district and the settlement at the discretion of those local self-governance bodies which would seek to establish a consolidated administration. That occurred shortly after a *de facto* failure of an attempt to regulate these problems in the law in the course of preparation of the amendment for the second reading.

In its final form, the amendment reads that the Statute of a municipal district and a settlement that forms its administrative center may provide for establishment of the local district administration to which the exercise of powers of the local administration of the said settlement should be assigned. While forming a contest commission in a municipal district, one-third of its members should be appointed by the municipal district’s representative body, another one-third - by the representative body of the settlement, and the remaining one-third – by the legislative body of the RF Subject upon submission of the supreme public official of the RF Subject. In November 2010, the RF President signed the respective amendments into the law¹.

It was not for the first time that the idea of establishment of consolidated administrations arose in the course of the debate on municipal reform, but it had earlier been considered in an absolutely different context. While discussing the draft of Federal Act № 131-FZ “On general principles of organization of local self-governance in RF”, it was proposed to provide for a possibility to establish consolidated administrations at the settlement level. That would help quench the cadre hunger and optimize costs. To cite an example, Germany boasts a similar experience, and numerous provisions of the municipal reform have become a replica of the Germany’s local self-governance mechanisms. However, the proposal was discarded at that stage. The new municipal law provided for a mandatory formation in each municipal entity of not only the representative body of local self-governance, as before, but the municipal entity’s head and local administration as well.

The effective mechanism of consolidated administrations bears an utterly different ideological load, for it constitutes an attempt to remedy, by means of raw power, an objective conflict that emerges under the two-tier municipal governance system. To grasp its very core, it should be noted that, according to the general rule, district centers appear the strongest settlements, with the greatest development potential and concentration of the most valuable resources. In the circumstances, the district authorities’ interests with respect to allocation and employment of these resources are objectively polar to the settlement’ authorities’ ones. Corruption-driven problems aside, there emerges a conflict of interests between deployment of

¹ Federal Act of 29.11.2010.№ 315-FZ “on introducing amendments to the Federal Act “On general principles of organization of local self-governance in RF”.

resources for the sake of development and their use for equalization purposes. Solving it necessitates bringing the conflict into the institutional framework, forming rules of the game that could ensure a balance of interests and fuel efficacy of implementation of each of them. Needless to say, creation of consolidated administrations does not solve the problem, and the latent conflict is still there, as brilliantly exemplified by formation of a local budget as cited in V. Chernikov's paper: "While drafting the district budget, the administration will have to be at pains to slash the part of spending for which the administrative center can qualify. As far as the city's budget is concerned, the same administration should strive to get a maximum possible piece of the budget cake from the district's budget. As these two things are impossible to do simultaneously, the administration will have to choose whom to block with, and here already is the conflict between two representative bodies, neither of which has a right to consent for infringement of its respective municipality's rights"¹.

Evidently, a conflict of this kind can be solved solely by means of the "administrative resource", which, in the overwhelming majority of cases, takes sides with the district administration. Hence a drastic weakening of one of the conflicting parties – namely, the district center, which in most cases forms the municipal district's development force. At this junction, there are practically no mechanisms left to counter the district authorities' *diktat* in this regard. As well, a contracted head of the consolidated administration, who has been appointed thanks to the regional and district authorities' joint efforts and pursues the municipal district's stance on all debatable issues sees no opposition to his activities. At this point, Anatoly Lokot, MP, was right to assert that, "This amendment and the Act on the whole open up a mechanism under which there will be no local self-governance at the district center settlement level ... In our opinion, it launched a mechanism of liquidation of local self-governance as a whole"².

Meanwhile, notably, that such novelties may have an adverse impact not only on the state of local self-governance. Our research showed that district heads often take a fairly conservative stance on compression of the development system, the social sphere restructuring and other similar processes capable of optimizing budget spending and creating more favorable conditions for economic growth. The center of gravity for the local rimland residents, a strong district center could counterbalance the trend and generate incentives to, and conditions for, activation of these processes. However, striking such a balance in the conditions of a consolidated administration does not seem warranted.

That said, the authors of the bill emphasize its other pluses – namely, the possibility to cut back on managerial costs and shape a single center of responsibility to which residents should bring their problems; however, such a presentation of the problem gets us back to the early 2000's, with their general debates on contours of the municipal reform options. At the time, opponents to the two-tier local self-governance model used to assert, time and again, that the model tended to engender increased administrative costs, the taxpayer's great uncertainty about which body was responsible for tackling which matters, and additional corruption risks³. The warnings were not heard of, as the two-tier structure was conceived of bearing fundamental advantages vis-à-vis any other structures: it was alleged to ensure economies of scale coupled with financial equalization and a due account of needs and interests. The back-

¹ Mestnoye samoupravleniye. № 12 (207) December 2010, p. 9.

² Ibid., p. 1

³ See, for example: Problemy reformy mestnogo samoupravleniya: strukturnye i finansovye aspekty//Konsortstium po voprosam prikladnykh ekonomicheskikh issledovaniy: M.: IEPP, 2005.

ground of the municipal reform demonstrated that once withdrawn from the context of a formed institutional matrix and a real system of interests, such advantages remain merely theoretical. The two-tier model's defects were implemented in full, while its efficiency manifested itself primarily in intensification of centralization and cuts of the guarantees for local self-governance. Hence a more global than the problem of consolidated administrations question: to what extent is the selected model of municipal reform generally adequate to Russia's conditions and can it in principle allow local communities' (where such communities really exist) self-organization mechanisms to flourish? The answer to the question clearly lies beyond the frame of the present review, though.

6.7.2. Renunciation of Direct Mayoral Elections

Yet another trend is gaining momentum now. It is associated with the increasingly widespread municipal entity governance model, under which the municipality head is elected from the representative body, while the administration is run by a city manager contracted with a regional authorities' vigorous participation. Such a model ensures a maximum possible blockage of the local community's influence on formation of the municipal bodies of power and ensures a greater influence on them by the RF Subject's leadership.

The strive for abandonment of elections of municipal entities' heads has been clearly visible through the period following the transition to appointment of governors. Attempts to directly replicate the region-level model at the municipal one faced serious legal challenges, as they contradicted the RF Constitution. However, some other ways to solidify the "vertical" were found – that is, limiting the municipal entities' independence, broad practiced prosecution of "disloyal" city mayors, and, finally, downplaying the local communities' role in elections of heads of municipal entities¹. In a situation when the municipality head is elected from the local representative council, the voters cast their ballots for the composition of the latter, but cannot express his opinion on whether this or that candidate qualifies for the municipality head. It is the instrument that was substantially activated in 2010.

As concerns the practice of contracting heads of local administrations, which the model in question also provides for, the mechanism is fairly widespread around the globe. However, there causes behind its rise were absolutely different from Russia's. In the US, for example, during the so-called municipal revolution of the 1920s the call for professional administration of municipal entities was in a sense the at-large public's reaction to monopolization of the political sphere by individual groups that had been dominating municipal elections and getting stock of the municipal policies. But the Western nations' assessments of the background in question are far from being unambiguous. Experts note that Europeans are restoring the institution of direct elections: "the Europeans have seen for themselves that there is no efficient

¹ During his recent live TV public Q & A session, PM V. Putin voiced the federal authorities' stance on the issue. Mr. Putin believes that direct elections of municipality heads in tandem with an insufficiently efficient civil society form the cause for criminalization of the regional and local power. (Minutes of a special TV broadcast "Talk with Vladimir Putin. Continuation" // The official website of the Chairman of the Government of Russian Federation. 16 December 2010. <http://www.moskva-putinu.ru/>. Access date: 26.01.2011). Experts note: «The push for abolition of elections is going on under a vehement participation of governors, who often promote such decisions citing a "political decision on introducing city managers nationwide" made on the federal level. Source: Index politicheskogo vliyaniya glav 100 krupneyshikh gorodov Rossii // IA REGNUM. Posted: 01:07 23.12.2010 – at <http://www.regnum.ru/news/polit/1359603.html>. Access date: 26.01.2011.

local governance, but a strong self-governance”¹. For example, the increasing number of German municipal entities favors a local administration model under which the *Burgmeister* runs both the City Hall and the local representative council.

That said, it is impossible to draw a direct comparison between the Russian city manager model and the Western one. As the ‘GOLOS’ association noted in a statement in the aftermath of recent Russian municipal elections, “This analogy is not applicable, as the mechanism of appointment of the contracted head of administration fixed in the Russian law may not be appreciated as free elections, because the rationale for the provision of the RF Subject authorities with the right to appoint 1/3 of members of the contest commission raises doubts”². The vehicle the Western nations would employ to bolster democratic mechanisms is used in Russia as an instrument of further centralization.

Available data suggest that introduction of the institution of city manager resulted in abolition of direct mayoral elections in 43 regional capital cities³. To cite specific examples, in 2009, direct elections were abolished in Samara, Stavropol, Ryazan, Tyumen, Kazan, Ufa, Tver, among other cities. In 2010, the woeful list expanded to include Nizhny Novgorod, Smolensk, Blagoveschensk, Elista, Vladimir, Kurgan, Orenburg, Chelyabinsk, Perm, and Ekaterinburg, to name a few more cities.

Notably enough, the peculiarity of 2010 became expansion of the process onto the urban centers exemplary for their strong and independent local governments, such as Chelyabinsk, Ekaterinburg and Perm. On 15 September 2010, at their working meeting in Ekaterinburg representatives of the civic coalitions for retaining direct mayoral elections from the above three cities agreed on establishment of a nationwide civic network to defend the elections. According to Mr. Igor Averkiev, chairman of the Perm civic chamber, the civic network organizers’ cumulative efforts would unlikely be limited with resistance to abolition of mayoral elections, as there are other profound challenges associated with the Russian authorities’ attempts to debar the populace from the possibility to exert a direct influence on authorities, including abolition of gubernatorial elections and current manipulations with majority and proportional election systems⁴. Despite the coalition’s efforts, direct elections were abolished in all the three cities.

In Chelyabinsk, the elections were abolished in 2010, almost immediately after Mr. Mikhail Yurevich, the former mayor, had been appointed the governor. Interestingly, once elected as the mayor of Chelyabinsk, Mr. Yurevich succeeded in amending the city’s Statute, which had earlier provided for existence of a city manager, while despite local residents elected Mr. Yurevich the mayor, he was supposed to exercise powers of the chairman of the local representative body.

In the city of Perm, the procedure of abolition of direct mayoral election was launched in the spring of 2010, with the final decision taken in the summer. The initiative faaced an ener-

¹ Markwart E. Vse mestnoye samoupravili po vertikali. Ot vyborov merov tozhe reshili otkazatsya// Ё-Online. 27.12.2010 – URL: <http://kommersant.ru/doc.aspx?DocsID=1564980&print=true>. Access date: 26.01.2011.

² From the first statement of the GOLOS association by results of a long-term monitoring of municipal campaigns for the elections set for October 10, 2010 (the stages of nomination, registration and the start of the campaign trails). Moscow, 6 September 2010 – URL: <http://golos.org/a3878.html> . Access date: 26.01.2011.

³ Meram postavili “dvoyki” za ikh vliyatelnost// RBK 23.12.2010. URL: <http://top.rbc.ru/politics/23/12/2010/519860.shtml?from=qip> . Access date: 26.01.2011.

⁴ Protivniki otmeny vyborov obyedinyayutsya//Obschestvennaya kompaniya “Sokhranim pryamy vybory glavy Permi”. 16.09.2010 – URL: <http://www.vyborpermi.ru/node/358> . Access date: 26.01.2011.

getic protest from a public coalition named “For direct elections” founded by 7 local civil society organizations. While as many as 79% of local residents (the Levada Center data) upheld the idea of retaining direct mayoral elections of the city administration’s head¹, the representative body decided otherwise.

In the periphery of Perm Kray, in the city of Kudymkar, the ex-center of Komi-Pemyatsky Autonomous Okrug, developments took a far dramatic turn. In August 2010, seven members of the local Duma stepped down from office and refused to take part in the representative body’s work. As a result, the Duma lost its legitimacy. The rebel Duma members claimed that the main reason for their demarche was the exhaustion of any other ways to maintain the dialogue with the regional executive authorities on the method of election of the local administration head. It cannot be ruled out of course that there were certain economic and political interests behind the demarche; however, an out-of-the-world region managed to establish an unprecedented for today’s Russia precedent².

Similar attempts to abolish mayoral elections in urban settlements in Sverdlovsk oblast and Khanty-Mansy autonomous okrug sparked serious conflicts. In some of these localities, the push for the Federation’s model was repelled, too. Thus, by contrast with Perm, having known the local residents’ views, deputies in the city of Surgut refused even to put up the issue of changes in the local administration system for public hearings and retained direct elections of the city’s head. According to monitoring of the socio-political situation in Surgut run by the Committee for socio-political analysis and public relations under the Okrug administration, 89% of residents approved general direct election of the city’s head, while another 8% favored the concept of city manager, and the remaining 3% found it difficult to answer or believed the city’s head should be appointed³.

Overall, according to the available information, as many as 11 out of 20 Russia’s largest cities have so far managed to retain direct elections⁴.

6.7.3. Modification of the Election System

The tendency of embedding the local self-governance system in the vertical of power also manifests itself in modification of the electoral law. Back in 2005, municipal entities were granted the possibility to choose between the majority system and the mixed or purely proportional systems of municipal elections. In April 2009, the federal legislature made another step forward by establishing a new order according to which at the municipal elections run by the proportional system the right to put up the list of candidates can be granted solely to branches of a political party which, in compliance with the federal law, enjoys the right to take part in elections. Prior to the novelty, the same right had been granted to electoral associations formed by public associations (public organizations, movements) during elections to local self-governance bodies. Nowadays, public associations that do not constitute political parties

¹ Posted on the website “Rossiyskaya gazeta. Perm sky krai. 25 May 2010. Ilya Izotov. “Levada-Center”: 79 percent of Perm’s residents spoke for retaining the direct mayoral elections. <http://www.rg.ru/2010/05/25/reg-ermkray/opros-anons.html>.

² Buntari s okrainy. // Expert.ru. 12.08.2010. – URL: www.expert.ru/2010/08/12/bunt_okraina/. Access date: 26.01.2011.

³ Surgutchane za pramyie vybory glavy goroda//Obschestvennaya kompaniya “Sokhranim pramyie vybory glaavy Permi. – URL: <http://www.vyborpermi.ru/node/271>. Access date: 26.01.2011.

⁴ Index politicheskogo vliyaniya glav 100 krupneyshikh gorodov Rossii // IA REGNUM. Posted: 01:07 23.12.2010. – at <http://www.regnum.ru/news/polit/1359603.html>. Access date: 26.01.2011.

enjoy the right for just putting forward candidacies for their inclusion in a party ticket, and this is exercised following procedures set by the Federal Act “On political parties”. Meanwhile, the problem of securing guarantees of realization of the passive electoral right of citizens who do not hold membership in a political party or an electoral association proved having been delegated to the regional level.

The string of tendencies has been recently complemented by another bill on the proportional system at local elections. Submitted by the RF President, the bill reads that no less than a half of deputy mandates in the representative body of a municipal district or an urban district with the overall number of deputies being 20 and more is to be allocated between lists of candidates put up by electoral associations in proportion to the number of votes each such list of candidates has received. An RF Subject’s law can provide for a necessary for access to such an allocation of deputy mandates minimum rate of votes received by the list of candidates, which may not exceed 5% of ballots cast by voters who have taken part in the voting. These changes concern some 1,200 representative bodies of municipal entities¹.

As concerns elections of representative bodies of other municipal entities, including representative bodies of municipal districts and urban districts with the number of deputies under 20, there may be used the proportional electoral system, or the mixed, or the majority one. The terms of the use of a specific electoral system in such municipal entities are set by an RF Subject’s law.

In connection with the aforementioned changes, the bill in question establishes requirements to deputies included in a faction, as well as to factions in representative bodies of municipal entities. The requirements are similar to those set for deputies included in a faction, as well as to factions in the RF Subjects’ legislative (representative) bodies of state power. More specifically, the faction comprises all the deputies elected on a party ticket; as well, it may comprise deputies who have run in a single-member constituency or in a multi-mandate one. The faction may comprise a single deputy elected on a party ticket. The deputy of the faction is bound to hold membership in the political party of whose faction he is a member. The deputy elected on a party ticket may not quit the faction. Failure to comply with these requirements results in early termination of the deputy powers.

While assessing the tendencies to strangling the local self-governance, experts point out to a direct connection between the abrogation of direct mayoral elections and the increase of the role the federal parties play in localities. These *de facto* are two sides of the same coin. “It so happens that under such a scenario the municipality administration is formed under the regional authorities’ intervention, on the one hand, and under the federal authorities’ intervention, on the other (Russian parties are notorious for their utter centralization and their federal leadership permanently interfering in their regional and local branches’ operations)”².

Key Take-Aways

Transformation of local self-governance into an impotent appendix of the vertical of power is a process that has advanced for several years already, thus not being the distinct character-

¹ Prezident vnes v Dumu zakonoproekt o proporsionalnoy sisteme na mestnykh vyborakh// The state Internet channel “Rossiya”. 14.12.2010. 09:06. – URL: <http://www.vesti.ru/doc.html?id=413763&cid=5>. Access date: 26.01.2011.

² From the first statement of the GOLOS association by results of a long-term monitoring of municipal campaigns for the elections set for October 10, 2010 (the stages of nomination, registration and the start of the campaign trails). Moscow, 6 September 2010 – URL: <http://golos.org/a3878.html>. Access date: 26.01.2011.

istic of 2010 only. That is why let us note just two peculiarities of the period in question that characterize the unfolding tendencies.

First, the violation of guarantees of self-governance in Russia drew the international community's attention. In the autumn of 2010, the Congress of Local and Regional Authorities of the Council of Europe presented the third Report on the state of Russian democracy in the light of implementation of the European Charter on Local Self Government. The Report highlighted serious negative tendencies in the sphere concerned¹. More specifically, in order to improve the national legislation in the local-self-governance area, Russian authorities were recommended to:

- Abolish recent amendments to art. 74 of federal Act of 6 October 2003 № 131-FZ “On general principles of organization of local self-governance in the Russian Federation” that concern dismissal of city mayors so that to guarantee for them the possibility to freely exercise their powers in office without being concerned of interference or political pressure by legislative bodies or governors;
- Continue to improve the division of powers between federal, regional and local government bodies and undertake measures on cutting the number of combo mandates and spheres subjected to them;
- Appropriate respective funding for local authorities or permit them to collect taxes, as per the Charter, to make them able to exercise their mandate in the area of the public services delivery;
- ensure that integration of localities is done only upon holding consultations with respective elected assemblies.

The above list does not comprise all the Congress's recommendations, making it clear nonetheless that they question consistency of some fundamental provisions of the municipal law and recent amendments adopted to further the process of introduction of substantial limits with regard to local authorities' autonomy and *de facto* putting them under the regional authorities' political control with the European Charter.

Second, the increasing number of experts has made an unconsoling diagnosis to the state of Russia's public administration, with the key word therein being *degradation*. That said, the process in question is in many ways determined by upsetting the balance in the public governance system, striving to control the whole shooting match out of the center, dumping legitimate channels of the population's influence on adoption of managerial decisions. Let us cite two expert opinions on the issue: *Evgeny Gontmakher*, Head of the Center for Social Policy of the Institute of Economics of RAS: “Degradation of the state has reached such a stage when, enchanted by mirages of “vertical of power” and “managed democracy”, the political elite has lost control over the ongoing processes in the country”². *Emil Markwart*, President of the European Club of Experts on Local Self Government: “By all accounts the degradation of public institutions and local self-governance will not just continue, but exacerbate. The populace and the power will be increasingly drifting apart”³.

¹ Sovet Evropy postavil Rossii neuteshitelnyi diagnoz.//Echo planet Itar-Tass. 10 November 2010. http://ekhoplanet.ru/world_500_8910.

² Gontmakher .E. Gosudarstvo i obschestvo. Modernizatsiya dlya svoikh. Posted: 20.12.2010 г. – URL: http://www.4cs.ru/materials/wp-id_1342/. Access date: 26.01.2011.

³ Markwart E. Vse mestnoye samoupravili po vertikali. Ot vyborov merov tozhe reshili otkazatsya// Ё-Online. 27.12.2010 – URL: <http://kommersant.ru/doc.aspx?DocsID=1564980&print=true>. Access date: 26.01.2011.

Annex 1

Specifics of Skolkovo Project Administration

One of the most interesting novations in Russian legal system on 2010 was enactment of federal laws and subordinate legislation regulating the activities of Skolkovo Innovation Center. The following acts regulate the specifics of Skolkovo participants activities: *Federal Law No.244-FZ “On Skolkovo Innovation Center” of October 28, 2010*; *Federal Law No.243-FZ “On Amending Certain Legal Acts of the Russian Federation in Relation with Enacting Federal Law on Skolkovo Innovation Center” of September 28, 2010*; *Directive of the President of the Russian Federation No.446-rp of July 2, 2010*; *Resolution of the RF Government No.565 “On Subsidizing the Key Measures Related to Skolkovo Innovation Center Set-Up and Operations Support from the Budget of Non-for-Profit Organization “Foundation for Development of the Center for New Technologies Promotion and Monetizing”” of July 26, 2010*, as well as other acts.

Legal framework regulating the activities of Skolkovo Project participants was developed within the record-breaking short period of time; however, it contains a number of principal novelties, which can be rolled-out to support other areas of social and economic development of the Russian Federation. In particular, the following absolutely new principles were included into this legal framework:

- 1) An attempt to create “friendly administration” of the activities of Project participants;
- 2) “Outsourcing” the functions of state and local self-government as one of the ways to create a “friendly” regime;
- 3) Unprecedented level of tax and customs reliefs versus the effective taxation system.

Speaking about regulatory solutions used for setting up a new innovation center, they became a logical follow-up of previous reforms; however, these “old” ideas were most radically manifested in the new legal framework for Skolkovo.

Thus, the idea of granting special tax reliefs (a special tax regime) to the residents of one particular territory was implemented at the stage of creating Special Economic Zones (SEZ) for new technology implementation, and the idea of creating infrastructure which the innovation companies could use – at the stage of setting up Research and Technology Parks. Neither of these two methods of innovation support taken separately has produced the desired result, however, they provided for developing a system of methods for innovation support which is still operational.

In particular, SEZ function starting from 2005 based on the Federal Law No.116-FZ “On Special Economic Zone in the Russian Federation” of July 22, 2005. The following types of SEZ are stipulated by the Law (Article 4):

- Industrial Manufacturing Zones;
- Technology Implementation Zones;
- Tourist Recreational Zones;
- Port Zones¹.

¹ In addition to that two SEZ function in Russia – they were created for the purposes of regional development. These are Kaliningrad and Magadan zones. They were established back in 1990-s to promote economic development of these regions, they are not subject to regulation providing for tax reliefs.

Lack of active growth of innovations in Technology Implementation Zones (TIZ) may be to a certain extent explained by the fact that tax reliefs granted in TIZ territories are not significant.

TIZ residents are also entitled to select the free customs zone regime within the zone's territory¹. Also they have certain benefits when writing-off R&D costs. Article 262 of the RF Tax Code provides for the possibility for average taxpayers to account the R&D expenses only after completing the research and after starting to implement their results². In case these conditions are met, they may evenly account their R&D costs throughout one year³. For TIZ of the RF Tax Code allows for the regions to reduce the rate of Profit Tax subject to be paid into the budgets of the RF entities down to 13.5% - for the activities carried out in the territory of Technology Implementation Zone. TIZ residents are also granted privileges with regards to the Corporate Property Tax rates⁴.

The attempts to create a system of Research and Technology Parks turned out to be even less efficient. Other problems during their implementation were lack of clearly stated legal requirements towards this form of innovation support and the selected method: Research and Technology Parks were set up by the regions under the condition of receiving special earmarked subsidies from the federal budget. The possibility of receiving these subsidies was not dependent on regional Research and Technology Parks performance. As a result, the regions were focused more on receiving subsidies than on innovations per se.

In 2008–2009 the legislators attempted creation of “friendly regimes” in some areas of social and economic development. However, in our opinion they produced very little effect for the “target groups” at the same time damaging some public interest. One of the examples:

¹ This allows SEZ residents to receive privileges with regards to payment of customs duty and VAT on foreign goods imported into the zone territory and recover (reimburse) VAT paid by them as part of the cost of Russian goods brought into the SEZ territory from other parts of the Russian Federation.

² According to paragraphs 1 and 2 of item 2 of Article 262 of the RF Tax Code, taxpayers expenses for R&D pertaining to creating new or improving currently manufactured goods (work, services), in particular – inventions costs incurred by the taxpayer independently or jointly with other companies (in the amount matching this particular taxpayer's share), and based on contracts which this taxpayer executed as the customer for such R&D, shall be recognized for the purposes of tax assessment after completion of such R&D (or their stages) and execution of respective Delivery-Acceptance Acts by both parties. The above mentioned expenses shall be evenly included by the taxpayer into “other costs” during the period of one year under condition of using the results of such R&D in manufacturing and/or selling goods (work, services) starting from the 1st date of the month following the month of R&D (or their stages) completion.

³ Contrary to other taxpayers, SEZ residents are entitled to account for R&D costs directly in the tax period (reporting period) when these costs were incurred. According to p. 2 of Article 262 of the RF Tax Code, “R&D costs (including the ones not resulting in a positive result) incurred by taxpayers – organizations registered and operating in special economic zones territories shall be recognized in the tax period (reporting period) when they were incurred – in the amount of actual costs.

⁴ Until 2010 TIZ residents were also exercising UST (Unified Social Tax) benefits allowing for decreasing the payroll tax burden. According to Article 241 of the RF Tax Code (currently lost effect), TIZ residents were paying UST at 14% rate instead of standard 26%. And because UST was actually decreased by the amount due to the Pension Fund, actually TIZ residents were paying only to the Pension Fund. However, the Federal Law No.212-FZ “On Insurance Contributions into the RF Pension Fund, the RF Social Insurance Fund, and the RF Compulsory Medical Insurance Fund and territorial medical insurance funds” of July 24, 2009, substituted the UST with separate payments to the extra-budgetary funds, and the total amount of payments increased. TIZ residents were also affected by this raise.

regulating the procedures of control and supervision by state power bodies¹. Limitations were imposed in 2008–2009 on the grounds for field audits of small and medium-size businesses²; the time for field audits of small businesses was reduced³; licensing of certain types of public services traditionally provided by small businesses was abolished; extra-judiciary rights of the RF Ministry of Internal Affairs were significantly limited leading to prohibition of tax audits performed by this Ministry without participation of Tax Inspectorate and to prohibition of other audits of businesses on the grounds other than on suspicion of a crime⁴, etc. These amendments resulted in some immaterial decrease of administrative pressure on small businesses with simultaneous growth of customers' risks caused by abolishing licenses and by decreasing the level of control over quality of products/work/services sold by small businesses to the public, as well as growth of tax evasion risks.

However, in principle, “friendly administration” regimes are quite possible for certain types/areas of business activities. The distinctive features of a “friendly regime” are as follows:

- Reduced number of procedures requiring permits/approvals (*licenses*);
- Facilitated provision of government services;
- Reduced number of checks/audits and improved protection for those being subject to such checks/audits;
- Setting-up a “one stop” approach for interaction with government authorities;
- Improved protection of businesses against illegal actions or failure to act on behalf of government authorities.

¹ A series of decisions focused on removing administrative barriers in the interests of small and medium-size business were made in 2008–2009 at the federal level. The following laws were enacted with this purpose: Federal Law No.294-FZ “On Protection of Rights of Legal Entities and Individual Entrepreneurs in the Process of State Control (Supervision) and Municipal Control” of December 26, 2008; Federal Law No.313-FZ “On Amending Certain Legal Acts of the Russian Federation with Regards to the Possibility to Substitute Mandatory Certificates with Declarations of Conformity” of December 30, 2008; Federal Law No.293-FZ “On Amending Certain Legal Acts of the Russian Federation with Regards to Excluding the Extra-Judiciary Rights of the RF Internal Affairs Departments in Checking Businesses and Entrepreneurs” of December 26, 2008, as well as some other legal acts.

² These limitations did not pertain to all types of audits, e.g., tax audits were not affected.

³ According to pp. 2 and 3 of Article 14 of Law No.294-FZ, the total amount of time of a scheduled field audit per one small business entity may not exceed 50 hours for a small business and 15 hours for a micro-business per year. In some exclusive cases associated with the need to conduct a complex and/or time-consuming audit including complicated tests, trials, expert evaluations and investigations based on justified proposals of supervisory authority officers or municipal control officers engaged in such scheduled audit, the period of such field audit may be extended by no more than 20 working days with regards to a small business, and by no more than 15 hours with regards to a micro-business.

⁴ Federal Law No.293-FZ of December 26, 2008 prohibited law-enforcing agencies in case of suspecting a legal entity to have committed a criminal or administrative offense to carry out audits of the activities of such legal entity or to demand such audits, as well as to carry out inspection of business premises and transportation vehicles owned by such legal entity, to study its documentation, to withdraw samples of raw materials and commercial good for expert evaluation (with this purpose sub-paragraph 25 of Article 11 of the Federal Law “On Militia” was abolished). With that “suspicion of crime” still provides for sufficient grounds for the militia to control organizations/businesses through all the above mentioned measures.

“Friendly Administration” in Skolkovo

The attempt to implement “friendly administration” principles was to the maximum extent tried during development of the legal framework Skolkovo Innovation Center (IC). It should be noted that it was for the first time that Russian legislators tried to create special government administration conditions at a limited territory. Previously all privileges including special tax regimes pertained mainly to financial benefits, such as: reduced rates for taxes and duties, subsidies from the budget, reduced lease fees for state and municipal premises, etc. However, now the attempt is made in the new law to provide a different kind of benefit, formalization of which is extremely difficult at the legislative level, in particular – the benefit of “friendly administration” and removing some administrative barriers impeding business activities across the country¹.

And this special regime was formed not just in the taxation sphere, but for different areas of innovative companies’ activities associated with the need to obtain permits and approvals (construction, land use, fire and sanitary control, etc.).

In order to overcome the traditional Russian administrative barriers specialized offices of government authorities will be established in the territory of Skolkovo to perform the functions of control, supervision, issuing permits, approvals and licenses. For example, it is planned to set up specialized divisions of the RF Ministry of Internal Affairs, migration, tax control, customs, fire prevention and fire-fighting and emergency response, consumers’ rights and public well-being protection, intellectual property/patents/trade marks protection.

Also, similar to major taxpayers, Skolkovo residents will all be registered with one specialized tax inspectorate, checking procedures for them will be performed in one and the same government agencies.

It should be noted that setting up specialized tax inspectorates (and other supervisory authorities subdivisions) does not guarantee “friendly regime” in real life². The problem is – it is practically impossible to formalize in the law the obligation of supervisors/auditors not to violate the taxpayers’ rights and to perform all the required checks/audits with minimal time and effort. The experience of major taxpayers’ regime shows that the fact of being registered with specialized tax offices has not led to improving the services. However, it may be assumed that informally directors of taxation and other agencies recognize their responsibility for assuring high quality and convenience of services that they will be providing to Skolkovo Project participants. In relation to this the experiment of improving government services within one particular territory may turn out successful. It seems that it would be feasible to formalize “friendly administration” targeted at improving the conditions for the Project participants in the regulations covering the respective function of supervisory authorities. In future these regulations may serve as best practices examples and become the basis for improving the

¹ We already mentioned above that such “friendly” regime would be very useful not just for Skolkovo Project participants, but to all the taxpayers who suffer from the same problems as companies operating within Skolkovo territory. In particular, it could lead to resolving one of the key problems in Russian innovations sector and give a new spur to demand for innovations on behalf of the real sector of Russian economy (this demand currently still being pretty low). However, the model proposed for innovation center may not turn out operational for the whole country, so its massive roll-out is impossible. Other measures will be required to support innovation companies not engaged in Skolkovo Project, as well as innovative products customers.

² The same related to other spheres of government control exercised by specialized government agencies in the territory of Skolkovo Innovation Center.

quality of government services, as well as facilitating and simplifying administrative procedures beyond the territory of the Innovation Center.

Simultaneously some additional complications may emerge in the process of implementing the “friendly administration” approach. In particular:

a) A number of innovative projects planned for implementation in the territory of Skolkovo IC should be launched right now, while specialized supervision and control agencies will start functioning at least several years from now, after the respective infrastructure is set up. It looks like the most feasible solution would be to set up specialized agencies including those of tax control now and already use them for registration of innovation companies taking part in Skolkovo Project implementation prior to full-scale launching of the Innovation Center;

b) “One Stop” approach remains not fully implemented in interaction with tax authorities and extra-budgetary funds. Both tax authorities and extra-budgetary funds keep their powers for independent control over taxpayers’ activities and powers for calling them liable. Besides, single tax return is not an option stipulated for Skolkovo Project participants. Thus, all the negative consequences of passing the insurance contribution administration function to extra-budgetary funds will have equal negative effect both on regular taxpayers and on Skolkovo Project participants;

c) The practice of provision of additional procedural guarantees used during audits of small businesses and self-regulating organizations so far has not been used in “friendly administration”. Such practice of providing additional procedural guarantees for the right of audited entities is stipulated in the text of Federal Law No.294-FZ “On Protection of Rights of Legal Entities and Individual Entrepreneurs in the Process of Government Control (Supervision) and Municipal Control” of December 26, 2008. However this Law does not cover tax and fiscal control, currency control and some other types of control. Due to this, general procedural guarantees provided to audited entities in accordance with Federal Law No.294-FZ of December 26, 2008, do not allow for full-scale “friendly administration” which that much needed by Skolkovo Project participants.

“Outsourcing” the Functions of State and Local Self-Government Bodies

The rights of regional state power bodies and local self-government bodies with regard to carrying out control and audit measures within their sphere of competence are limited in the territory of Skolkovo IC. These limitations are associated with granting the respective powers to the managing company and are also targeted at reducing administrative barriers and the number of permits/approvals. The new concepts introduced by Law No.244-FZ of September 28, 2010 allow speaking about “*outsourcing of functions of state and local self-government bodies*”.

The law defines special status of Skolkovo Project managing company and its subsidiaries. The functions of the Managing Company are as follows:

- Holds the titles for land plots and owns infrastructure facilities within the territory of the Innovation Center;
- Provides for overall organization management and coordination of Project implementation activities, in particular, approves the Project Rules defining the , определяющие aggregate of rights and responsibilities of Project participants;
- Approves documents used instead of the general layout, land use and development regulations, as well as city planning documentation based in such documents;

- Approves technical regulations, sanitary and epidemiological rules and other similar documents regulating legal relations in the territory of Skolkovo;
- Issues invitations for foreign citizens to enter the Russian Federation to work in Skolkovo Innovations Center (soft regulations for obtaining work permits for foreigners are applied);
- Approves the rules of medical and educational activities in the territory of the Innovations Center and issues permits for such types of activities (the law stipulates private medical organizations and non-government educational institutions rendering services in the territory of the Innovations Center);
- Agrees the issues related to Skolkovo infrastructure, including installation of outdoor advertising;
- Makes decisions about providing and terminating the Project Participant status, etc.

A non-government not-for-profit organization “Foundation for Development the Center for New Technologies Promotion and Monetizing” was assigned as the Managing Company for the Project of creation of a territorially delineated complex for research and development and monetization of their results. The Foundation’s mission is to assure formation of a full innovation process cycle in the territory of Skolkovo Center including educational and R&D activities and monetization of their results. The Foundation also performs such auxiliary functions as provision of centralized services in relation with organizing the innovation process, and participation in its funding. The following organizations are founders of the Foundation:

- Russian Academy of Sciences (RAS);
- State corporation “Development and Foreign Economic Activity Bank” (Vnesheconombank or VEB);
- State corporation “Russian Corporation for Nano-Technology” (ROSNANO),
- Moscow State Technical University named after N.E. Bauman;
- OJSC “Rossiyskaya Venturnaya Kompaniya” (Russian Venture Company);
- Foundation for Support of Smaller Businesses in Research and Technology.

The Foundation has the following governing bodies:

- Foundation Board is a top corporate governance body comprising at least ten members. The Board shall be initially formed by the founders in agreement with the Commission for Russia Modernization and Technology Development with the President. Board members shall perform their functions on a pro bono (voluntary) basis. The Board shall be headed by two co-chairpersons;
- Advisory Research Council is a specialized expert authority. The number of its members shall be defined by the Foundation Board based on the needs of projects currently in implementation. The Advisory Research Council shall be headed by two co-chairpersons;
- Board of Trustees is a collegiate body approving the key objectives of the Foundation and supervising its activities and the use of its assets. The Board of Trustees shall perform its functions on a pro bono (voluntary) basis. The members shall be appointed based on the decision of the Commission for Russia Modernization and Technology Development with the President. The Board of Trustees shall be appointed for 3-year term and shall comprise at least seven members. Members of the Foundation Board and the Foundation President shall not be members of the Board of Trustees;

- The Foundation President shall be appointed by the Foundation Board for the term of 2 years. The Board shall be entitled for early termination of the President's term. Currently the functions of the Foundation President are performed by Victor Vekselberg.

As a result of granting outstandingly broad powers to the Managing company in accordance with Article 20 of Law No.24-FZ of September 28, 2010, regional authorities were deprived of their powers in the field of land provisioning, withdrawal of land plots for public purposes, road management and public transportation, setting the administrative liability norms, approving territorial planning and layout documents, as well as setting-up emergency rescue teams, carrying out energy saving measures, etc.

Local self-government bodies have also lost part of their previous powers.

The main purpose of transferring certain powers of regional and local authorities to the managing company and setting up specialized divisions of supervisory agencies in the territory of Skolkovo is to eliminate part of administrative barriers in the process of receiving permits and approvals from different levels of government in the above listed fields. The eventual outcome should be creating a friendly environment for investors.

The key specific feature of outsourcing the state and local self-government functions is that the managing company is a private entity (not a government agency or its subdivision). Moreover, this company is allowed to transfer the outsourced functions to its subsidiaries.

So far the Russian Federation lacks such experience, which does not allow for comprehensive evaluation of potential consequences of state and municipal functions outsourcing in the sphere of regulations and control. However, certain complications may be assumed to arise during such practice.

The following risks may be stated as the key ones:

- In the event of any disputes the transfer of powers assigned to the RF entities and municipalities in favor of the managing company may not necessarily be recognized as constitutionally acceptable. Article 72 of the RF Constitution directly states the fact that land use relations and some other types of relations (the regulation of which has been transferred to the managing company in Skolkovo case) pertain to joint competence of the Russian Federation and its constituent entities. No regional laws or other acts were adopted to formalize the transfer of powers from regional authorities to the managing company – e.g., in the field of provisioning and withdrawing land plots, setting the administrative liability norms, etc.;
- The border lines for Skolkovo IC jurisdiction have not been clearly defined in any legal document. It would be very important to establish the limits of applying this special legal regime, where local self-government powers are significantly reduced. This particular problem was highlighted by the State Duma Committee on Local Self-Government in its expert opinion on the draft legislation on Skolkovo (further enacted as Law No.244-FZ) No.87/1 of June 17, 2010. The Committee emphasized: "it remains unclear, what borders the Innovation Center will be operating within, as well as what is the correlation between the IC territory and the territory of Novoivanovskoye urban settlement of Odintsovo district of Moscow Region. The future of the local population (should there be any current residents of the territory allotted for Skolkovo), as well as the future of real property there is also vague". Overall, one may agree with the concerns of the Committee: both the issue of the limits of special legal regime and the issue of the future for the current residents and real property may require additional regulation on behalf of the government;

- The status of the Project Rules within the system of legal acts is not completely clear either (in particular, whether these rules should be recognized as a legal act or as a corporate regulatory document). Sub-paragraph 11 of Article 2 of Law No.244-FZ defines the Project rules as “an aggregate of rights and responsibilities of entities participating in the Project implementation subject to approval by the managing company in accordance with the Federal Law hereof and designed to create mechanisms of interaction between the Project stakeholders; respectively, availability and compliance with such rules shall be necessary pre-requisites for these participant to operate”.

Russian legal framework does not contain any clear definition of a legal act. Due to that judicial practice uses the definition of constituent elements of legal act stated by the Supreme Court of the Russian Federation in p. 9 of its Plenum Ruling No.48 “On the Practice of Court Proceedings of Cases about Challenging Legal Acts Fully or in Part” of November 29, 2007¹. In its Ruling the Supreme Court determined the following:

- Normative legal act shall be issued in the prescribed order by the authorized state power body, local self-government body or a government official;
- Such act shall contain legal norms (rules of conduct) mandatory for general public, meant for multiple applications, and targeted at settling social relations or at change/termination of existing legal relationship.

Commenting the status of Skolkovo IC Project Rules, “ConsultantPlus” legal information system experts² were completely and justifiably right to point that the Project Rules do not fully correspond with the definition of a legal act determined by the Supreme Court, because the managing company is not a state power body or a local self-government body. However, in their opinion, the fact of the managing company performing some of the functions of regional state power bodies and local self-government bodies allows for qualifying Skolkovo Project Rules as a normative legal act.

Overall such approach may be recognized as a correct one, however, outside judicial interpretation it may turn out inapplicable. In particular, until a particular court judgment is given it is impossible to say precisely:

- If the stakeholders including those not participating in the Project, appeal against the Rules in accordance with the procedure set in Chapter 23 of the RF Administrative Procedural Code or in Chapter 24 of the RF Criminal Procedural Code, and in particular – bring an action in court to recognize certain clauses of the Project Rules (as of a legal act) null and void;
- What should the procedure be for holding liable for those having violated the Project Rules set by the private (managing) company and not by state power bodies – with respect to civil liability and especially administrative and criminal liability³. Let’s assume, civil

¹ These interpretations are widely used both by regular courts of general jurisdiction and by arbitration (commercial) courts (see also Determinations of the RF Supreme Court No.45-G10-7 of May 19, 2010 and No.88-G09-7 of January 13, 2010; Determination of the RF High Arbitration Court No.VAS-7517/10 on case No.A58-2632/09 of June 23, 2010 and No.VAS-5892/10 on case No.VAS-17598/10 of May 24, 2010.

² See ConsultantPlus: Analytical Overview of October 12, 2010. Federal Law No.244-FZ “On Skolkovo Innovation Center” of September 28, 2010.

³ According to p. 1 of Article 18 of Law No.244-FZ “failure of entities/persons participating in the Project to comply with the rules and norms established and/or applied in the territory of the Innovation Center – in particular, health and hygiene rules and standards, fire safety requirements, urban-planning requirements, advertisement placement and dissemination rules, technical regulation requirements, rules of medical and educational activities –

liability may be used with regards to Project participants based on the agreements executed between them. However, the RF Criminal Code and Administrative Offence Code do not contain any articles setting liability for violation of Project Rules established by a private managing company (that means – not having the legal act status). Due to this the possibility of administrative and criminal prosecution of entities/persons violating sanitary, urban-planning and other norms acting in the Project jurisdiction may be disputable.

- The Law does not describe the procedures for the managing company to exercise control over the Project participants' activities. At the same time, the right to establish a controlling division and hire full-time controllers is vested with the managing company. According to p. 3 of Article 18 of Law No.244-FZ, “the managing company is obliged to approve the list of its employees directly involved in controlling the compliance with the established requirements and rules”. In all appearances, the procedure for the managing company to perform checks and audits will be settled within the Project Rules. However, this may turn out to be insufficient. For example, being vested with both rule-making and controlling powers, the managing company may not be interested in sufficient guarantees of rights of other Project participants. Besides, Project participants may need special procedures for formalizing and challenging the results of checks and audits performed by the managing company, because these results may serve the basis for various sanctions (including exclusion of the respective participant from the Project).

In the process of discussing the draft Law No.244-FZ in addition to outsourcing government functions experts pointed at other potential problems in the Innovation Center activities¹, including:

- The need to include the managing company into the Customs Brokers Register. According to Article 18 of the RF Customs Code, the activity of any persons in the capacity of customs brokers (representatives) shall be allowed only subject to their inclusion into the Customs Brokers (Representatives) Register. Thus, the managing company may provide customs brokerage services only in case of complying with the requirements set by the Customs regulations. Should it turn out that the managing company does not satisfy the criteria of a customs broker, this will be another issue to deal with;
- The need to specify the conditions for receiving subsidies by the Project participants to compensate for customs duties payments in the RF Budget Code. According to the budget laws and regulations of the Russian Federation, customs duties paid by the Project participants in relation with their Project activities may be reimbursed to the in the form of subsidies. According to Article 78 of the RF Budget Code, costs are reimbursed to legal entities by way of gratuitous and non-reciprocal subsidies. Such subsidies are granted in relation with providing/selling goods/work/services. According to Article 5 of Federal Law No.5003-1 “On Customs Tariff” of May 21, 1993, customs duty is a mandatory payment to the federal budget collected when the goods cross the customs border of the Russian Federation (imported into or exported from the customs territory of the Russian Federation). Movement of goods across the customs border is not qualified as providing/selling goods/work/services. Thus, reimbursement of customs duties does not look

shall be qualified as violation of the respective legislation of the RF and shall be subject to civil liability, administrative liability and criminal liability in accordance with the laws of the Russian Federation”.

¹ See <http://asozd.duma.gov.ru/mai №.№sf>

possible under the effective legislation, so it is recommended to stipulate respective amendments to the budget laws and regulations;

- According to p.6 of Article 15 of the Law on Skolkovo Innovation Center, “no public hearings shall take place on the draft Master Plan for Skolkovo Center”. This may be qualified as unlawful restriction of the citizens’ rights and may be disputable.

Tax Reliefs in the Territory of Skolkovo IC

The Project participants shall be granted certain tax reliefs, including the following key ones:

- 1) Reimbursement of customs duties and VAT paid by the Project participants in relation to imported goods used by them in Skolkovo IC territory (Article 11 of Law No.244-FZ).

Reimbursement of customs duties seems to be a very serious relief; however, it constitutes certain risk for Russian state.

First of all, after setting up the Customs Union between Russia, Kazakhstan and Belarus granting such a relief may lead to additional budget expenditure, because the Agreement for the procedure of import customs duties (other duties, taxes and fees of equivalent effect)¹ assessment and distribution applied within the Union stipulates for the need to distribute the customs duties between the three countries². It means that 100% of the customs duties shall be remitted into the federal budget of the RF, and the Russian Party shall have to reimburse the total amount paid by Skolkovo Project participants. For example, the entity paid RUR 100 when importing the equipment. It means that when reimbursing this amount Russian budget will lose RUR 112.3, because RUR 12.3 will go to the budgets of Belarus and Kazakhstan, but this amount will have to be reimbursed to Skolkovo Project participant from Russian federal budget at the expense of other revenues.

Secondly, tax duties reimbursement privilege does not stipulate any mechanisms against tax optimization leading to potential abuse of the new Law. In particular, Project participants may act as intermediaries for importing equipment which may be further sold to those not involved in Skolkovo Project at any price, because zero Profit Tax is stipulated for Project participants. Should the equipment be sold at the write-up value, the buyer may increase depreciation costs;

- 2) VAT and Corporate Profit Tax reliefs. In addition to reimbursement of customs duties and VAT paid by the Project participants in relation to importing goods required for certain activities, Law No.243-FZ “On Amending Certain Legal Acts of the Russian Federation due to Adopting the Federal Law on Skolkovo Innovation Center” of September 28, 2010, relieves the Project participants from:

- accounting;
- VAT payments (this right shall be granted to them for the term of 10 years from the moment they register as Project participants and until the time when total profit amount YTD for every participant exceeds RUR 300 mln in the year following the year when total revenues received by this participant exceeded RUR 1 bln – starting from the 1st day of the tax period in which the above indicated excess of total profit took place under condition that total amount of profit does not exceed RUR 1 bln 300 mln);

¹ http://www.tsouz.ru/MGS/mgs21-05-10/Pages/Sogl_o_mexa№izme_zachisl_poshli№.aspx

² The following distribution (shares) of customs duties is stipulated within the Customs Union: Belarus 4.70%; Kazakhstan 7.33%; Russia 87.97%.

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- Corporate Profit Tax payments – until the moment of achieving a certain level of return on R&D investment (the conditions under which this relief is terminated are same as for VAT relief) or until losing the status allowing for using such tax reliefs. The relief is granted in the form of zero Profit Tax rate;
 - Corporate Property Tax payments with regards to property and assets used for research.

Also Law No.243 FZ of September 28, 2010 stipulates the decrease of mandatory pension, health and social insurance contributions down to 14% for the Project participants. Besides, the Law provides for the managing company (owner of land plots constituting the territory of Skolkovo Innovation Center and of the assets located on these plots) to be relieved from Land Tax and Corporate Property Tax. Skolkovo residents shall also be relieved from Corporate Property Tax.

Granting the above described reliefs may create a series of problems in controlling tax compliance of the Project participants, in particular:

- 1) Tax reliefs with regard to certain types of taxes do not mean reliefs from desk and field tax audits of Skolkovo residents. According to the new version of p. 2 of Article 89 of the RF Tax Code, decision about conducting a field tax audit of an organization, having received the status of Skolkovo Project participant in accordance with the Federal Law on Skolkovo Innovation Center, shall be made by a tax inspectorate with which the tax registration of the respective entity was done.

With that, a field tax audit may be conducted based on decisions of other tax authorities within jurisdictions of detached subdivisions (branches) of Project participants. The law does not limit the participants in setting up their branches or subdivisions. The only requirement for their territorial location / jurisdiction is that the parent company must have the Project participant status and its governing bodies should be based in Skolkovo IC, as well as bodies authorized to exercise activities on behalf of Project participant without a need for special Power of Attorney (sub-paragraph 2 of p. 2 of Article 10 of Law No.244-FZ). The need to pay property tax may arise at the jurisdiction in which the subdivisions/branches are located, and it will be very difficult to control given the fact that the Project participants (parent companies for subdivisions) are relieved from accounting. It should be noted that currently taxpayers are not obliged to provide for accounting at their subdivisions/branches. According to sub-paragraph 5 of p. 1 of Article 23 of the RF Tax Code, organization for which accounting is mandatory shall submit the accounting records and tax returns only to the tax authority of its location/jurisdiction, which is understood (as the RF Ministry of Finance indicated in numerous letters and memorandums) as location of the organization headquarters. At the same time the RF Ministry of Finance directly determines that there is no obligation to submit accounting records at jurisdictions of organizations' branches/subdivisions (see Letters of Minfin No.03-02-07/1 of July 7, 2009, and No.03-03-06/1/527 of August 18, 2009);

- 2) VAT relief and zero Corporate Profit Tax shall be granted to the Project participants until their profit and revenues exceed certain limits¹. At the same time, it is not quite clear – how will the participants be audited to confirm they have reached the established “threshold” and what documents will be the basis for such audit given the fact that the project

¹ Relief will stay in effect until the time when total profit amount YTD for every participant exceeds RUR 300 mln in the year following the year when total revenues received by this participant exceeded RUR 1 bln – starting from the 1st day of the tax period in which the above indicated excess of total profit took place under condition that total amount of profit does not exceed RUR 1 bln 300 mln.

participants shall be fully relieved from accounting. The point is that in p. 20 of Article 381 of the RF Tax Code there is no obligation for the Project participants to at least notify tax inspectorates about their profit amounts. They only shall submit revenues and expenditures data, which are not sufficient to check against the criteria set in Article 145.1 of the RF Tax Code;

- 3) In case Project participants do not do their accounting, certain difficulties may arise when requesting data about counterparties. Starting from 2006 the concept of counter tax audit was excluded from the Tax Code. However, it was practically replaced by the right granted to tax inspectorates for requesting data about the audited entity from its counterparties (which may be held liable for failure to provide such data). Thus, according to p. 2 of Article 126 of the RF Tax Code, failure to provide taxpayer's data at the request of a Tax Inspectorate in the form of documents stipulated by the Tax Code, and equally other forms of evasion from submitting such documents or submitting documents with consciously inaccurate data leads to a fine of RUR 10 thousand. That means, organization should be able to provide documents stipulated by the Tax Code and not by special laws and regulations. Failure to provide such documents may lead to tax liabilities arising;
- 4) Laws No.243-FZ and No.244-FZ have a serious logical contradiction. When using zero Profit Tax rate (p.5.1 of Article 284 of the RF Tax Code) Skolkovo Project participants should provide for tax accounting in the format stipulated for a different format of taxation – simplified tax system (Article 346.24 of the RF Tax Code). Thus, they need to use the tax rate from one type of tax, but the tax accounting procedure – from a different type of Tax. At the same time, the accounting methods for Profit Tax and for simplified tax system are different: accruals method is used for assessing the Profit Tax base, and cash-based method is used for assessing the simplified tax system tax base. This may lead to the following problems:
 - It is not clear whether Project participants should be using accruals basis or cash basis in their tax accounting. As was mentioned before, simplified tax accounting requires using the cash basis, and at the same time Article 246.1 states that Project participants shall assess their sales revenues using the rules stipulated in Chapter 25 of the RF Tax Code, which means – using the accruals basis;
 - Accounting of revenues and expenditures on a cash basis as per the procedure described in Article 346.24 of the RF Tax Code does not stipulate accrual of depreciation. And because Skolkovo Project participants are relieved from accounting, the tax authority shall be deprived of controlling capabilities with regards to correctness of accrual of depreciation of the fixed assets used by Project participants.

All the above leads to the following conclusion: the “friendly administration” option proposed for Skolkovo Innovation Center is one of the most radical. At the same time, it is difficult to say anything yet about its efficiency, because there has been no judicial practice in this field. However, the level of novelty in the proposed approach allows for assuming that in the process of implementing this model of administrative interaction between the government and the private sector the need for additional improvement and additional “fine-tuning” of the effective legislation will arise.

Annex 2

International assistance in tax issues between the CIS countries, Common Economic Space and Framework Agreements: analysis of existing agreements

International assistance, provided by the relevant authorities in different countries in terms of tax collection, is one of the main conditions for effective development of international economic relations. The standards of international agreements of various types are established, in varying degrees, to provide a procedure for such international assistance. Currently, many of the agreements provisions thereof do not meet the immediate objective: the effective mutual assistance of the tax authorities between different countries require amendments and supplements to optimize the provision of such an assistance.

What are the real possibilities of using international agreements, concluded between the country-members of economic integration with Russia in order to require / to render the international tax assistance by tax services to each other.

Specific methods of interaction between the tax authorities of various countries should be regarded as international tax assistance. These methods include:

- exchange of updated information on various tax issues (information on the taxpayer registration details, property, paid taxes and fees, about the violations of legislation on taxes and levies, etc);
- providing assistance to the tax authorities in the seizure of the documents;
- adoption of interim measures in regard to the property of tax debtor in a foreign country.

In the first turn, the question is about of such an interaction of tax services of the countries with the closest international relations in trade and economic cooperation with Russia.

These countries include the member-states of the Customs Union (hereinafter - CU), the Common Economic Space (hereinafter - the CES) and the Commonwealth of Independent States (hereinafter - CIS).

It appears, that the interaction of the Tax Service of Russia with the countries of the CU, the CES and the CIS should be active and comprehensive, taking into account the current economic relationships. Moreover, the interaction of tax services in Russia, Kazakhstan and Belarus (in the framework of CU and CES) should be most close in the issue of collection of tax arrears in comparison with a similar interaction between all other CIS countries

The legal environment of the interaction of tax services of the country-members of these regional associations in providing international tax assistance are three types of contracts:

- special agreements on mutual assistance in tax issues between the CIS countries (bilateral and multilateral);
- agreement on avoidance of double taxation (Article “Assistance in tax collection”, Art. "Mutual assistance in tax collection, Art." Exchange of information ");
- agreements on legal assistance (bilateral and multilateral).

Analysis of those types of agreements allows to conclude that the most convenient for tax services tax collection is namely the first type of agreements - agreements on mutual assistance in tax issues, containing special rules for the recovery / assistance provision.

Standards of agreements on avoidance of double taxation are also applicable to require / assist in tax collection, but only if such agreements also contain an article on exchange of information and an article on assistance in tax collection. Only two agreements on avoidance of

double taxation, concluded by the Russian Federation with the country-members of CIS, namely Uzbekistan and Armenia, contain both articles. Other agreements contain only an article on exchange of information, which is certainly insufficient for effective assistance in tax collection procedure for exercising the rights of Contracting States on taxation organizations, deriving profit in another state, rather than tax administration. In addition, agreements on avoidance of double taxation outline, how the rights of Contracting States on taxation organizations, deriving profit in other states, rather than the order of tax administration.

Agreements on legal assistance provide only a judicial procedure for assistance in tax collection. For example, when it comes to mutual assistance in tax collection in the form of collection of the Federal Tax Service of Russia (Russian Federal Tax Service) a debt from foreign debtors - a branch or representative office (located in Russia) of an entity - a resident of a foreign state. In this case, the Federal Tax Service of Russia may need to obtain such type of assistance from foreign tax authorities, such as:

a) to receive information about foreign assets of the debtor; b) the seizure of property of a foreign debtor. In this case, we are talking about property of a foreign debtor located in the territory of a foreign state. FTS OF Russia can obtain information about the debtor's property in two ways:

- apply to the Russian arbitration court to impose provisional measures on property of the debtor (in accordance with international agreements of Russia on mutual legal assistance) ;
- apply to the tax office of a foreign state to request assistance in providing relevant information (in accordance with international agreements on double taxation with Russia on cooperation and mutual assistance on tax compliance).

FTS has the right to seize property of the debtor in only one way - by an application to the Russian arbitration court for interim measures in the form of suspension of operations with taxpayer's bank accounts and / or seizure of property of a foreign debtor. This is due to the fact that the request for assistance in collecting taxes from the Tax Service of Russia has the right to address the tax office of a foreign country only for providing information and / or filing documents. Imposition of provisional measures (seizure of property, suspension of operations with the accounts) is not included in the subject of the request for assistance in accordance with international agreements on double taxation of Russia / on cooperation and mutual assistance in tax compliance. That is, seizure of the debtor's foreign tax debtor can only be performed through application to the court for the adoption of interim measures in respect of the debtor's property. Upon the receipt of petitions from the Federal Tax Service of Russia on the interim measures in respect of property of a foreign debtor, Russian Arbitration Court is forced to apply for legal assistance to the judicial authority of a foreign state. Legal mechanism for legal assistance is the transfer of judicial inquiries, which is implemented in two main ways: through diplomatic channels - through the department of Foreign Affairs (for Russia - the Ministry of Foreign Affairs) and the transfer of the central authorities of Justice (for Russia - the Russian Ministry of Justice). Herewith, the second way of sending the request is much faster than the first one. However, neither the Arbitration Procedural Code of Russia (hereinafter - the Russian PC), nor international agreements do not establish any specific time frames for providing legal assistance in the form of the judicial inquiry on the application of interim measures. Thus, the application of legal assistance agreements with the Russian tax authorities to obtain assistance in tax collection is difficult due to several factors. First, the agreements provide for the general order of appeal to the Court of Arbitration for tax

services, and for other persons, i.e., there are no special rules for tax service on the application procedure. Second, the agreements provide for a rather complicated mechanism for assistance in collecting taxes from foreign tax authorities only through the court by sending a special request. In this case, the agreements do not include the subject of such a request, i.e., there are no regulations for specific types of assistance. Third, neither the agreements, nor the Russian PC do not provide any time frames for the receipt of such assistance.

Agreements on Cooperation and Mutual Assistance in Tax are agreements that contain specific provisions for international tax services. First, such agreements grant the rights for the receipt of nearly any kind of information on all types of taxes. Information can be provided as under request, as well as spontaneously. Agreements contain minimum requirements to the request format (written form, signature of the official list of questions). There are reasons (but rather general) for refusal to comply with the request.

The disadvantages of such agreements include the following points: the term for response to a request and execution of the response to request are not specified neither in the agreements, nor in any other documents. Agreements contain general, not subject to appeal, grounds for refusal to comply with the request. Standards provide for old-fashioned way the request sending - via email. In addition, the agreements contain insufficient legal mechanisms that are used by tax authorities for the execution of the request. In addition, the agreements contain insufficient legal mechanisms that are used by tax authorities for the execution of the request. The idea is that the tax service of one country has the right to request the tax office of another country only for the purpose of obtaining any information on the taxpayer or to provide any documents. Also, a significant drawback is the lack of agreements automatic exchange of information on the regular tax matters (on the registration data of the taxpayer, the amounts of taxes paid, etc.)

However, due to the fact that namely agreements on cooperation and mutual assistance in tax issues are the special type of agreements providing for interaction between tax authorities of country-members of CIS, the CU and the CES, it is proposed to optimize some of the existing provisions of those agreements, taking into account their shortcomings and to take other additional solutions, allowing to broaden and extend the cooperation of tax services in the former Soviet Union environment.

First, agreements or special supplements to such agreements should set the minimum scope of requirements for the recovery of collection, for which assistance should be provided by a competent authority of the CIS countries, the CU and the CES. This amount can be set, say, at the level of 100 thousand rubles.

Second, in order to streamline the work of tax authorities on the issue of international cooperation among tax authorities, the following key timeframes should be set: the term of request and validity term for claims for recovery.

Third, it is proposed to approve a single request form for the uniform application of all the tax authorities of CU, CES and the CIS member countries and also to establish a priority electronic way to send a request.

As mentioned above, the grounds for refusal to comply with the request contained in the effective agreements are general in nature. In this regard, it is proposed to further specify the following grounds of refusal: the requested authority is not obliged to provide information that cannot be obtained with the recovery of claims arising in the country; if disclosure is related to violation of the commercial, industrial or professional secrets.

However, the most important changes should be the articles about ways to increase international assistance in tax issues. In this connection, it is necessary to identify additional legal mechanisms for recovery of tax debts of a foreign debtor, which could be applied by tax authorities of country-members of the CU, the CES and the CIS:

- search of the property (accounts, movable / immovable property);
- security measures (seizure of accounts, property);
- assist in the sale of property at auction in a foreign country by tax authorities;
- joint tax audits

To simplify interaction between the tax authorities of various countries, it seems possible to establish an automatic exchange of information on basic tax issues between in the CIS, the CU and CES, such as:

- information on the registration of enterprises, their branches and representative offices, including information about their location, subordination, ownership, beneficiaries, etc.;
- information about opening accounts in the state and commercial banks, corporations and individuals, as well as the presence and movement of the funds;
- information about all types of businesses and individuals income obtained in the territory of that state;
- information about the paid amount of taxes or other information related to taxation.

Thus, in order to improve the interaction of tax services in the framework of international assistance to each other in the CIS countries, the CU and the CES are invited to make several changes to the existing system of agreements on cooperation and mutual assistance in tax issues. The purpose of the proposed changes is to create an integrated taxpayers' database of the CIS, the CU and the CES country-members, as well as the harmonization of methods and forms of tax accounting and reporting, i.e., harmonization/unification of tax administration. In addition, optimization of the existing order of international cooperation of tax services will lead to the possibility of joint control over the activities of companies-exporters and importers. Joint and coordinated actions of the country-members of the CIS, CU and CES tax authorities will lead to an increase in tax revenues, fees and charges, effective detection and prevention of economic crimes.

Annex 3

Mutual Assistance between the EU Countries for Recovery of Claims Relating to Taxes: Recent Modifications

In 2010, the European Council adopted a new Directive on mutual assistance for the recovery of claims relating to taxes, duties and other measures¹. The ultimate objective of its enactment was to improve the current situation with regard to rendering mutual assistance for recovery of claims, duties and other measures within the EU. The Directive suggests, in particular, the possibility to request assistance for recovery of claims prior to exhaustion of all the possibilities in a given country, attend and contribute to a competent body's operations in another EU country. The Directive also introduced the requirement to submit requests and documents in the digital form by means of electronic networks and a number of other provisions.

¹ EC Directive 2010/24/EC of 16 March 2010.

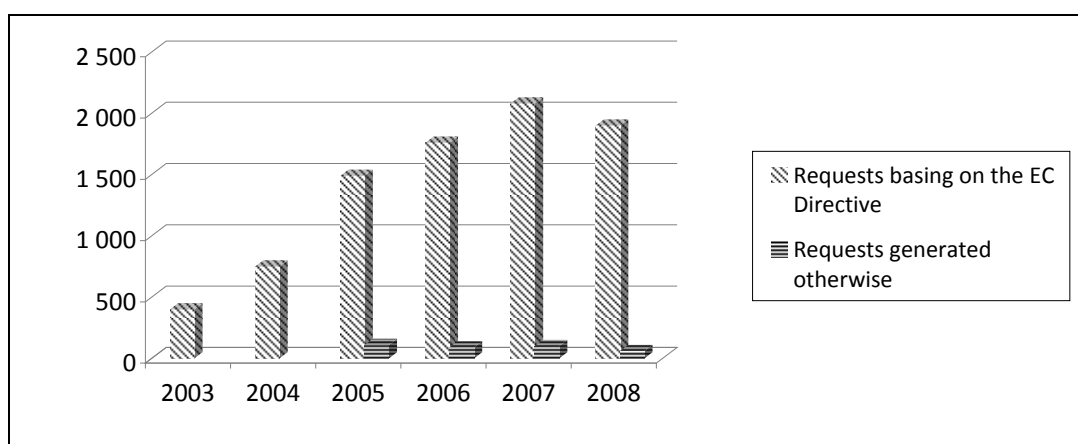
Recovery of tax assets from foreign legal entities, as well as execution of requests for recovery of tax assets submitted from overseas face considerable challenges in Russia. The Federal Tax Service believe this is due to the absence of concrete mechanisms of interaction on the matter between Russia's competent agencies and their counterparts overseas. EU has lately seen a significant rise in amounts recovered by back taxes claims submitted by foreign competent agencies, and the recovery mechanism develops permanently. This makes the EU, as Russia's strategic economic partner, an instrumental counterpart in improving the mechanism of recovery of foreign debtors' tax assets.

Provisions of the Directive may be of interest to a broad circle of agents in RF, including FTS, taxpayers, who plan to start/carry out their business in EU, and domestic tax counselors.

The EU member states render mutual assistance for a broad array of taxes, duties, levies, and other measures, and the amount of recovered back taxes has been increasingly on the upswing. Meanwhile, the efficacy of rendering assistance for recovery of claims is fairly low. The EC report on implementation of provisions on mutual assistance for recovery of claims relating to duties, levies, taxes and other measures between 2005 and 2008¹ holds that the claim recovery rate roughly accounts for 5%.

Given the 2005-08 statistical data the EU members states provided to the European Commission and cited in the noted report, one can draw the following conclusions:

- The number of the aforementioned requests basing on provisions of the said Directive is on the upsurge;
- The provisions in question are enforced far more often that provisions of other bi- and multilateral treaties between the member states on rendering mutual assistance;
- The use of other bi- and multilateral treaties between the member states on rendering mutual assistance is in decline²;
- Most requests concern either VAT, or income tax, or tax on capital;
- The amounts recovered are on the rise.

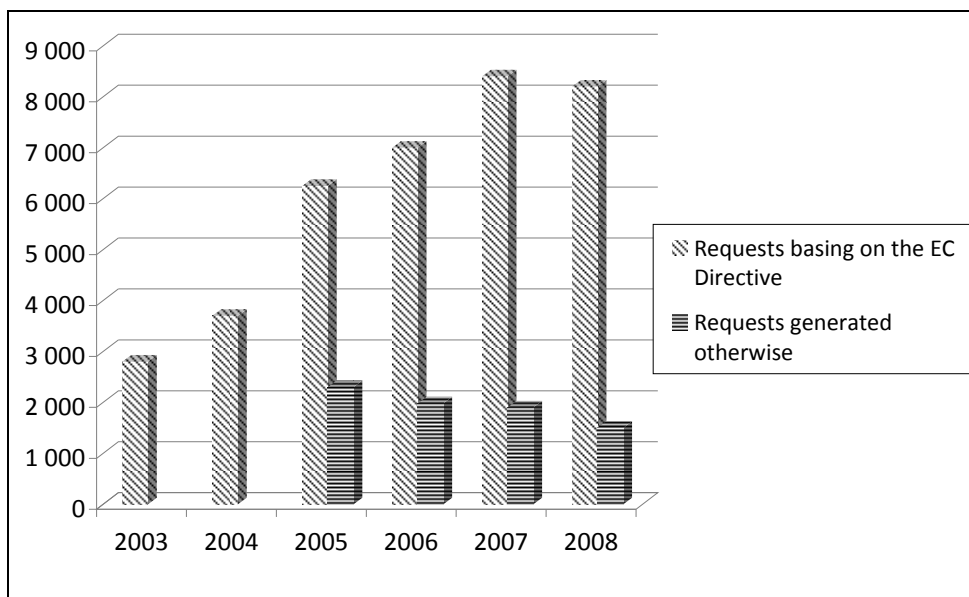


Source: The European Commission Report on enforcement of provisions of mutual assistance between member states for recovery of claims relating to taxes, duties, levies and other measures in 2005-2008 (Brussels, 2009).

Fig. 1. Change in the number of requests for provision of information

¹ [http://ec.europa.eu/taxation_customs/resources/documents/common/whats_new/com\(2009\)451_en.pdf](http://ec.europa.eu/taxation_customs/resources/documents/common/whats_new/com(2009)451_en.pdf)

² The data on employment of provisions of other bi- and multilateral treaties on rendering mutual assistance between the EU member states are given in the report for 2005-08

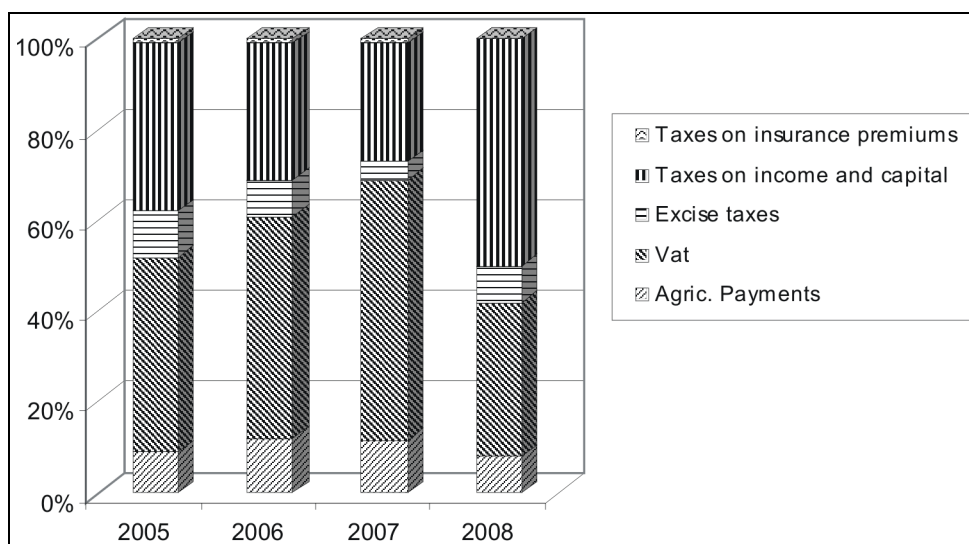


Source: The European Commission Report on enforcement of provisions of mutual assistance between member states for recovery of claims relating to taxes, duties, levies and other measures in 2005-2008 (Brussels, 2009).

Fig. 2. Change in the number of requests for rendering assistance with recovery of claims

Requests for rendering assistance for recovery of claims concern:

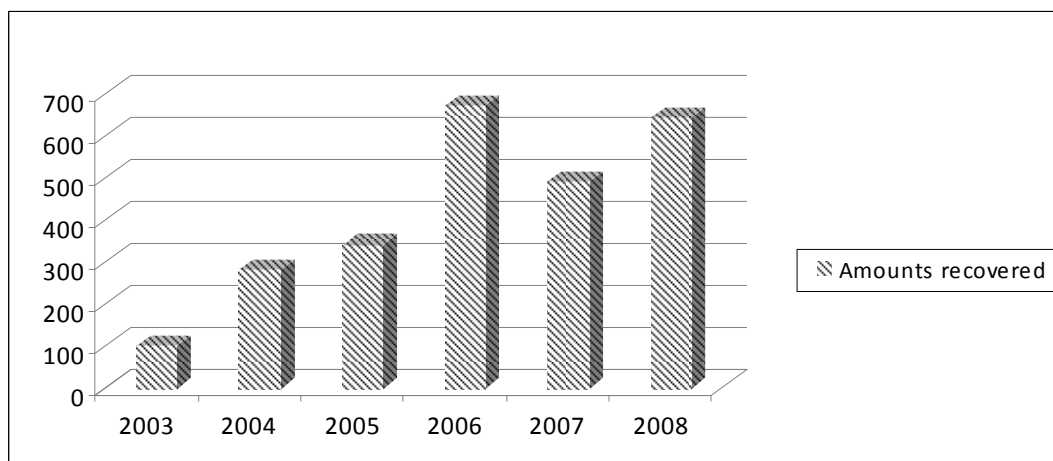
- VAT, with the respective requests accounting for a considerable portion of all the requests for rendering assistance for recovery of claims (up to 34% in 2008);
- Taxes on income and capital (the respective requests accounted for up to 50% in 2008);
- Excise taxes (ca. 10% of all the requests);
- Agricultural payments (ca. 10% of all the requests);
- Taxes on insurance premiums (a negligible fraction, no requests reported in 2008).



Source: The European Commission Report on enforcement of provisions of mutual assistance between member states for recovery of claims relating to taxes, duties, levies and other measures in 2005-2008 (Brussels, 2009).

Fig. 3 Correlation between requests for rendering assistance with recovery of claims

Amounts recovered in the frame of provision of mutual assistance are increasingly on the rise. In 2005, the respective amount was more than 3-fold as big as the 2003 figure, in 2007 – nearly 5-fold, and in 2008- more than 6-fold as big as in 2003. That said, it should be taken into account that some 80% of satisfied requests for assistance fall on the year in which the request was put forward or on the two prior years.



Source: The European Commission Report on enforcement of provisions of mutual assistance between member states for recovery of claims relating to taxes, duties, levies and other measures in 2005-2008 (Brussels, 2009).

Fig. 4. Change in the amounts recovered in the frame of provision of mutual assistance for the recovery of claims

The first legislative initiative on recovery of claims became EC Directive 76/308/EEC of 15 March 1976. The Directive concerned mutual assistance between the member states for the recovery of claims relating to customs duties and some kind of agricultural levies¹. In the course of time, the list of taxes, duties and levies with regard to which mutual assistance for recovery was rendered was significantly extended. The Directive of 15 March 1976 was extended by introducing articles on VAT (EC Directive 79/1071 EEC² of 2 December 1979), articles on excise taxes (EC Directive 92/108/ EEC³ of 14 December 1992), and articles on direct taxes and taxes on insurance premiums (EC Directive 2001/44/ EU⁴ of 15 June 2001).

The effect of Directive 2010/24/EC of 16 March 2010⁵ embraces all the taxes and duties imposed on behalf of, or directly by, the EC member states or their administrative or territorial branches, including local ones, or imposed on behalf of the EU. Administrative fines, penalties, levies falling under requirements of respective agencies competent to levy taxes or duties or exercise administrative requests in regard with them⁶.

As in Directive 2008/55 of 26 May 2008⁷, the new one likewise holds that any information, which in an explicit form can be instrumental in the course of recovery of a claim,

¹ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31976L0308:EN:HTML>

² <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31979L1071:EN:HTML>

³ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:31992L0108:EN:HTML>

⁴ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32001L0044:EN:HTML>

⁵ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2010:084:0001:01:EN:HTML>

⁶ The Directive is expected to come into effect in 2013.

⁷ <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2008:150:0028:01:EN:HTML>

should be made available upon request. The competent agency of execution is not obligated to deliver information:

- Which appears impossible to obtain while recovering claims arising in a given country;
- Whose disclosure is associated with a breach of commercial, production or professional secret;
- Whose disclosure will entail infringement of security or contradicts a given country's public policy.

The competent agency of execution is obligated to inform the competent agency that submitted the request of the reason for refusal of provision of information.

However, Directive 2010/24/EC provides for a possibility to request assistance for the recovery of claims prior to exhaustion of all the possibilities for recovery of claims within the country in the event:

- It becomes clear there are no way to recover claims in the requesting country or procedures will fail to result in the recovery in full, and the requesting agency has information proving that the respective entity has assets in the territory of the country of execution;
- Application of such procedures in the requesting country will entail disproportionate difficulties.

The new Directive also provides for the possibility to attend and contribute to operations of the competent agency in another EU member state.

Upon agreement between the requesting agency and the agency of execution and according to procedures of the agency of execution, the officially authorized representatives of the competent agency can:

- Be present at office premises of the competent agency of execution;
- Be present in the territory of the competent agency of execution's state during execution of requests;
- Render assistance to officially authorized representatives of the competent agency of execution's state during litigation.

While recovering claims, the competent agency of the country of execution uses procedures, regulations or administrative statutes of its country, which are applied to the same taxes and duties or, in the event there are not such taxes and duties, to similar ones.

In the event there are no similar such taxes or duties, the Directive instructs to apply procedures, regulations or administrative statutes with regard to the income tax.

The Directive facilitates the procedure of granting deferments, extensions with regard to payment of taxes and duties, with a possible collection of interest.

In the event the law, regulations or administrative statutes of the country of execution allow giving debtors time or offering the payment by installments with a possible collection of interest, competent agencies can grant deferments, extensions with regard to payment of taxes and duties.

The Directive provides for development of uniform instruments permitting the recovery, which should exclude problems associated with translation and recognition of foreign instruments¹.

¹ Directive 2010/24/EC specifically holds that it is problems associated with translation and recognition of foreign instruments that result in inefficiency of the existing instrument of rendering assistance.

Concomitant with any claim for the recovery should be a uniform document that grants permission to exercise the recovery in the country of execution. The said uniform document should contain the following information:

- Description of the claim, including its nature, period under which the claim falls, dates associated with the process of the recovery, amount of the recovery and its components, eg. a tax, fine;
- Name and other information related to the debtor's identification;
- Name, address and other contact information of the office responsible for assessment of the claim or the office where additional information can be obtained.

The Directive specifies the age of enforceable claims of the recovery.

As before, the competent agency of the country of execution still is not obligated to render assistance for the recovery of claims by which more than 5 years passed between the moment of execution of a claim in the requesting country and the moment of signing of the request for assistance for the recovery of the claim. However, in the event a request or a document permitting recovery in the country of execution was challenged, the 5-year term begins from the moment it was determined in the requesting country that the request or the document concerned could not be challenged any longer. Furthermore, in the event the competent agency of the requesting country permits deferment of payment or payment by installments, the 5-year term begins from the moment when the full term is over.

Meanwhile, the Directive specifies that in such cases the competent agency of the country of execution is not obligated to render assistance for the recovery of claims by which more than 10 years passed from the moment of execution of the claim in the requesting country.

The Directive caps the amount of sums due for the recovery and their minimum amount.

The competent agency of the country of execution is not obligated to render assistance in the event the amount of the claim for the recovery is under Euro 1,500.

The Directive sets reimbursement, at the debtor's expense, for costs incurred by the country of execution in relation to provision of assistance.

To encourage the EU member states to render an efficient mutual assistance, the Directive introduces a clause that enables the country of execution to compensate, at the debtor's expense, for costs incurred due to provision of assistance.

The Directive holds that information obtained in the frame of mutual assistance can be used by a EU member state that received the information for purposes not stipulated in the Directive.

This possibility is provided for cases where it is permitted by the domestic law of both EU member states - that is, the EU member state that supplied the information and the one that received the information.

The Directive provides for establishment of a contact office responsible for contacts with other EU members states in the mutual assistance area.

As well, the Directive set strict timelines for provision of information on mutual assistance.

Until 31 March of the year following the period under review every EU member state submits to the European Commission information, as follows:

- The number of requests received and submitted during the year in question, by kinds of assistance,
- Amounts with regard to which assistance for the recovery is needed;
- Amounts recovered.

The EU member states may also submit any other information which may be instrumental to assessment of provisions on mutual assistance per the Directive concerned.

It is evident that the EU record in improvement of the mechanism of rendering mutual assistance for the recovery of claims relating to taxes, duties and levies can bestead Russian Federation in the frame of development of a mechanism of rendering mutual assistance.

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