

GAIDAR INSTITUTE FOR ECONOMIC POLICY

**RUSSIAN ECONOMY IN 2013
TRENDS AND OUTLOOKS
(ISSUE 35)**

**Gaidar Institute
Publishers
Moscow / 2014**

UDC 330.34(470+571)"2013"

BBC 65.9(2Poc)

Agency CIP RSL

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R95 **Russian Economy in 2013. Trends and Outlooks.**
(Issue 35) – M.: Gaidar Institute Publishers, 2014. 516 pp.

ISBN 978-5-93255-393-0

The review provides a detailed analysis of main trends in Russia's economy in 2013. 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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ISBN 978-5-93255-393-0

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Section 1. The socio-political context

1.1. Challenges of Russian economic growth: reconstruction or acceleration?

In 2013 the Russian economy entered a new phase of socio-economic development. The period of tempestuous development, during which the primary trends and objectives had been those of recovery and which had lasted almost twelve years (1999–2012), had come to an end. The crisis of 2009 did not end in a replacement of this growth model; on the contrary it perpetuated its existence, given the need for a return to pre-crisis levels of output. The need for a new model became one of practical necessity, since rates of economic growth fell to a level that was unprecedented, a deceleration that could not be attributed exclusively, or even predominantly, to external factors. Corresponding conclusion was politically executed in the President's Address of 12 December 2013.

The internal factors at work within the Russian economy have to be examined in the context of the continuing global economic crisis. This crisis provides not only the economic but also the socio-economic background to Russian economic development and in particular circumstances it can be a significant factor in the adoption of internal political decisions.

We shall begin with an analysis of the current phase of the global crisis (Section 1.1.1). Then, in Section 1.1.2 we shall provide a brief account of the key socio-economic achievements in Russia by 2014. In Section 1.1.3 we shall deal with the reasons for the deceleration of economic growth and on this basis we shall consider in Section 1.1.4 the risks surrounding economic policy. The concluding Section 5 describes institutional priorities that will be needed in socio-economic policy if a new growth model is to emerge.

1.1.1. The global economic crisis

Defining somewhat schematically the problem that we encountered this year we could say that at a time when the leading world economies were beginning to emerge from the crisis, Russia began, perceptibly, to descend into it. Of course, the contrast was not so clear-cut: the crisis in the West remains severe and the effects of anti-crisis measures will continue to be felt for a long time. The macroeconomic situation continues to be complicated. Nor can one discount the slow down of growth in China, with all of the consequences that this entails for the world economy. (*Table 1*)

The developed world has once again demonstrated its stability and strategic effectiveness. The locomotive force for exiting the crisis has once again been provided by the USA, and the economic stability of Germany has been crucial in enabling the European economies to overcome the crisis. A significant role in the American case has been played by cheap energy; limits, during the years of the crisis, on the level of wages; and a relative depreciation of the

dollar. These factors combined to ensure a recovery of economic growth. Growth in the American economy, though it was to a greater degree domestic than before the crisis (the current-account deficit fell to below 2.2% of GDP), stimulated a growth in demand for goods throughout the entire world. Presumptions that, this time round, the growth of emerging markets would make an important contribution to bringing the crisis to an end were not confirmed. Of course, the high growth rates of the Chinese economy played an important part in damping down the risks of global recession.

Table 1

**Growth rates for selected countries and groups of countries
2005-2013 (% of previous year)**

	2005	2006	2007	2008	2009	2010	2011	2012	2013
World	4.7	5.2	5.3	2.7	-0.4	5.2	3.9	3.2	2.9
Developed countries	2.8	3.0	2.7	0.1	-3.4	3.0	1.7	1.5	1.2
Major developed countries (G7)	2.5	2.6	2.2	-0.3	-3.8	2.8	1.6	1.7	1.2
European Union	2.4	3.6	3.4	0.6	-4.4	2.0	1.7	-0.3	0.0
Canada	3.2	2.6	2.0	1.2	-2.7	3.4	2.5	1.7	1.6
France	1.8	2.5	2.3	-0.1	-3.1	1.7	2.0	0.0	0.2
Germany	0.8	3.9	3.4	0.8	-5.1	3.9	3.4	0.9	0.5
Italy	0.9	2.2	1.7	-1.2	-5.5	1.7	0.4	-2.4	-1.8
Japan	1.3	1.7	2.2	-1.0	-5.5	4.7	-0.6	2.0	2.0
Great Britain	3.2	2.8	3.4	-0.8	-5.2	1.7	1.1	0.2	1.4
USA	3.4	2.7	1.8	-0.3	-2.8	2.5	1.8	2.8	1.6
Portugal	0.8	1.4	2.4	0.0	-2.9	1.9	-1.3	-3.2	-1.8
Ireland	6.1	5.5	5.0	-2.2	-6.4	-1.1	2.2	0.2	0.6
Spain	3.6	4.1	3.5	0.9	-3.8	-0.2	0.1	-1.6	-1.3
Greece	2.3	5.5	3.5	-0.2	-3.1	-4.9	-7.1	-6.4	-4.2
Brazil	3.2	4.0	6.1	5.2	-0.3	7.5	2.7	0.9	2.5
China	11.3	12.7	14.2	9.6	9.2	10.4	9.3	7.7	7.6
India	9.3	9.3	9.8	3.9	8.5	10.5	6.3	3.2	3.8
Russia	6.4	8.2	8.5	5.2	-7.8	4.5	4.3	3.4	1.3
South Africa	5.3	5.6	5.5	3.6	-1.5	3.1	3.5	2.5	2.0

Source: IMF.

The financial markets of the developed countries experienced a revival amounting to 15-30% over the year (the growth of S&P reached 30%, a level that had not been attained for almost 20 years). Macroeconomic indicators in these countries improved. Most notably, there was a reduction in budget deficits. There was a fall in unemployment, albeit with a delay relative to the recovery of GDP, a circumstance that, in our opinion, reflects the structural modernization of the developed economies.

It is true that this positive dynamic took place in the context of an unprecedentedly soft monetary policy introduced by the central banks of the leading countries, primarily the USA and Japan. Amongst economists there are great doubts as to the feasibility of returning in the foreseeable future to the high growth rates of the last two decades. These doubts apply to the developed world as much as to developing markets¹. A debate continues over the “new

¹ Laurence Summers has expressed doubts as to the feasibility of achieving sustainable growth in the USA in the foreseeable future and in this connection has warned against drastic measures by the Federal Reserve System to stimulate growth. See Summers Laurence. 2013. Why stagnation might prove to be the new normal // Financial Times. 2013. December 15; Summers Laurence. 2014. Washington must not settle for secular stagnation // Financial Times. 2014. January 5). In parallel, there have been discussions as to whether the high growth rates of

normal” - a post-crisis growth model typified by lower growth rates than those that were experienced during the period 1990-2000.

From this point of view, a key problem in 2014 will be the effect upon economic development of a tightening of monetary policy, a change that seems unavoidable in the immediate future. There is a more general problem: what are the medium-term macroeconomic prospects of the leading world economies, given the unprecedented growth in the balances that have been accumulated by their central banks during the last few years? This question is of interest not only from a theoretical point of view, but also in terms of current economic policy. Here, the contribution of the USA to the trends that will emerge during 2014-2015 can once again be decisive – if the ending of the stimulation programs of the Federal Reserve System has the effect of slowing down the growth of the American economy and increases the cost of capital throughout the world.

Another problem is of a long-term nature and has to do with the outlook for globalization. Despite the recovery of GDP and the overcoming of acute financial crisis, the movement of capital across frontiers has slowed down significantly. Whereas in 2007 financial flows between the economies of the G-20 amounted to 18% of GDP, this indicator now stands at under 4.5% and in the world economy as a whole it has fallen by 60%¹. Of course, some economists might see in this a strengthening of the stability of the world economy, and an expression of the well-known dichotomy “stability that fends off the crisis or growth that precipitates the crisis”. In our opinion, the cost of this stability could be a long-term deceleration of economic development.

Gradually, the contours of the post-crisis world system are becoming clear. These reflect new geo-economic and geo-political balances of power, new technological priorities, and changing prospects for world currencies, state regulation and economic doctrines. We do not yet have a full picture, but some features are already apparent. Let us list a number of the trends that will assert themselves in the foreseeable future.

- There are new trends in the regional distribution of production throughout the world. The importance of industry in the developed world has increased, in some cases amounting to a “re-industrialization”. However, even if this re-industrialization becomes established in the long-term it would be incorrect to interpret it in terms of traditional branches of industry returning from developing to developed countries. Rather, we are witnessing the formation of new branches of industry, one characteristic of which is a relative reduction of the share of labor in production costs and an increase in the importance of such factors as proximity of the research base (resulting from an increase in the share of research and development (NIOKR or R&D)) and of basic consumer demand. An important consideration is the increased cost of labor in the leading developing countries, particularly those of South-East Asia.
- A lowering of energy prices, associated both with the introduction of new technologies for the extraction of non-traditional forms of gas and oil, and with a significant expansion the infrastructure for delivery. As a result, there has been an unexpected revolution in the field

the developing economies during the last twenty years were anomalous, such that there will now be a correction to the levels typical for the 1970s-1980s. (Aslund Anders. 2013. Why Growth in Emerging Economies Is Likely to Fall. Washington D.C.: Peterson Institute for International Economics. Working Paper 13-10. 2013, September)

¹ Lund Susan, Daruvala Toos, Dobbs Richard, et al. 2013. Financial Globalization: Retreat or Reset. Global Capital Market 2013. McKinsey Global Institute, 2013; Atkins Ralph, Fray Keith. 2014. Rapid fall in capital flows poses growth risk // Financial Times. 2014. January 6.

of energy prices, to the point where, during the last year, there was discussion not so much of the possible scale of price increases as of a possible price stagnation or fall in prices (to be more precise, whether a fall in real prices would be accompanied by a decline in nominal prices). Naturally, this revolution in the energy market is also becoming a factor in the process of re-industrialization.

- The situation in world currency markets is becoming clearer. On the one hand the dollar and the Euro have retained their key role as world reserve currencies. It has become clear that of these two the dollar will predominate, given that the American economy once again been at the forefront in overcoming the world economic crisis. At the same time, notwithstanding serious challenges and risks, the Euro consolidated its international role, albeit in second place to the dollar. The Yuan has not yet become a reserve currency and is unlikely to acquire this status until the Chinese economy and Chinese society have undergone liberalization and are able to demonstrate the political stability that will result from this. For the time being, it remains unclear whether the role of regional reserve currencies can be increased – this will depend upon the stability of the regional economic alliances that are currently forming.
- In the past, the resolution of world economic crisis gave rise to the formation of new models of economic management – with the sharp increase in dirigisme in the mid-twentieth century (after the 1930s) and the liberalization of state regulation at the end of the twentieth century (after the crisis of the 1970s). At the beginning of the recent crisis there was some talk of returning to the “big state”, but this has not come about. At the same time, some increase in state regulation of the economy is to be expected. In all probability, this will take the form not of direct intervention or of an increase in the share of state-owned property, as during the Great Depression, but in closer regulation of financial markets at national and international levels. This is especially the case with the banks, which are now more strictly regulated in respect of capital requirements and of the kind of transactions they are allowed to engage in.
- The world economic crises of the twentieth century resulted in the formation of a new, dominant, economic philosophy. Although the present crisis has provided a significant amount of data for economic research, there are as yet no grounds for concluding that a new economic philosophy has materialized.

1.1.2. Russian socio-economic performance in 2013

In formal, macroeconomic terms, the situation in Russia seems to be stable (see *Table 2*). The economy is growing, albeit at a decelerating rate; there is a policy of balancing the budget; there is a low level of government debt; employment is high and inflation is under control. However the outlook for development gives grounds for concern.

Two sets of circumstances account for the important change comparing with Russian economic developed in previous twelve years.

The first is an abrupt deceleration of economic growth which in year 2013 fell below the world average (1.3% of GDP compared with 3%). This is unprecedented in the last 12 years, if one excludes 2009. However, in that year, the steep decline resulted from an external shock, had a catastrophic impact and was rapidly contained thanks to fairly effective measures adopted by the government.

Now the situation is different. The world economy is emerging from the crisis. Of course, in some countries of the BRICS group growth is also slowing down, but this framework for

comparison is not valid politically or economically. Economic growth was the key issue in discussions of economic policy during 2013 and we shall now consider this question in more detail below.

Table 2

Basic macro-economic indicators of Russian development 2007-2013

	2007	2008	2009	2010	2011	2012	2013
GDP % relative to corresponding period in preceding year	8,5	5,2	-7,8	4,5	4,3	3,4	1,3
Industry % relative to corresponding period in preceding year	6,8	0,6	-9,3	8,2	4,7	2,6	0,4
Agriculture % relative to corresponding period in preceding year	3,3	10,8	1,4	-11,3	23,0	-4,8	6,2
Final household consumption % relative to corresponding period in preceding year	14,3	10,6	-5,1	5,5	6,8	7,9	3,4
Investments in basic capital, % relative to corresponding period in preceding year	23,8	9,5	-13,5	6,3	10,8	6,6	-0,3
Surplus (+)/Deficit (-) of consolidated budget, % of GDP	6,0	4,9	-6,3	-3,4	1,5	0,4	-1,3
Reserve Fund (2007) – Stabilization fund, end of year, billion dollars	156,81	137,09	60,52	25,44	25,21	62,08	87,38
National Welfare Fund, end of year, billion dollars		87,97	91,56	88,44	86,79	88,59	88,63
Consumer Price Index, December to December	11,9	13,3	8,8	8,8	6,1	6,6	6,5
Producer Price Index December to December	25,1	-7,0	13,9	16,7	12,0	5,1	3,7
Average interest rate on rouble loans to enterprises	10,0	12,2	15,3	10,8	8,5	9,1	9,5
Average interest rate on private deposit accounts (excluding instant withdrawal accounts)	7,2	7,6	10,4	6,8	5,4	6,5	6,5
General level of unemployment (MOT methodology), average for year	6,0	6,2	8,3	7,3	6,5	5,5	5,6
Average monthly salary paid out (thousand roubles)	13,6	17,3	18,6	21,0	23,4	26,6	29,9
Level of savings % relative to available income	23,0	16,5	22,4	23,9	18,5	17,4	15,5*
Balance of payments, billion dollars							
Current account	71,3	103,9	50,4	67,5	97,3	72,0	32,9
Balance of trade	123,4	177,6	113,2	147,0	196,9	192,3	177,3
Exports	346,5	466,3	297,2	392,7	515,4	528,0	521,6
Imports	-223,1	-288,7	-183,9	-245,7	-318,6	-335,7	-344,3
Direct investments	11,1	19,1	-6,7	-9,4	-11,8	1,8	-18,6**
–in the economy of the RF	55,9	74,8	36,6	43,2	55,1	50,6	78,4**
–Abroad	-44,8	-55,7	-43,3	-52,6	-66,9	-48,8	-97**
–Reserves (“-“ growth)	-148,9	38,9	-3,4	-36,8	-12,6	-30,0	22,1

* For January-November 2013.

** Investments in the banking sector excluded.

Source: Rosstat, CBRF, MinFin of Russia.

The second serious problem was increasing strain on the budget, It has been customary in the Russian budget process since 1999 for de facto realized revenues to exceed planned revenues annually. This was the result of a more rapid increase in oil prices and of higher inflation than had been envisaged in the Budget Law. The political opposition constantly accused the government of incompetence in its budget planning, but it was more generally understood that the government’s approach created a stability reserve and that the surplus revenues facilitated the solution of not only economic but also political problems.

Now this reserve no longer exists. The oil price, whilst it has remained at an exceptionally high level, has stopped increasing and in real terms will, in all probability, fall. Inflation, although it is at present somewhat higher than the level forecast, is nevertheless approaching the level assumed in the budget and if a rigorous system of inflation targeting is introduced this source of supplementary nominal revenues might completely disappear.

It is against this background that a number of trends, important for the medium-term development of the economy, have emerged.

The problem of modernization: Labor productivity is increasing slowly, as can be seen from the high level of employment. However, at a time of structural crisis the pace of modernization should increase more significantly.

If we compare the branch structure of the economy with that of the pre-crisis year, 2008, the problem becomes clear (*Table 3*). By comparison with the *pre-crisis period*, the increase in industrial production in 2013 was 105.7%. This level was achieved thanks to a growth in the extraction of natural resources, in the output of processed goods of the chemical industry, in the production of transport equipment and of food produce. The majority of processing industries have not regained the levels of output of 2008. Moreover, the 2013 figures for the production of investment goods are even farther from pre-crisis levels than the figures for 2012.

Table 3

**Growth of industrial output by category 2009-2013
(% relative to 2008)**

	2009	2010	2011	2012	2013
Index of industrial output	-9,3	-1,9	2,7	5,4	5,7
Extraction of minerals	-0,6	3,0	4,9	6,1	7,4
Extraction of energy minerals	0,4	3,5	4,9	6,1	7,4
Extraction of minerals excepting energy minerals	-7,4	-0,6	4,1	5,1	6,9
Processing industries	-15,2	-5,2	1,0	5,1	5,2
Production for consumer demand	-3,7	2,0	3,4	7,6	8,9
production of food produce, including drinks and tobacco	-0,6	4,8	5,8	11,2	13,8
Textile and clothing	-16,2	-6,1	-3,6	-5,5	-0,9
Leather, leather goods and footwear	-0,1	18,6	28,8	15,8	9,6
Pulp and paper production, publishing and printing	-14,3	-9,2	-7,6	-5,7	-10,6
Production of intermediary goods	-10,1	0,0	4,0	7,6	8,3
Timber processing and production of timber products	-20,7	-11,7	-8,1	-5,1	-3,8
Coke and refined petroleum	-0,6	4,4	7,4	9,8	12,0
Production of chemical industries	-6,9	6,7	12,2	13,7	19,3
Production of rubber and plastic goods	-12,6	6,2	20,1	29,0	35,7
Basic metals and fabricated metal products	-14,7	-4,1	-1,3	3,1	0,7
Production of investment goods	-32,9	-18,8	-7,3	-0,6	-2,1
Manufacture of transport equipment	-37,2	-17,0	3,4	16,6	17,6
Production of investment goods excluding transport equipment	-30,4	-19,8	-13,5	-10,5	-13,3
Production of various non-metallic mineral products	-27,5	-19,7	-12,3	-7,4	-7,1
Production of machinery and equipment	-31,5	-23,1	-15,8	-15,5	-21,9
Manufacture of electrical equipment, electronic and optical equipment	-32,2	-16,7	-12,5	-8,7	-11,3
Production and distribution of electricity, water and gas	-3,9	0,0	0,1	1,3	-0,5
<i>Reference:</i>					
Investments in basic capital	-13,5	-8,1	1,9	8,6	8,3
Retail trade turnover	-5,1	1,1	8,2	15,1	19,6

Source: Rosstat.

One factor determining this trend in the development of Russian industry is the dynamic of domestic demand for its goods. The output of investment goods recovered steadily from the first quarter of 2010 to the second quarter of 2012, but the rate of growth of this output was ambivalent. Growth was achieved against a background of accelerating recovery of investment activity in the economy as a whole: investments in basic capital over this period grew at average rates of around 10% per annum. However, as of the third quarter of 2012 investment programs began to slow down and this was accompanied by a fall in the output of investment goods. It is of significance that for the greater part of this output, the decline began before pre-crisis levels of output were attained. The output of machinery and equipment during

2013 was 22% lower than the pre-crisis level, the output of electrical equipment was 11% lower and the output of construction materials was 8% lower.

Employment remained at a high level. Unemployment remains low and after a slight increase in the first quarter of 2013 (when it was 5.8% of the economically active population) it ended up at 5.6% by the end of the year. This is an exceptionally low level in the post-communist period of the Russian economy (though the absolute minimum of 5.1% occurred in October 2012) and also in comparison with the world's leading economies. Other significant parameters are the growth of budget funded wages and the continuing tendency for the growth of incomes to exceed that of labor productivity; an increase in revenues from personal income tax (NDFL) accompanied by a reduction in revenues from profits tax and VAT; and an increase in contributions to the Pension Fund and other social extra-budgetary funds.

Trends in the labor market have remained unchanged during the last 20 years. Employers are reluctant to cut back on their labor force under crisis conditions. Certainly, there is a new phenomenon – a stable level of employment, in conditions in which rates of economic growth are slowing down, is being accompanied by increases in wages. This can be attributed to an increase in wages in the social sectors (in conformity with the Decree of the President of the Russian Federation “On measures for the implementation of government social policy” of 7 May 2012) and to the continuing decline in the number of people of working age who are employed which increases pressure from above on the labor market (in terms of employment and wages).

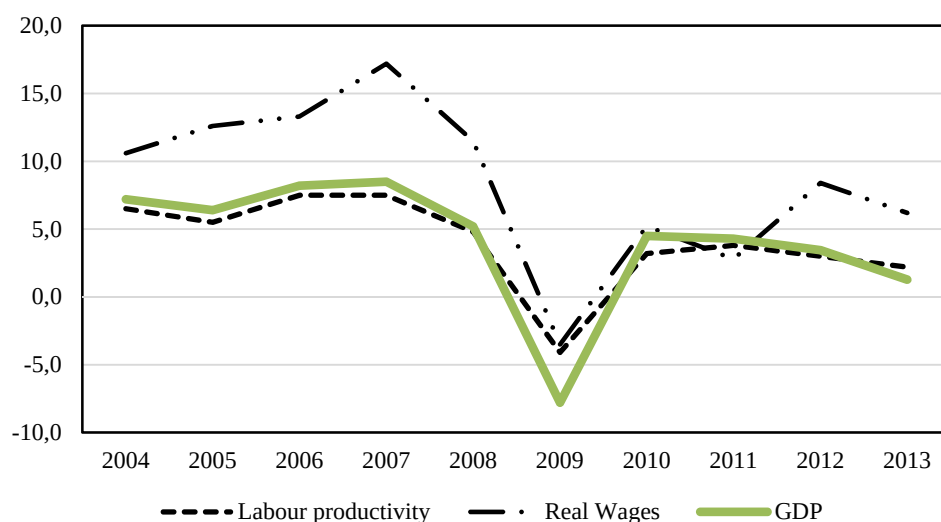
Social leniency and financial strain:

A significant aspect of developments during 2013 was an increase in the share of wages relative to a reduction in the share of profits in GDP. The economic system is becoming more socially oriented and less attractive to investors. This is reflected in the structure of tax revenues which reports an increase in revenues from personal income tax and a reduction in revenues from profits tax and VAT.

During 2013 the growth of the Russian economy continued to be determined, essentially, by factors of consumer demand, attributable to a growth in wages and consumer credit. The growth of wages consistently exceeds the rates of growth of GDP and of labor productivity (*Fig. 1*). Whereas GDP grew in 2013 by only 1.3%, the growth of real disposal income was of the order of 3.3%, wages increased by 5.2% and the volume of credit granted to physical persons increased by 28%. As a result, retail trade turnover increased by 3.9% and the volume of paid services to the population by 2.1%.

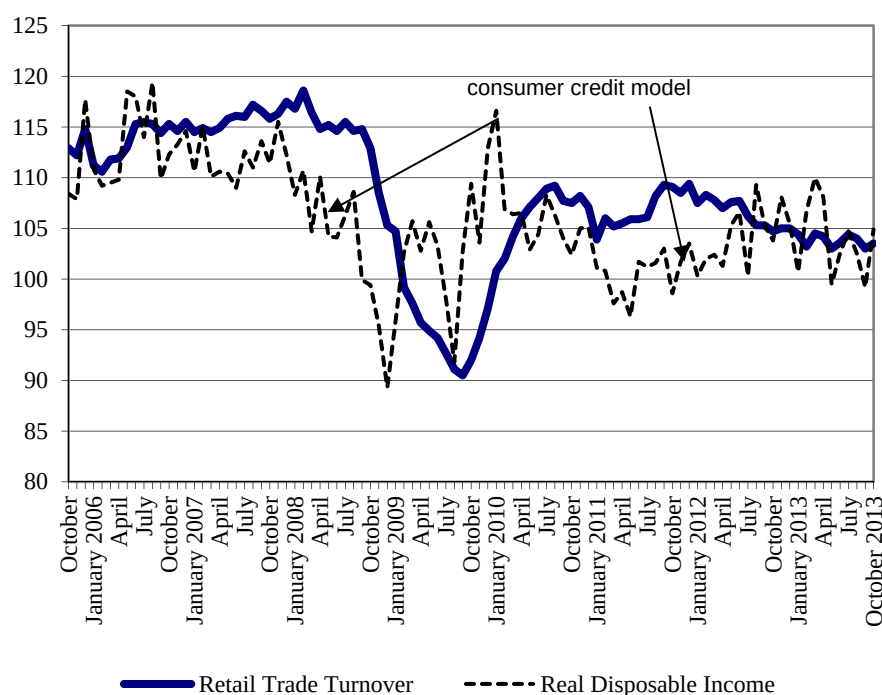
Certainly, in the year that has past, the rates of growth of retail trade turnover declined, though they exceeded the growth of GDP, which in turn was influenced by a fall in the rates of growth of the population's disposable income and of retail credit. In *Fig. 2* we indicate those periods when consumption was to a noticeable degree stimulated by bank lending and those when it was stimulated by an increase in wages.

The share of wages of hired workers exceeded 50% of GDP. This not only strengthened the consumer orientation of the economy but might even signal the approach of a crisis. When this proportion exceeded the 50% threshold in 1997-1998 and in 2007-2008 the result was a crisis: either a devaluation of the currency or a decline in the volume of production, or both at once.



Source: Rosstat.

Fig. 1. Annual rates of growth of GDP, labor productivity and real wages

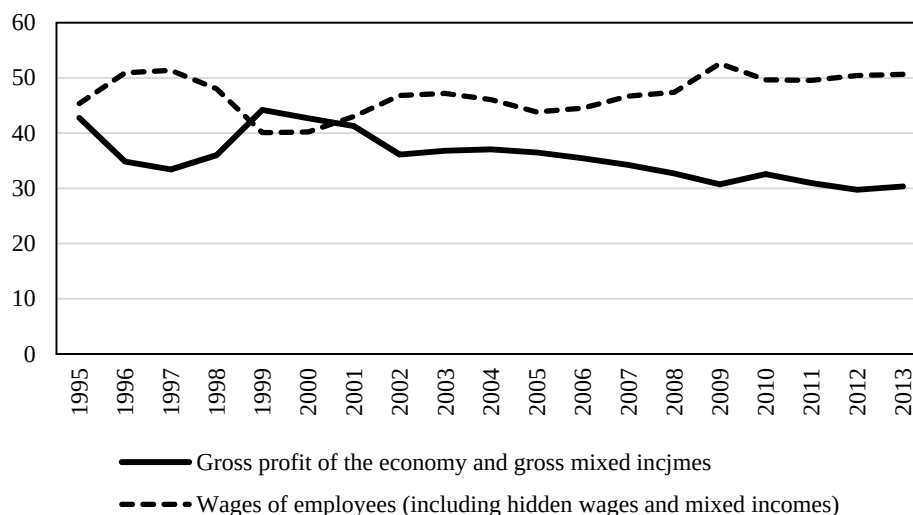


Source: Rosstat.

Fig. 2. Real disposable income and retail trade turnover growth

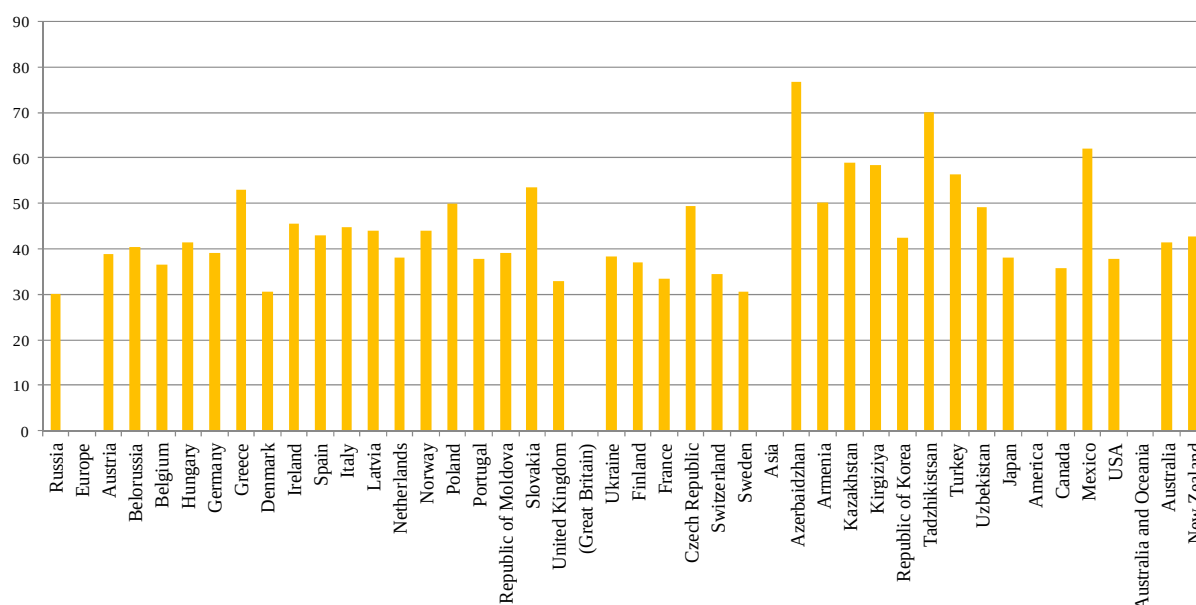
The increase in personal incomes was accompanied by a deterioration in the position of enterprises – the balance of profits relative to basic forms of activity fell by almost 20%. Profits are one of the principal sources of investments for the average Russian enterprise. At the same time, in sectors of production and investment demand, profits contracted to a significantly greater extent than in sectors of consumer demand and trade. The share of profits in Russian GDP is at a low level when compared to the majority of developing and developed

countries (Fig. 3 and 4). Furthermore, since the beginning of the global crisis there has been a tendency for the share of own resources in investments to increase, whilst borrowing for investment and budget funded investment have decreased (in the latter case in respect of regional budget funding). This is reminiscent of the situation that existed at the beginning of the 2000s.



Source: Rosstat.

Fig. 3. Gross profit and mixed incomes, wages of employees, as % of GDP



Source: IMF.

Fig. 4. Share of gross profit in GDP by country

In so far as, in present-day Russia, 50-75% of investments are funded out of enterprise profits and approximately 60% of profits derive from the oil and gas sector and trade, a reduction in the share of profits denotes a diminution of investment resources, predominantly in the non-raw materials sectors.

The Growth of wages in the budget sector became an important issue of social and economic policy in 2013. Recently, military personnel in all of the armed forces and Federal level civil servants were awarded significant pay rises and last year saw the implementation of the Decree of the President of the RF on pay increases for workers in education and health care. The government's intention is to make work in the development of human capital more attractive and to highlight the importance of these workers in the country's socio-economic policy. It is the expectation that the increase in wages will attract highly qualified specialists and bring about a significant institutional transformation.

The *budget* is in a fairly healthy state, especially when one bears in mind the budget crisis being experienced in the majority of developed countries. The Federal budget is in balance, and government debt, though it has increased somewhat, remains at an exceptionally low level (10% of GDP, of which external debt is under 2.5% of GDP). A partial amendment of budget rules affects only shortfall in budget revenues and for that reason does not create additional risks of an uncontrollable increase in budgetary obligations. Even so, any departure from the principle of balancing revenues, given that estimates are based on a multi-year average for the price of oil, represents an actual relaxation of budget policy and in future could result in a further increase in the non-oil budget deficit. The non-oil budget deficit, which leapt to 6.7% of GDP in 2008 and to 13.8% of GDP in 2009, is at a dangerously high level.

Taking all of this into account, the high degree of reliance, for stability, on the oil price (a parameter that lies outside of the control of the government), and the habit, formed over a decade, of relying upon increasing revenues, are problems that cannot be ignored.

Regional finances are in a more precarious state. Here the problem is a significant fall in revenues in circumstances where a rapid and appropriate reduction in the volume of expenditures is rendered impossible by an increase in sub-national borrowing.

According to data of the Federal Treasury, for 2013 the fall in the sum of the overall revenues to the consolidated budgets of subjects of the Russian Federation amounted to 0.9% of GDP in comparison with 2012. Meanwhile, tax revenues fell by 3.4% and transfers from the Federal Budget fell by 12.4%. The overall decline in tax revenues was due to changes in profits tax, revenues from which fell during the period in question by 18.4%. The decline in the general volume of tax revenues paid into regional budgets might have been greater if there had not been an increase in revenues from other taxes, primarily personal income tax (NDFL) of 4.0%.

In the meantime, expenditures of the consolidated regional budgets fell in 2013 by only 0.4% of GDP. In order to offset the fall in revenues while maintaining expenditures at a given level the sub-national authorities were obliged to increase their borrowing: the volume of regional debt (municipal debt excluded) during 2013 for all subjects of the Russian Federation increased by over 10% in nominal terms. At the end of 2013 aggregate regional debt stood at around 2.5% of GDP or 22.8% of the aggregate tax and non-tax revenues of sub-Federal budgets. There is also a trend towards steadily increasing volumes of borrowing, which, unless there is a change in budgetary policy, could lead to an increase in the debt burden which could attain critical proportions (by some indicators) in the medium term.

For 5 years now there has been an increase in the social expenditures of the regions, and a decline in expenditures aimed at investment: the share of social expenditures in the general expenditures of the consolidated budgets of subjects of the Federation increased by almost 10% over the period 2009-2013 and in the past year this has amounted to around 62%. By

contrast, expenditures on housing and communal services (ZhKKh) and transport (which are most closely tied to investment) fell by about 21%.

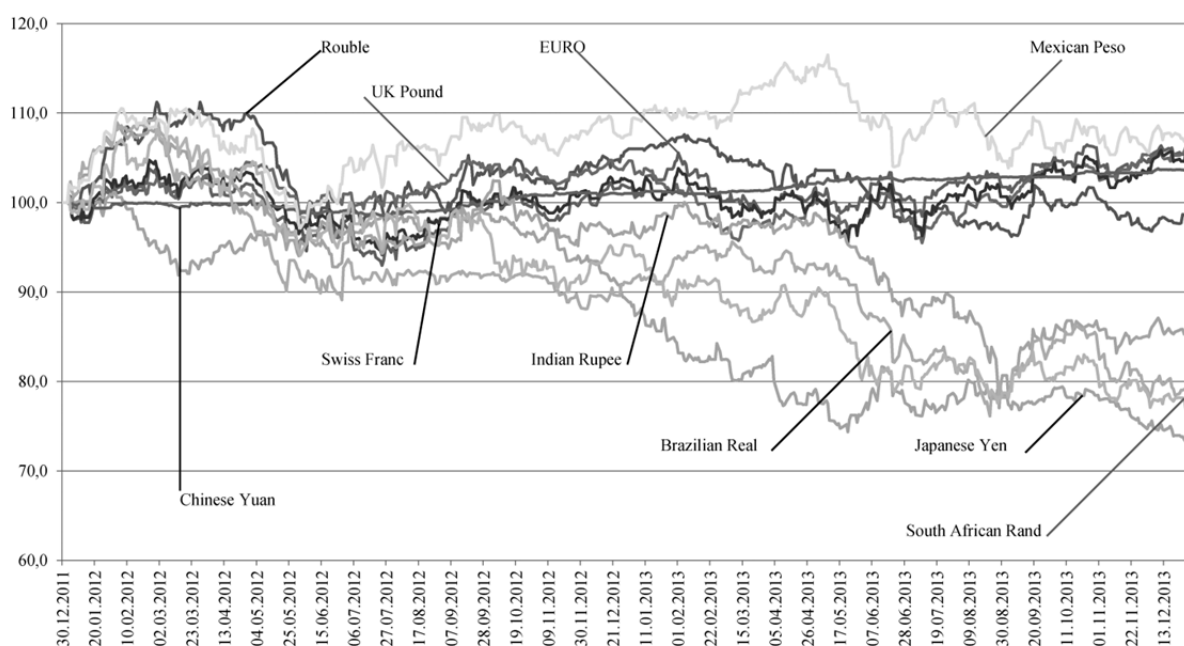
Monetary policy remains conservative and gives priority to inflation targeting. The first objective is disinflation and only once this has been achieved will the objective become a lowering of interest rates. Although there has been widespread criticism of the conservative approach of the Central Bank, we consider this approach to be justified. The less than perfect credit history of the national currency and continuing risks of high inflation mean that there must be the monetary authorities must exercise great caution with regard to any increase in the money supply. This is all the more the case in that in conditions of declining growth, stagflation could become a serious problem.

A rate of inflation of 6.5% exceeds the targets adopted by the Central Bank and remains the greatest problem for monetary policy. By this measure, the performance of the Russian economy lags behind that of the majority of the leading world economies (above all behind the performance of the “G-20”). There are both macroeconomic and institutional factors behind continuing high inflation: the macroeconomic factors have to do with growing household demand; the institutional factor is increasing charges by natural monopolies.

Finally, during 2013 the exchange rate of the rouble fell by 7.6%, which is attributable to both domestic and foreign reasons. Domestic factors include the slowing down of the economy and an entrepreneurial climate which encourages the export of capital abroad. Developments in the world economy were no less important: the marked recovery of the US economy and an attenuation of the crisis in Europe produced the response that is typical in such circumstances of a “flight into quality” – an outflow of capital from developing into developed markets. Money is being transferred into the US dollar and the Euro. This is an entirely natural process and one that has recurred in the history of markets during the last 50 years.

In the circumstances described, the exchange rate of the rouble fell much less during 2013 than the exchange rates of other emerging market economies that are comparable with Russia. This is evidence of the stability of the Russian monetary system and suggests that the policy of the Russian monetary authorities was correct (*Fig. 5*).

However, it would be a mistake to assume that a fall in the rouble exchange rate will serve to stimulate the economy and encourage import substitution, as was the case after the crisis of 1998. Now any positive consequences of a depreciation of the rouble would be very limited: the revenues of exporters would increase and there would be a slight improvement in competitiveness, but this would have no impact on the structure of exports (a reduction in the share in exports of raw materials and energy resources) and there would be no boost to technology exports. Any serious effect of import substitution would require not a fractional devaluation but a devaluation of several times the current rate and this would carry the risk of political upheaval. Furthermore, in present conditions, devaluation would punish those who participate in the chain of technological cooperation and who depend on supplies of parts or equipment. In 2013, 65% of imports consisted of intermediary and investment goods, so that, unlike the situation of five years ago, a rouble devaluation would bring about a drastic division of the industrial manufacturing industry into distinct groups of “winners” and “losers”.



Source: According data of central banks of corresponding countries

Fig. 5. Dynamic of rouble exchange rate compared with other currencies

During 2013 there were significant changes in the *regulation of the financial markets*. The Central Bank became the sole regulator. Only time will tell how effective this model is going to be. In present conditions this reform seems to make sense, being in line with a global trend towards strengthening financial regulation.

One new measure that could have far reaching consequences consisted in steps taken by the Bank of Russia to sanitize the commercial banking sector. Licenses were withdrawn not only from insolvent banks but also from banks involved in illegal financial operations. These measures had the effect of cleaning up the banking market. This policy does involve one particular risk, namely that of provoking a run on the commercial banks and a transfer of deposits into the state banks. This would be a regrettable consequence as far as the strategic development of the banking system is concerned and so there is a need for accompanying measures to increase the size of banks and encourage mergers between healthy banks.

Finally, one can see a number of *initiatives in foreign economic relations* which will have definite consequences for internal economic development. The most important of these were two projects for post-Soviet integration – the formation of a Customs Union and the creation of a Eurasian economic space. These initiatives will soon acquire greater significance as new member states join in.

This recent political progress in the international arena is undoubtedly the result of 10 years of political stability and an accumulation of financial reserves. Russia is one of the few developed countries at present to have financial reserves that provide some scope for initiatives in foreign affairs. Of course, these reserves are not unlimited and they cannot be allocated simultaneously to both domestic and foreign objectives. The events of 2013-2014 demonstrated that the Russian authorities are ready to invest in international and military policy, and in the foreseeable future expenditures in those areas will have a significant impact on budget policy.

1.1.3. Challenges of economic growth

A most important development in the socio-economic life of Russia is a significant slowing down of growth rates. Investment activity slowed down, there was almost zero growth of industrial production, and there was a deceleration of the growth of consumer demand. It is likely that in the near future these problems will cease to be merely economic and will acquire an important political dimension.

There are several reasons for this slowing down of growth rates. The external economic conjuncture played an important part. It was inevitable that the recession in the EU, Russia's principal foreign trade partner, would have a negative impact on the dynamics of the Russian economy.

Another factor was the particular character of the domestic investment cycle. In Russia, the large state companies play an important part in the investment process. Recently they concluded huge investment projects and this had a due effect on growth rates.

However, these conjunctural factors were not crucial to developments. In Russia a braking *mechanism* is at work which results from the exhaustion of the model of economic growth that has been in existence since 1999. The problem is essentially institutional in nature.

The 1999-2011 growth model was based on a rapid increase in demand (internal and external) which was catered for by mobilizing a significant volume of inactive production capacity. Essentially, opportunities for stimulating internal demand (from an extremely low

starting level that originated in the immediate post-Communist reforms) fortuitously combined with a dynamic recovery of the world economy, which generated external demand. Given a favorable external conjuncture, recovery growth can be achieved almost irrespective of the investment climate, provided there is socio-economic stability. However, recovery growth is a diminishing and finite process. The exhaustion of reserves makes for a deceleration that can only be reversed by the formation of conditions favorable to investment and by the emergence of conditions for new growth.

Exhaustion of the post-transformation (recovery) model of growth has been discussed during the last few years, but this model still possessed specific internal advantages, including continuing high prices for oil and an accumulation of financial reserves. The 7% fall in GDP in 2009 also played a part: a response to this was the mobilization, for a certain period, of production capacities, but these have now once again been exhausted. The slow down began in the second half of 2012, when Russian GDP rose above the pre-crisis level (that is, reconstruction capacities were exhausted) and the growth of exports practically came to a halt.

It is worth noting that recovery growth, as a rule, lasts longer than economists tend to forecast. This means that at a particular stage, when, according to forecasts, growth rates should start to decline, but they do not decline significantly, politicians start thinking that the high level of growth of the recovery period is a natural consequence of their policies and that this growth will continue as long as it suits them. These kinds of assumptions can themselves contribute to the outbreak of an economic crisis.

The *basic components of the mechanism of deceleration in the present-day Russian economy* are as follows:

Firstly: the dominance of consumer demand (wages) at the expense of investments (profits). This is evident in the growth of the share of wages and the decline in the share of profits, and also in the more rapid increase in wages than of GDP and of the productivity of labor. The level of accumulation has remained low – at, on average, 21.8% of GDP during the last five years. During the last half-century, the countries that have achieved stable dynamic

growth have been those where investments has been no less than 25% of GDP and investment in education and healthcare has remained around 7-8% of GDP. Overcoming the lag in labor productivity requires a higher level of investment; but the consumer-led growth model functions thanks to a relatively low level of investments.

Secondly: market inefficiency, which prevents the transfer of labor and capital into the more efficient sectors, creates the risk of preservation of the existing economic structure. There as a low level of competitiveness of internal markets that is associated with unattractive conditions for conducting business and with the existence of an overlarge non-market or monopoly sector of the economy and of an over large state sector; there is labor market inefficiency against a background of high and increased expenditures on labor.

Thirdly: the low level of effectiveness of state regulation inhibits the emergence of institutional and macroeconomic conditions for long-term investment; there is a high level of inefficient public expenditure.

Fourthly: there is a low level of participation in world trade - there are obstacles to the expansion of non-raw materials exports and to the integration of Russian firms into the international chain of added value; tariff levels are high.

All of this has resulted in Russia falling into the “middle income trap”. This is a predicament in which a country, having achieved a fairly high level of welfare, encounters obstacles in the form of the price of labor (it is already high) and institutions (they are already inadequate). Such a country is unable to compete with developed economies that possess a highly qualified labor force and with low income economies that have low wage levels and produce low cost industrial goods. The dilemma of the Russian economy at the present time derives from inefficient utilization of labor and capital, the absence of conditions for increasing output of high value-added goods and services. All of these factors are critical given the relatively high level of costs.

The way out of this dilemma is to be found in a qualitative renewal of institutions a renewal of the formal and informal rules that govern economic development. Much has been said in recent years about the need for institutional reforms. However, these discussions will never be transformed into action until economic indicators show that within the existing institutional framework the potential for growth has been exhausted. Of course, measures can be taken to accelerate growth within the existing institutional framework, but such a policy is unlikely to have a sustainable outcome.

This brings us the question of the risks confronting Russian economic development and Russian society in the period that lies ahead.

1.1.4. Socio-economic risks in the short and medium term

Let us begin by examining those risks that are associated with the adoption of a new growth model, or, more accurately, the risks that would derive from an inadequate response to the present deceleration of growth. These risks fall into two categories and they are divergent in nature: firstly, a passive acceptance of the current rate of growth as being historically unavoidable; and, secondly, the adoption of artificial (inappropriate) measures intended to achieve a break-through.

In 2013 there were significant changes in official evaluations of the prospects for socio-economic development. If, previously, the government’s economic forecasts bore a resemblance to plan variants of the past and included aspirational (and at times even fantastic) development scenarios, then from the autumn of last year the official forecast comprised, for

the most part, an extrapolation of existing trends, which is to say that it almost entirely excluded scenarios involving institutional reforms.

The official forecast is now based on an assumption of 3% economic growth in the period up to 2030, that is, substantially less than the 5% that had been considered desirable, and the need for which has been officially declared during the last few years. In part, this was justifiable, in so far as a forecast, by its very nature, cannot allow for changes in economic policy that have not yet been made. However, this new forecast carries the risk of becoming self-fulfilling, the risk that a variant of development based on low growth rates will be politically accepted and that institutional reform will be avoided. During 2013 there were significant changes in official evaluations of the prospects for socio-economic development. Whereas previous government economic forecasts had resembled “plan variants” and contained desirable (and sometimes even fantastic) development scenarios, as of autumn of last year the official forecast came to be based primarily on an extrapolation of current trends, that is, projections based on the introduction of institutional reforms were almost entirely disregarded.

The risk associated with a policy of nominal acceleration – an increase in economic growth rates without improvement in the quality of growth, is potentially more dangerous. A policy of acceleration in these conditions would entail a weakening of budgetary and monetary policy, especially if there is a relaxation of “the budget rule”.

A conservative macroeconomic policy always encounters sharp criticism, and the advocates of such a policy come up against the combined forces of the representatives of all sectors and branches, and are always in a minority. The arguments of those who favour increases in budget expenditure, a lowering of interest rates and currency manipulation are always very persuasive, since the supporters of such measures believe (quite sincerely) that they will achieve high rates of economic growth. Of course, it is difficult to implement a conservative budgetary policy in a country that has many serious socio-economic problems. Such a policy is twice as difficult to implement where there is a substantial accumulation of reserves and the government has funds at its disposal. But it is this kind of policy that always achieves sustainable economic growth, whereas a policy of unrestricted budgetary expansion always results in a serious crisis – as was the case during the “great leap forward” of the 1930s and the “acceleration” of the 1980s.

The experience of economic policy during the last decade of the Soviet régime offers many lessons for the present day. The present macroeconomic situation is remarkably similar to that of the turn of the 1970s-1980s. The oil price in real terms is at approximately the same level; the USSR achieved a steady annual rate of growth of 3%; the budget was in balance thanks to the fact that all revenues from exports of carbohydrates were used to cover budget expenditures; there was an active construction of gas pipelines; prices were stable, though the goods shortage was becoming increasingly acute (this denoted inflation masked by fixed prices); the level of external government debt was not high; universal employment was guaranteed, though labour productivity was low; the political system of the USSR was incapable of responding flexibly to new global changes (technological, economic and political).

All of this was in contrast with the situation in the West, which was in the throes of a deep structural crisis, characterized in CPSU publications of the time as the “third stage of the general crisis of capitalism”. The growth rates of the leading capitalist countries were either negative or close to zero. There were high levels of unemployment and inflation, the

unprecedented combination of which gave led to the formulation of a new economic category – “*stagflation*”.

At that time is seemed that the Soviet economy was experiencing sustainable growth whilst the West was in a state of crisis. In reality, the market-based democracies were going through a phase of structural and technological modernization, the necessary prerequisite of a qualitative leap forward, whereas the Soviet Union preserved its economic structure and became the hostage of fluctuations in raw materials prices that the government could not control. As later became clear, the crisis in the West was actually approaching its conclusion by the end of the 1970s and a new paradigm of economic policy was being adopted that entailed a reduction in the regulatory role of the state (deregulation),

By 1985, economic growth rates in the West exceeded Soviet growth rates and the obsolescence of a system based on central planning had become evident to all. The Soviet government attempted to redeem the situation with methods of aggressive budget stimulus. It undertook a vigorous programme of investments at the expense of increasing government debt (which doubled between 1985 and 1990) and of a budget deficit (which appeared in 1985 and increased rapidly thereafter). The growth rate of the USSR did, indeed, increase and came almost to equal that of the USA (though it remained lower than that of Great Britain) but this lasted only two years, from 1987 to 1988. In 1989 an economic decline commenced that lasted for almost 10 years (*Fig. 6 and 7*).

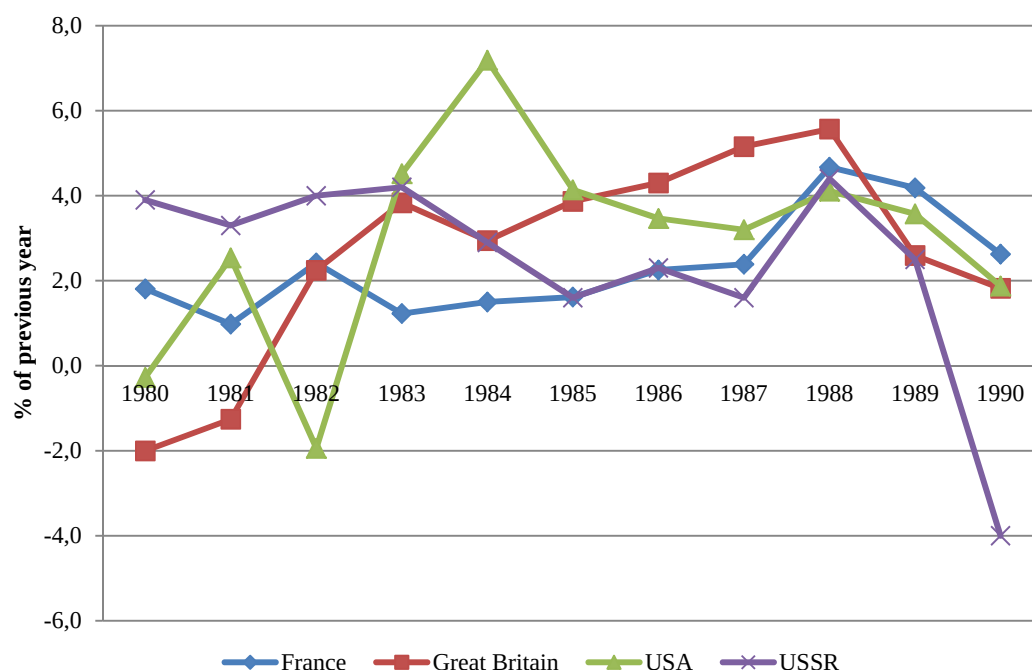


Fig. 6. GDP growth rates in the USSR, USA, Great Britain and France (1980-1990)

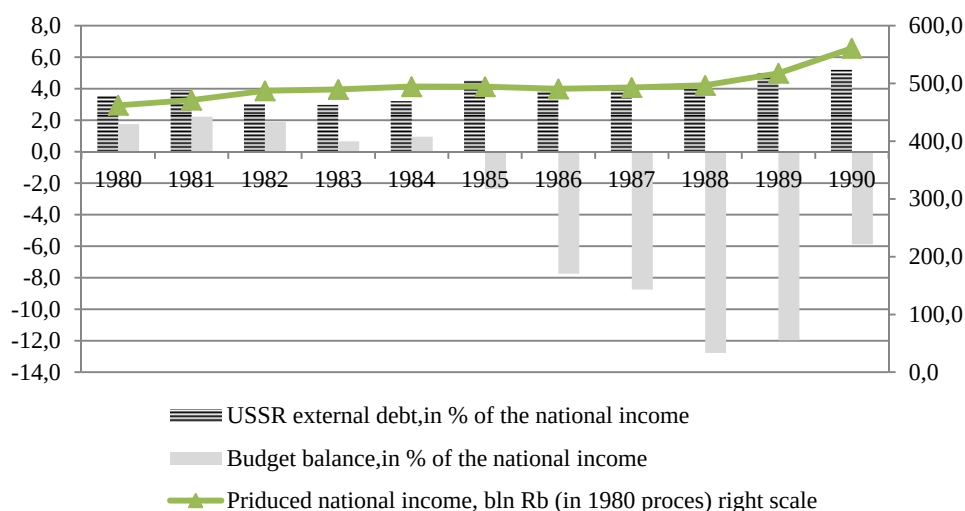


Fig. 7. National Income, Budget Balance, Foreign Debt of the USSR

The budget policy of present-day Russia takes into account the risks of fluctuations in the global economic conjuncture, though, following the crisis of 2008, the Federal budget began completely to absorb current revenues from the export of energy resources. The sovereign debt of the Russian Federation is much less than that of the USSR. The Russian Federation does not depend on food supplies to the extent that the Soviet Union did. The existence of private property means that the situation is qualitatively different. The political system is unquestionably more flexible than the Soviet system was.

Even so, there are similarities with the situation of thirty years ago. In the developed countries the structural crisis is gradually being overcome. The USA is witnessing a rapid technological renewal that will stimulate a similar process in Europe. When growth rates in the developed countries recover, in Russia the idea of “catching up and overtaking” (as a rule, at any price), usually becomes popular.

It is this possibility that Russia might be drawn into the pursuit of, not qualitative, but quantitative parameters of growth, and be willing to pay the price in terms of macroeconomic destabilization (which is usually followed by political destabilization) that constitutes the *principal political-economic risk of the years that lie ahead*.

In addition to these dangerous consequences, budgetary and monetary stimulus could, in present circumstances, drive the country into the trap of stagflation – low or negative growth rates accompanied by steady high inflation. Exiting from stagflation is a difficult and painful process. Present day Russia differs from the majority of developed countries in maintaining a high level of inflation. For this reason, it is unable to apply the measures of low interest rates and quantitative easing that were so popular in the West after 2008. In our opinion the *risk of stagflation is real* and must be taken into account in the drafting of economic policy.

A policy of *budgetary stimulation of demand* would, at present, be ineffective and fraught with risk. As recent research has shown, an increase in effective demand in the absence of any increase in productivity and competitiveness results in inflation and an increase in imports. There is already evidence of this, in that we are unable to achieve an acceptable level of inflation (lower than 5%) and imports are growing faster than exports. In a country with a high level of demand and low productivity there is a marked tendency for the rich to purchase the goods of rich countries and for the poor to purchase the goods of poor countries. This

results in a situation in which, domestically, primarily raw materials and services are competitive and everything else is imported.

The budget system must avoid *the risk of increasing indebtedness in the regions*. Special institutional measures should be introduced to restrict (or even prohibit) the deficit financing of regional budgets. The risks become even more acute if the Federal government lacks revenue surpluses that can be rapidly mobilized in the event of any increase in social tensions.

We draw attention to the *risks associated with an increase in wages in the budget sector* aimed at achieving a renewal of personnel and attracting highly qualified specialists. In this instance, a failure to synchronize wage increases with institutional reforms can result in continuing inefficiency, in so far as in-post staff will have no incentive to make way for newcomers, and new staff will have no incentive to apply for jobs if they perceive that the old principles of organization are being preserved.

A rise in wages also creates macroeconomic risks. As it happens, the budget sector is beginning to set the pace and dynamic of wage levels in the economy and is competing with the private sector. At a time when overcoming the crisis requires improvements in efficiency, the economy is being sent a signal that increasing costs is acceptable. However, the budget sectors do not exist in isolation and the dynamic of wages in these sectors has an impact on the rest of the economy.

This is all the more important in that the budget sector, from the standpoint of its attractiveness to employees, has ceased being uncompetitive. From the stand point of security of employment, work load, and wages, work in budget funded organizations (as well as in state corporations and institutions of public administration) has become highly attractive to a significant part of the population. The result is a competition for labor between the state sector and private enterprise and this will have a negative impact on the competitiveness of the Russian economy.

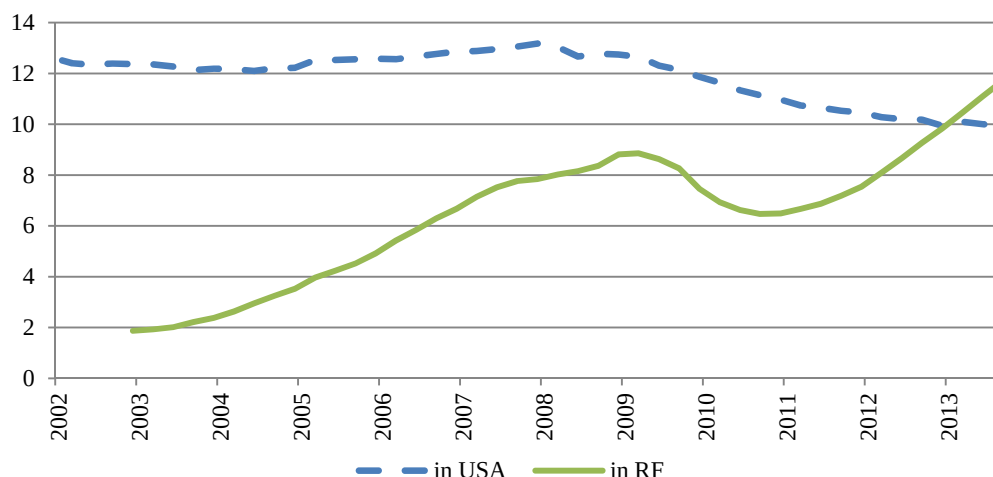
The ever increasing appeal of the state sector is becoming a serious impediment to private business activity. Insufficient attention is currently being paid to this aspect of the investment climate. The time when public sector wages were uncompetitive has passed. Now work in the public sector (state-owned companies included) has become extremely attractive to employees. To some extent this state of affairs resembles the financial market of the mid-1990s when the yield of state bonds (GKO) sucked investments out of the private sector.

The *risk of rising unemployment* cannot be disregarded. Traditionally, Russian businesses, in times of economic difficulty, have tended to retain workers, reduce wages and go over to part-time employment. Such measures, while they contributed to socio-political stability were an impediment to modernization. It is likely that, this time, the business community will respond differently. Entrepreneurs are now more inclined to adopt the employment model that is used in the market economies, and the government in the autumn to winter of 2013 gave a signal that it would no longer impose political restrictions on redundancy that was needed for purposes of modernization. This could create an entirely new situation in the labor market, and this, in turn, will force the government to improve the efficiency of the employment agencies, with particular attention to their role in facilitating labor mobility throughout the territory of the Federation.

Given possible changes in the labor market, *the high and constantly increasing level of consumer credit presents an additional risk*. The volume of accumulated debt of the population in Russia is not great when compared with that of the developed market economies – just under 10 trillion roubles (15.9% of GDP). However, taking into account a

significantly higher level of interest rates (on average 17.5% per annum) and the limited duration of loans (under 3 years on average), the servicing of bank debt (the cost of the entire debt portfolio) in Russia is approximately 12% of the population's disposable income (in the USA this indicator is around 11% for a volume of indebtedness of around 80% of GDP).

In other words, the debt service burden is already higher than that of the USA, notwithstanding a lower volume of debt (*Fig. 8*)



Source: Rosstat, CBRF, FRS USA.

Fig. 8. Servicing of household debt to disposable household income, %%

Certainly, this risk may be partly offset by the slowing down last year of the rate of increase of consumer borrowing. New loans to physical persons in 2013 were to a large extent granted not for consumption but for the refinancing of existing loans. However, this does dispel the serious risk of a rapid increase in debt arrears, which might make for an increase in social tension.

Amongst serious institutional risks we should also include any rapid change in the “rules of the game”, even if these are changed for the better. When law enforcement practices change (even if the laws do not), and what until recently had been normal business behaviour becomes a crime, entrepreneurs and citizens can be deterred from forming new businesses and organizations. This is all the more likely in that private initiative and entrepreneurship in Russia have always been regarded with suspicion and mistrust – whether in the nineteenth century or the twenty first.

1.1.5. Priorities of an economic policy aimed at consolidating growth

The priority objective at the present time should be the formulation of an economic policy that will secure sustainable growth in the medium term at rates exceeding the world average and include structural modernization. To this end, a new growth model must be adopted which will be underpinned not so much by a growth of factors of production – labor and capital (in respect of which we are limited both by domestic conditions of development and the external conjuncture) as by an increase in the efficiency of labor and capital, that is by an increase in aggregate factor productivity.

If our analysis is correct, the following guidelines for economic policy logically follow. These guidelines can be divided into “negative” (practices that should be discontinued and measures that should not be undertaken); and positive (measures that should be implemented).

Firstly: We must adhere to a conservative (prudent) macroeconomic policy. This means a balanced budget and reinstatement of the “budget rule”.

The “budget rule” must be reinforced by a readjustment of expenditures, that is, by a reduction in expenditures in some sectors and an increase in others. The existing structure of budget expenditures requires rationalization and enhanced efficiency. This cannot be achieved by bureaucratic and organizational measures. The fact that a budget is a performance budget is purely formal and does not ipso facto, alter its content.

The Federal Ministry of Finance in 2013, in consultation with experts, began work on the revision and reinterpretation of budget expenditures. This work must be continued, and priority must be given to the sectors that have a significant multiplier effect. Of course, decisions for rationalizing expenditure are always painful, politically, especially when the state disposes of significant resources and the level of debt is low.

It is no less important to improve the quality and transparency of budget procedures. In particular, the requirement to make all payments within calendar intervals (by the year end) or returning funds to the budget. This problem is beginning partly to be resolved in cases where budget institutions are funded by subsidy. However, this mechanism is not applied consistently in the sphere where it is most difficult of all to achieve planned targets in time, namely in investments.

Finally, there must be a thoroughgoing reconstruction and modernization of the network of budget institutions. This cannot be achieved merely by introducing normative-per capita funding and by liquidating inefficient budget-funded institutions. Rather, the organs of executive power must themselves decide on the future of particular state and municipal institutions (state, budget-funded, and autonomous).

Secondly: We must get beyond a situation in which economic policy is, essentially, reduced to the budget process. Every decision at Federal level is converted into a quest for funds to support one project or another (at branch, regional or institutional level) and then, once the project has been successfully completed, into a quest for budget funds to purchase whatever has been produced at budget expense (for example, funds are allocated to develop ship construction and then, if these investments bear fruit, additional funds are allocated for purchase of the ships.)

Thirdly: In agreeing the principles upon which economic policy should be based, we must avoid decisions that lead to an increase in costs. For all the importance of development in the social sphere and of the wages of public-sector employees, any disregard of the need for competitiveness will impact negatively on the willingness of investors to locate production in Russia.

Fourthly: We must introduce order into budget management in the regions and adopt measures to contain the increase in expenditure obligations and of debt. At the same time we must incentivize the regions to improve tax collection. We should encourage a broad debate around the true principles of federalism, expand the tax base and improve the collection of taxes that are the responsibility of the regions and municipalities and on this basis create the conditions that will encourage regions to compete for investors and entrepreneurs.

This will require thoroughgoing institutional change. To some extent, we could draw upon the experience of those states in the USA that, in the mid-nineteenth century, experienced a

number of defaults. At that time many states introduced a constitutional ban on deficit budgeting. This meant that states could borrow for specific projects but could not borrow to cover an overall budget deficit. In other words, borrowing could be undertaken for a specific purpose, but the cost of capital repayments and debt servicing were charged to the budget, which had to remain in balance.

Fifthly: Reform of the welfare state. The welfare state principles that were adopted at the turn of the nineteenth and twentieth centuries are no longer effective in post-industrial society. There is no point in allocating substantial funds to the social sphere unless it can be modernized and made fit to meet the challenges of the twenty first.

The post-industrial welfare state will differ significantly from its industrial-era predecessor. A number of new features are already apparent and these include the continuous and life-long delivery of educational and health-care services. Individualization means that a citizen will be able to define his or her educational needs and also the varieties and providers of health care and choose from a range of available options. The globalization of services will bring about international competition for customers – educational and medical institutions will compete not only at neighborhood or even national level but with corresponding institutions throughout the world. The privatization of social services will be accompanied by an increase in the share of private funding in the development of human capital, given that private funding or co-funding is not only a natural but also an inevitable consequence of the technological modernization of these sectors and of the growth of welfare of the population. New technologies will appear that will radically alter the nature of the services provided by these sectors.

Sixthly: An improvement in the conditions for conducting business, with emphasis on improvement in those areas where Russia figures particularly badly in ratings of the business environment (for example in Doing Business). This relates primarily to the five criteria by which Russia is rated below the first 100.

These are:

- “Dealing with construction permits”. This is the most difficult area and the one where our rating is lowest – at 178th.
- “Trading across borders” – 157 th.
- “Getting electricity” – 117 th.
- “Getting credit” – 109th.
- “Protecting Investors” – 115th (In this sphere particular attention must be paid to reducing risks associated with the possible criminalization of business activity, lowering the burden of regulation and reducing the burden associated with law enforcement.).

Seventh: Stimulating competition is one of the main institutional priorities. This will require thoroughgoing institutional and even ideological change. The focus of the anti-monopoly authorities must be redirected towards the support of competition and against the restriction of competition by administrative methods. They must cease obstructing successful firms whose efficiency has won them a large share of the market.

In this area there must be a significant reduction in the number of antimonopoly investigations and a concentration on the larger, and economically more significant companies; less preoccupation in antimonopoly policy with individual entrepreneurs, small and medium sized enterprises and companies with a small market share; less attention to regulating small and medium sized business and more resistance against the monopolistic tendencies of large companies that have substantial administrative resources.

Eighth: Reform of the labor market and improvements in the territorial mobility of the labor force.

Steps must be taken to improve the flexibility of labor legislation, which at the present time does not reflect the realities of the post-industrial era, especially in production where information technologies predominate. We must move from strict labor legislation that is weakly observed by economic actors, to flexible legislation that is strictly observed by market participants. Legislation must be introduced that relates to new forms of employment deriving from the development of information technologies. Specific measures in the reform of labor legislation should include:

- a redefinition of fundamental concepts such as “working time”, “the working day”, “job”, etc.
- improvements in the flexibility of employment relations, a simplification of the procedures for hiring and firing; a reduction in the period of obligatory notice of redundancy, a reduction in the costs of redundancy, including the size of the severance payment.
- a significant expansion of the conditions in which a time-delimited contract can be concluded, up to an including the right to abandon non-time-delimited contracts;
- simplification of procedures for changing the employment contract and terminating the labor contract on economic grounds;
- changes in the organization of working time, increasing scope for the introduction of flexible timetables, distance forms of employment, zero hours contracts, etc.
- Simplification of the system for keeping staff records, including abolition of the system of personal employment records.

In parallel, we must cease exerting political pressure on the regions and entrepreneurs to maintain artificial levels of employment. It is understandable that the government should wish to minimize the socio-political risks that can result from the dismissal of workers. Such risks are real, but they are mitigated by demographic trends (a reduction in the number of employees of working age).

Over and above reform of labor legislation, steps must be taken to encourage labor mobility between the regions. The potential for such mobility is not great – according to research of the Russian Academy for the National Economy and Public Administration, no more than 30% of the population is willing to change their region of domicile in order to find work and amongst those there is a trend for movement from east to west. Even so, we must encourage the mobility of employees in the interests of economic growth and this could in part be facilitated by a reduction in the numbers of the economically active population.

The following measures would assist in stimulating internal labor migration in the short term: the formation of a national data base of employment opportunities; improving the access of Russian citizens to social and other services in their place of actual residence – this relates primarily to medical insurance; the granting of notifying registration upon registration for tax purposes, which will ensure access to social entitlements throughout the territory; the provision of affordable rented housing for service personnel and of hostels for migrant labour, etc¹.

¹ Maleva, T. 2011 The Russian labour market: efficiency of employment or reduction of unemployment? // *Modernizatsiya i chelovecheskoe razvitiye (Modernization and human development)*. UNDP report on the development of human potential (Moscow, UNDP, 2001).

Ninth: Greater efforts to integrate the Russian economy into the international division of labor. In the first instance, the development and strengthening of the Eurasian Economic Community (EurAsEC) and determined efforts to create a single economic space with the EU. The need for integration must be at the forefront of the work of the monetary authorities. The rouble has genuine prospects of becoming established in the market of regional reserve currencies and monetary policy must strive to make progress in that direction.

* * *

The measures that have been proposed may be described as a policy for stimulating supply as distinct from a policy of stimulating demand. Different countries have given precedence to one or the other growth model over the years. The stimulation of supply depends upon creating conditions that are favorable to an increase in national productivity, which include a low level of inflation and, on that basis, low interest rates, the removal of institutional barriers to business, comprehensible and transparent rules of the game, a predictable and stable macroeconomic policy. The task of the government is to develop the social and technical infrastructure, including effective financial markets, create a flexible labor market and guarantee a superior quality of human capital through the systems of education and health care.

Section 2. Monetary and budgetary sector

2.1. Monetary policy

In 2013 inflation exceeded the target range (5-6%) established for 2013 in accordance with the Guidelines for the Monetary Policy of the Bank of Russia for 2013-2015, having reached 6.5%. On average, between January and December 2013 the M2 money supply had grown by 15.3% and as of 1 January 2014 was Rb 31,404.7bn. The international reserves reduced by 5% to \$509.6bn during the year.

In 2013 the Bank of Russia continued to improve its monetary policy within the framework of transition to inflation targeting. In particular, the Bank of Russia introduced the concept of a key interest rate reflecting the course of its monetary policy and, thus, completed the formation of an interest rate corridor.

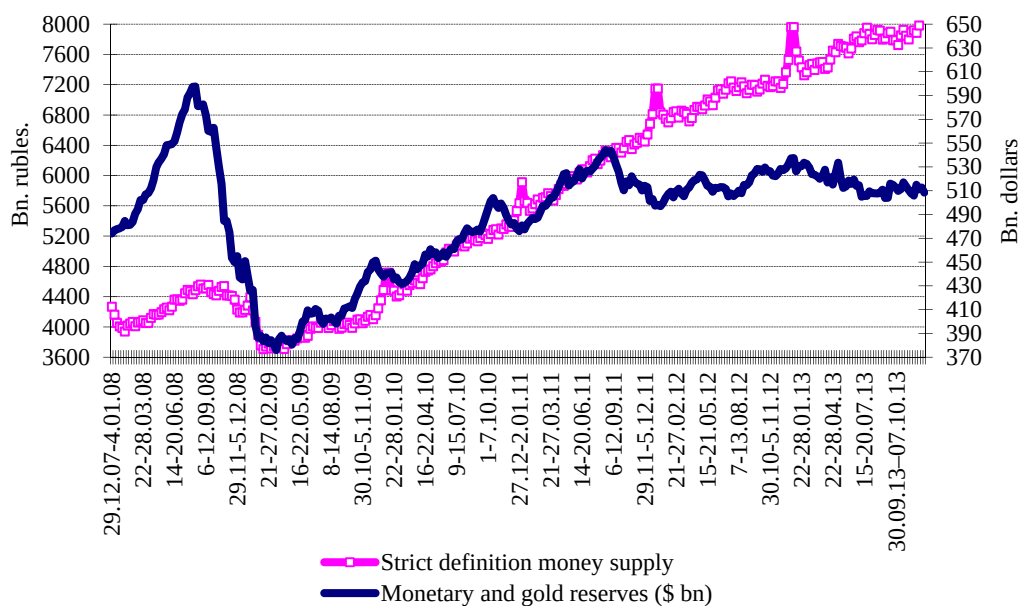
The Bank of Russia continued increasing the flexibility of the exchange-rate regime by increasing the sensitivity of the boundaries of the operational band to the number of FX interventions performed by the Bank of Russia and adjusting the mechanism of the exchange rate policy aimed at ensuring the neutrality of the Federal Treasury's FX transactions related to accumulation (expenditure) of sovereign funds.

2.1.1. Money market

Based on the results of 2013 the amount of the international reserve assets decreased by \$28bn (5%) and as of the beginning of January 2014 was \$509.6bn (*Fig. 1* and *2*). This reserve amount is more than sufficient for ensuring the stability of Russia's balance of payments, covering 13 months¹ of imports of goods and services in the RF. We should note that in 2012 the international reserves increased by \$38.97bn (7.8%) to \$537.6bn as of 1 January 2013 and the adequacy of reserves reached 14.5 months. In 2013 the volume of foreign exchange reserves decreased by \$16.97bn (–3.5%) compared to the beginning of the year due to implementation by the regulator of FX interventions aimed to smooth the volatility of the ruble exchange rate during periods of its fast weakening. In contrast, in 2012 the foreign exchange reserves grew by \$32.6bn (+7.2%), which was mainly due to transactions performed by the Ministry of Finance of Russia, repo transactions with non-residents and currency swaps, while the number of interventions in the domestic market was insignificant. The monetary gold reserves decreased by \$11bn (–21.6%) compared to the beginning of the year, which was mainly due to their negative revaluation. As a result, as of

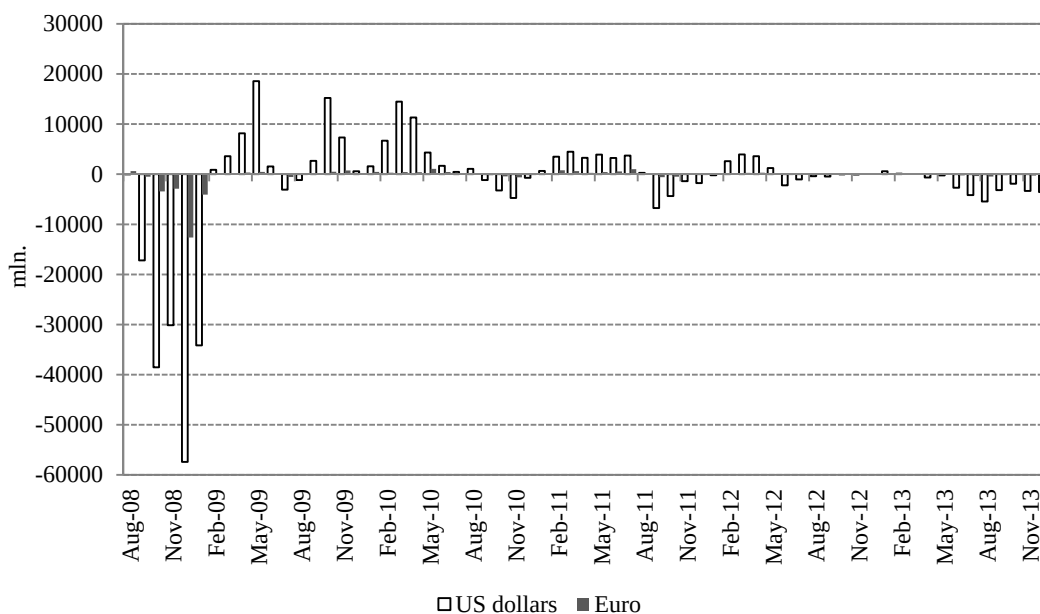
¹ Calculated on the basis of the monthly average cost of imported goods and services for the period from October 2012 to September 2013.

1 January 2014 the share of currency exchange reserves in the total reserve assets was 92.2% (90.5% in 2012), with the share of the gold component being 7.8% (9.5% in 2012).



Source: Bank of Russia.

Fig. 1. Dynamics of the monetary base (in a strict definition) and foreign exchange (international) reserves in the RF in 2008-2013



Source: Bank of Russia.

Fig. 2. FX interventions (net purchase of foreign currency) of the Bank of Russia in 2008-2013

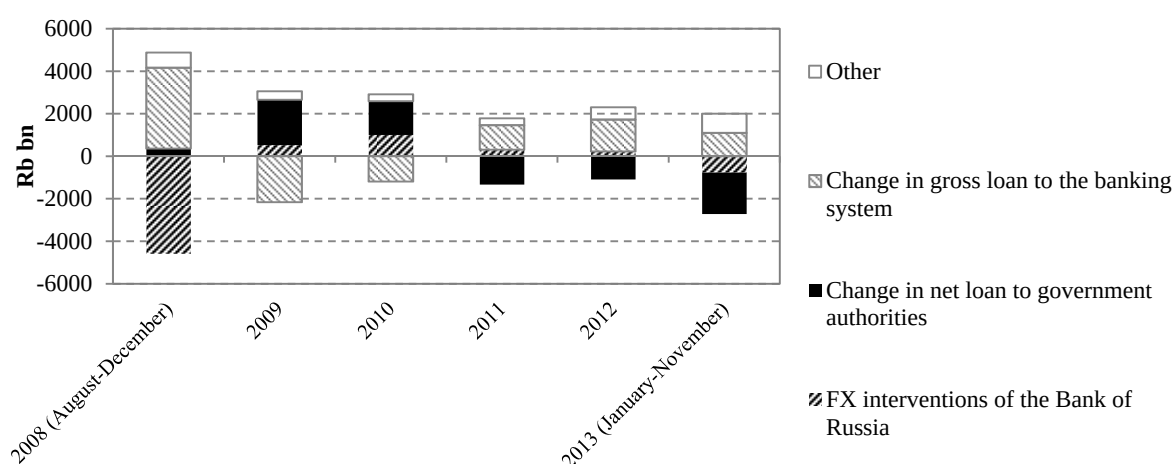
In 2013 the broad definition monetary base had increased by 6.6% and as of the beginning of 2014 was Rb 10.5 trillion. The main factors contributing to the reduction in the monetary

base in 2013 were the Bank of Russia's transactions for the sale of foreign currency in the domestic market and accumulation of the funds of the enlarged government in the Bank of Russia accounts (*Fig. 3*). At the same time, the key factor of the monetary base growth in 2013 was performance by the Bank of Russia of transactions for the provision of funds to commercial banks. We should note that in 2012 the monetary base had increased by 14% to Rb 9,853bn but here the accumulation of funds of the enlarged government in accounts in the Bank of Russia was the main factor restricting this growth.

The amount of the enlarged government's accumulated funds in accounts in the Bank of Russia for the first 11 months of 2013 has increased by Rb 1.9 trillion (38.6%) (*Table 1*).

We should note that despite the Bank of Russia's announcements about transition to an inflation targeting regime and taking measures aimed at increasing the flexibility of the exchange-rate regime, the Bank of Russia, in 2013, increased its presence in the FX market, performing considerable transactions for the sale of foreign currency. For comparison, since 2010, the net sales of foreign currency have been decreasing (in 2010 – \$34.1bn, in 2011 – \$12.4bn, in 2012 – \$7.6bn). However, in 2013 foreign currency net sales amounted to \$27bn. Apparently, such measures of the Bank of Russia were not only due to the necessity to smooth the ruble exchange rate volatility but also due to its intention to slow down the rates of ruble impairment under the conditions of decreasing current account balance and capital outflow from the country.

We should note that such an interventional policy by the Bank of Russia, perhaps, does not conflict with the task of transition to inflation targeting because, due to the effect of transfer of exchange rate into prices, ruble weakening causes a growth of inflation in Russia. At the same time, a considerable expansion of one-way (sale only) transactions of the Bank of Russia in the foreign exchange market appears to be unreasonable under the conditions of the fundamental tendency towards a reduction of the general balance of payments of the RF due to an expansion of the physical volumes of import with simultaneous export stagnation (both in physical and monetary terms) and the acceleration of private capital outflow from Russia.



Source: Bank of Russia, calculations of the Ye.T.Gaidar IEP.

Fig. 3. Key factors of the monetary base change (in a broad definition) in 2008–2013¹

¹ The period in question (2008–2013) is determined by availability of data on FX interventions of the Bank of Russia and the balance sheet of the Bank of Russia.

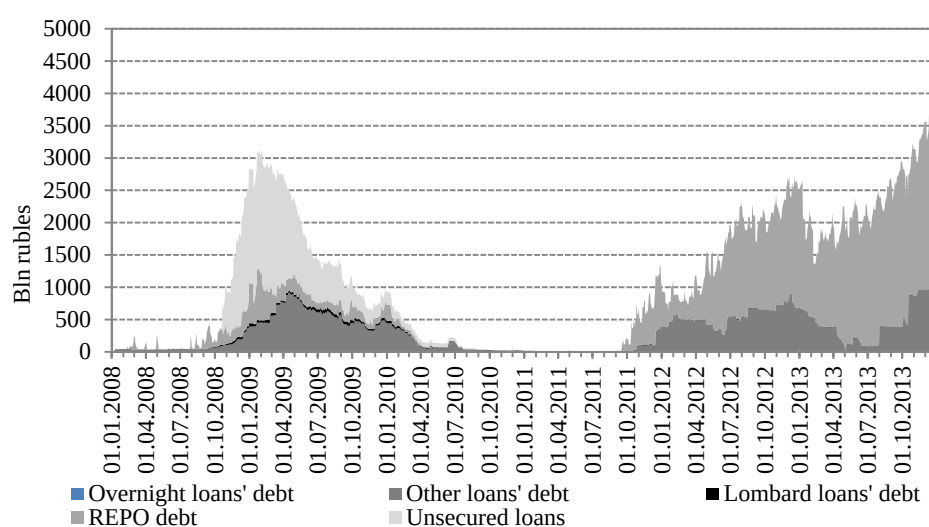
Table 1

Balance sheet of the Bank of Russia in 2012-2013

	1 January 2012		1 January 2013		1 December 2013	
	Rb bn	% of assets/ liabilities	Rb bn	% of assets/ liabilities	Rb bn	% of assets/ liabilities
Funds deposited with non-resident organisations and securities of foreign issuers	14,245,276	76.7	14,525,436	70.4	15,433,355	68.1
Loans and deposits	1,663,280	9.0	3,158,355	15.3	4,259,354	18.8
Precious metals	1,527,545	8.2	1,646,187	8.0	1,429,894	6.3
Securities	426,150	2.3	456,314	2.2	451,833	2.0
Other assets	97,857	0.5	251,549	1.2	451,350	2.0
Total assets	18,562,735	100	20,630,744	100	22,675,450	100
Cash in circulation	6,896,064	37.2	7,667,950	37.2	7,522,845	33.2
Funds held in accounts with the Bank of Russia	7,742,221	41.7	9,404,984	45.6	10,745,922	47.4
including of the RF Government	4,443,546	23.9	4,913,764	23.8	6,811,932	30.0
of resident credit institutions	1,748,402	9.4	2,185,349	10.6	1,616,635	7.1
Accounts receivable	36,217	0.2	158	0.0	23,290	0.1
Securities issued	-	-	-	-	-	-
Liabilities to IMF	472,335	2.5	447,686	2.2	497,885	2.2
Other liabilities	158,612	0.9	138,183	0.7	1,139,868	5.0
Equity	3,235,383	17.4	2,724,457	13.2	2,745,640	12.1
Profit in the reporting year	21,903	0.1	247,326	1.2	-	-
Total liabilities	18,562,735	100	20,630,744	100	22,675,450	100

Source: Bank of Russia.

Fig. 4 shows the dynamics of the debts of commercial banks to the Bank of Russia. Since 2011 there has been an observed tendency towards considerable growth in the provision of liquidity to credit institutions by the Bank of Russian. In 2013 debt exceeded the peaks of the crisis period, having increased by 65% and reached Rb 4.4 trillion as of 1 January 2014. The main source of attraction of liquidity by credit institutions on the part of the regulator are repo auctions, the average debt on which was Rb 1.95 trillion in 2013 (Rb 1.1 trillion in 2012, Rb 0.2 trillion in 2011). The maximum amount of funds is provided through 1-week repo auctions (on average Rb1.6 trillion for 2013).



Source: Bank of Russia.

Fig. 4. Debt of commercial banks to the Bank of Russia in 2008-2013

Provision of liquidity to credit institutions by the Bank of Russia was carried out mainly using short-term repo transactions, the average-weighted interest rates on which were 5.5-5.6% from January to December 2013. Since certain credit institutions lacked securities accepted as collateral on repo transactions and due to insufficiently active redistribution of funds in the interbank market, “currency swap” transactions with a 6.5% rate were used for the ruble part of transactions.

The second half of 2013 saw an increase in debt of the banking sector under loans of the Bank of Russia secured by non-market assets and guarantees. This was partially due to the introduction by the Bank of Russia of a new instrument of bank liquidity provision, a three-month credit auction secured by non-market assets (promissory notes, loans receivable) with a floating interest rate. Within the framework of the first such auction held on 15 October 2013 the regulator provided Rb 500bn at 5.76% per annum. The minimum cost of credit is linked with the key rate of a one-week repo, which was 5.5% at the moment of holding the first auction, plus 0.25 p.p. The advantage of a three-month auction over a similar one-year auction introduced by the regulator in June 2013 is the higher availability of collateral of required term for credit institutions and an increase in the collateral base of the banks by means of reducing the term for disbursement of funds. We should note that before the regulator introduced this instrument banks had shown low interest in refinancing instruments secured by non-market assets due to the high level of the fixed rate (7.5%). Despite the conditions of loan provision at a floating rate being quite favourable, only large banks with a notably higher collateral base can participate in such auctions.

The interest rate on interbank loans¹ has increased by 18.5% in 2013 (from an average of 5.4% in January 2013 up to an average of 6.4% in December 2013). The interest rate on interbank loans has been in the upper part of the interest rate corridor of the Bank of Russia, from time to time coming very close to its upper limit (*Fig. 5*). In general, the annual average MIACR on overnight interbank loans in rubles has increased by 10% from 5.5% in 2012 to 6.1% in 2013. We should note that, given that the key channel of the monetary base growth are the transactions of the Bank of Russia, it is the decisions of the Bank of Russia that determine the dynamics of the interest rates. Furthermore, revocation of the licences of certain Russian banks became an additional factor in the interest rate increase in the interbank market in the IV quarter of 2013.

As of 1 January 2014 the 70% share of total indebtedness of credit institutions to the Bank of Russia was owed by the 5 largest market participants (according to data as of 1 January 2013 a 70% share of indebtedness of banks to the regulator for the total amount of Rb 2.7 trillion was owed by 13 banks). In turn, the high degree of market concentration is evidenced by the fact that as of 1 January 2014 the 70% share of indebtedness of banks to resident credit institutions which accounted for Rb 2.6 trillion was owed by 10 banks (as of 1 January 2013 70% of debt for the total amount of Rb 2.7 trillion was recorded in the balance sheet liabilities sections of 13 banks)².

We should note that prospectively extension of the regulator’s use of long-term liquidity provision instruments (three-month or one-year repo auctions secured by non-market assets) will enable banks to release market collateral and create conditions for additional growth in the volumes and availability of interbank loans.

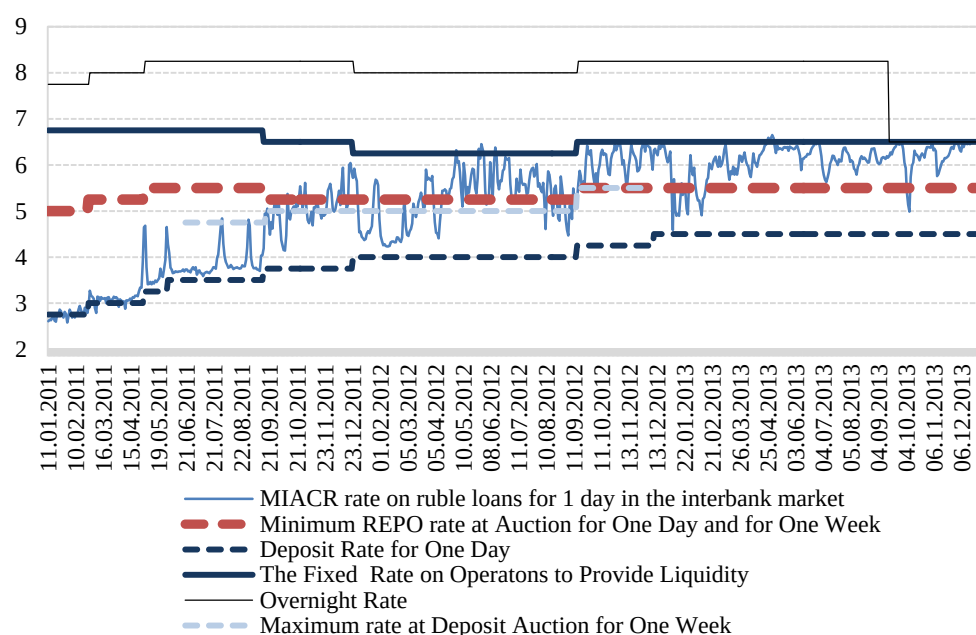
Let us consider the monetary base structure (broad definition) in more detail (*Table 2*).

¹ Interbank interest rate is an average monthly MIACR on overnight interbank loans in rubles.

² Based on calculations by the Centre of Structural Research of the Ye.T. Gaidar IEP.

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Source: Bank of Russia, calculations of the Ye.T.Gaidar IEP.

Fig. 5. The interest rate corridor of the Bank of Russia and dynamics of the interbank market in 2012-2013

Table 2

Dynamics of the broad definition monetary base in 2013 (Rb bn)

	1 January 2012	1 January 2013	1 April 2013	1 July 2013	1 October 2013	1 January 2014
Monetary base (broad definition)	8,644	9,853	8,628	9,063	9,117	10,504
– cash in circulation, taking into account cash balances on hand in credit institutions	6,896	7,668	7,102	7,420	7,369	8,308
– correspondent accounts of credit institutions with the Bank of Russia	982	1,356	856	1,002	1,098	1,270
– mandatory reserves	378	426	450	498	506	409
– deposits of credit institutions in the Bank of Russia	388	403	220	145	144	518
– bonds of the Bank of Russia in credit institutions	0	0	0	0	0	0
For information only: excess reserves	1,370	1,759	1,076	1,147	1,242	1,788

Source: Bank of Russia.

Among components of the broad monetary base, the number of which has decreased, the following should be highlighted: correspondent accounts (decrease in January-December 2013 by 6.3% to Rb 1,270bn) and mandatory reserves of banks (by 4% to Rb 409bn). Deposits of credit institutions in the Bank of Russia have increased by 28.5% to Rb 518bn and cash in circulation has increased by 8.3% to 8,308bn). For the 12 months of 2013 the total excess reserves increased by 1.6% and amounted to Rb 1,788bn. The decrease in balances of correspondent accounts in the Bank of Russia under the conditions of a growth of interest rates on interbank loans suggests a structural deficit¹ of liquidity in the banking sector.

¹ According to the Bank of Russia's definition, a structural deficit of liquidity means a condition of the banking sector characterised by the existence of a stable necessity for credit institutions to obtain liquidity by means of transactions with the Bank of Russia (from "Guidelines for the Single State Monetary Policy for 2014 and for 2015-2016").

On average, in January-November 2013 M2 money supply increased by 15.3% on an annualised basis. In 2010 the average money supply growth rate was 32.5%, in 2011 – 24.3% and in 2012 – 19.4%. In general, it can be noted that the tendency towards the gradual decrease in the money supply growth rates (compared to the correspondent period of the previous year) that had been observed since 2011 reversed in the first half of 2013, with M2 monthly growth rate stabilising at the level of 15.4-16.7% (on an annualised basis) in the second half of the year. We should note that the average M2 growth rate in the first half of 2013 (on an annualised basis) was 16.8%, with an average increase of the monetary base by 13.5% and of the money multiplier by 3%.

Thus in general, an increase in the rate of growth of the M2 money supply for the 12 months of 2013 was moderate compared to the previous periods taking into account the relatively low basic inflation of 5.6% (on an annualised basis) (5.7% in 2012) and, by itself, does not create any preconditions for a disturbance of price stability as a result of monetary factors.

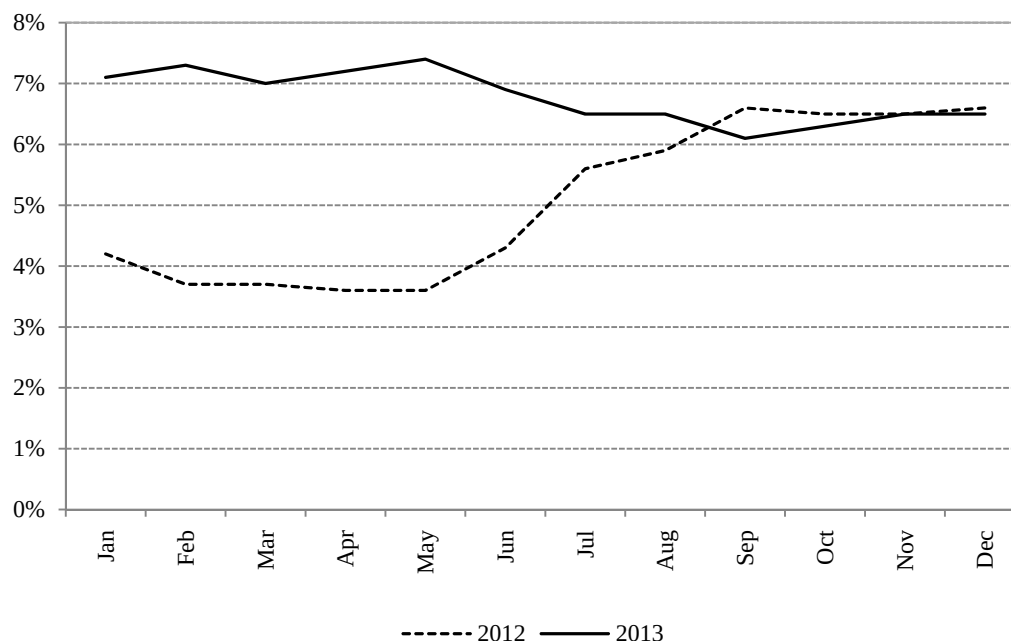
Taking into account that in 2013 the monetary base increased by 6.6% and the money supply grew by 14.6%, the money multiplier growth rate was 7.5%. From January to December 2013 the average money multiplier (M2/monetary base ratio) was 3.2, showing a slight increase compared to 2012 (3.0 in 2012, on average). This value of the money multiplier is typical of emerging economies whilst in developed countries it is usually with the 5 to 8 range. We should note that in eastern European countries during the last 20 years, money multiplier growth was observed as their banking systems developed. For example, in Poland from 1993 to 2013 the money multiplier increased from 3.1 to 6.1.

The monetisation level of the Russian economy (M2 to GDP ratio) for the period from 1999 to 2012 increased by 2.5 times to 51.5% in 2012. For comparison, in Belarus the M2 to GDP ratio for the same period increased by 1.8 times to 30.5%, in Kazakhstan – 2.6 times to 34.7% in 2012 and in Ukraine – 3.3 times to 54.9%. A relatively lower GDP monetisation growth rate in the period from 1999 to 2012 was typical of the majority of the Central and Eastern European countries, for example, in Poland the M2 to GDP ratio increased by 1.4 times to 57.9% in 2012, in France – 1.5 times to 158% in 2012, in Germany this indicator remained relatively stable, having reached 173% in 2012. We should note that the relatively low level of monetisation of the Russian economy was due to the comparatively low level of development of the financial system in the RF.

If we analyse the components of the money supply, we can note that individual saving in 2013 showed an average increase of 18.3% on an annualised basis (19.9% in 2012) and deposits by non-financial organisations and financial organisations showed an average increase of 12% (18.3% in 2012). M0 money supply demonstrated an average growth of 8.2% (on an annualised basis) in 2013 (12.7% in 2012) and its share in M2 was, on average, 22.6% (24% in 2012). Thus, in 2013 the share of cash in the money supply continued to decrease, which reflects the gradual development of the financial system of the RF, however, this proportion is still very high compared to developed countries where, as a rule, it is about 10%.

2.1.2. Inflation processes

In 2013 inflation was again above the target range (5-6%) established in the Guidelines for the Monetary Policy of the Bank of Russia for 2013-2015, having come very close to its upper limit in September 2013, and reached 6.5% based on the results of the year (6.6% in 2012) (*Fig. 6*).



Source: Rosstat; calculations of the Ye.T.Gaidar IEP.

Fig. 6. CPI growth rate in 2012-2013 (% per year)

Inflation exceeded the upper limit of the target range mainly due to non-monetary factors, in particular, the quicker than in 2012 increase in prices for domestic food products. We should remember that the average M2 money supply growth rate on an annualised basis for the 12 months of 2013 slowed down, amounting to 15.3% on an annualised basis. The increase in consumer prices was also pressurised by the indexation of tariffs for services provided by natural monopolies and the increase in excise duties on certain goods. Moreover, taking into account the considerable share of imported goods in the consumption of economic agents in the RF, the ruble weakening also contributed to the accelerated inflation. We should note that the effect of the transfer of exchange rate fluctuations on prices in the Russian economy is incomplete. On average, the one-month effect of transfer of the exchange rate on the CPI is 5% with the major part of the adjustments of the price levels to the ruble exchange rate fluctuations occurring within the following 6 to 12 months¹.

Meanwhile, we should add that when the Bank of Russia established the inflation target for 2013, it should have been important to take more accurate account of the possible influence of accidental factors (influence of the 2012 harvest on the conservation of fodder to be used in 2013; analysis of the market structure of different food and non-food products; consideration of the effect of the transfer of national currency depreciation into the prices for goods; introduction of new trade restrictions, etc.) and to assess possible deviation of inflation from the target range. Hence, inflation in excess of the target range is an unambiguous failure of the policy of the Bank of Russia.

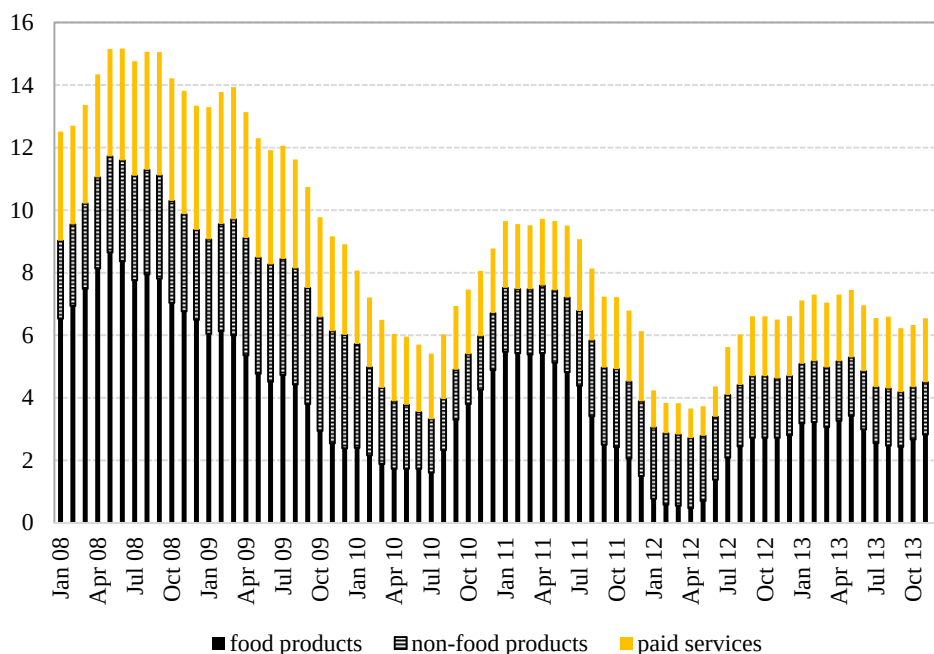
Let us consider the 2013 inflation process in more detail. As shown in *Table 3*, the growth rate of prices for consumer goods in the period from January to December 2013 was slightly

¹ According to estimates of the Ye.T. Gaidar IEP.

lower than in 2012. Growth of the following prices contributed greatly to the increase in prices for food products: eggs (+28.8%), butter (+18.6%), alcoholic beverages (+14.6%), milk and dairy products (+13.1%) and fruit and vegetables (+9.3%). The increase in prices of butter and dairy products as well as of eggs resulted from the deficit of raw materials due to the limited availability of fodder, caused by the poor harvest in 2012. The rise in prices for fruit and vegetables which had begun in October 2013 was associated with the poorer harvests due to heavy rain in the central part of Russia. We should note that restrictions on the import of certain goods to Russia from Belarus, the Baltic countries and Ukraine also contributed to the increase in food prices.

The rate of growth of non-food prices (+4.5%) also slowed down in 2013 compared to 2012. The quickest growth in this product group was observed for tobacco products due to the increase in excise duties. Furthermore, the increase in excise duties and wholesale fuel costs in the second half of 2013, due to the closing of several oil refineries, resulted in acceleration in the growth rates of gasoline prices.

In 2013 the prices for paid services rose by 8% compared to 2012. This was notably due to the indexation of regulated prices and tariffs for the services of organisations providing infrastructural activity. A slight acceleration in the rates of growth of prices for most groups of services should be noted. At the same time, the postponement of indexation from January to July seems reasonable to us, because, when a new harvest goes to market after tariff indexation, it causes a decrease in food prices and partially damps the effect of tariff indexation.



Source: Rosstat; calculations of the Ye.T.Gaidar IEP.

Fig. 7. Inflation structure in 2008-2013 (% per month to the corresponding month of the preceding year)

Table 3

**Annual price growth rates for certain types of consumer goods and services
in 2011-2013 (% to December of the preceding year)**

	2011	2012	2013	2011-2013*
CPI	6.1	6.6	6.5	20.5
Food products	3.9	7.5	7.3	19.8
Grains and legumes	-8.0	-7.0	3.2	-11.7
Butter	6.6	3.0	18.6	30.2
Vegetable oil	4.6	3.4	-3	4.9
Pasta	3.4	7.6	4.7	16.5
Milk and dairy products	6.3	4.4	13.1	25.5
Eggs	6.2	5.1	28.8	43.8
Bread and bakery	8.9	12.0	8.0	31.7
Meat and poultry	9.2	8.3	-3	14.7
Fish and shellfish	10.3	1.9	7.6	20.9
Fruit and vegetables	-24.7	11.0	9.3	-8.6
Alcoholic beverages	8.4	12.1	14.6	39.3
Non-food products	6.7	5.2	4.5	17.3
Construction materials	7.9	5.1	2.5	16.2
Petrol	14.9	6.8	5.7	29.7
Tobacco products	21.1	22.6	29.3	92.0
Services	8.7	7.3	8.0	26.0
Housing and utility services	11.7	9.4	9.8	34.2
Early childhood education services	11.3	6.4	9.9	30.1
Recreation and health services	9.0	5.9	5.7	22.0
Passenger transport services	9.1	6.9	8.9	27.0
Culture organisation services	11.3	8.8	10.5	33.8

* Inflation for 2011-2013.

Source: Rosstat.

To end this section we compare the growth rates in prices for consumer goods in Russia and the other CIS countries (Table 4).

Table 4

**Dynamics of consumer price indices in CIS countries in 2011-2013,
% per annum**

	2011	2012	2013*	2011-2013**
CIS countries				
Azerbaijan	8	1	1.7	10.9
Armenia	8	3	4.5	16.2
Belarus	53	59	13.8	176.8
Kazakhstan	8	5	4.2	18.2
Kirgizia	17	3	2.9	24.0
Moldavia	8	5	4.4	18.4
Russia	8	5	5.95	20.1
Tajikistan	13	6	3.35	23.8
Ukraine	8	0.6	0.0	8.6
Developed countries				
Germany	2.1	2.0	1.3	5.5
France	2.1	2.0	0.7	4.9
USA	3.2	2.1	1.2	6.6
Netherlands	2.3	2.5	1.5	6.4

*Data for January-November.

** Inflation for 2011-2013

Source: Interstate Statistical Committee of the CIS (<http://www.cisstat.com/>), OECD database (<http://stats.oecd.org/>).

For the period from January to November 2013 Russia was in second place after Belarus among the CIS countries by growth rates in consumer prices. Based on the results of the 11 months, Ukraine saw a zero level of inflation. Inflation in Russia from January to November 2013 increased 2.5-8.5 times compared with the value for the developed countries (*Table 4*). Thus, inflation in the RF continues to remain relatively high, both in comparison with developed countries and emerging economies.

In 2014 factors restraining inflation could be a slowdown of economic activities, moderate growth of monetary supply, the favourable situation with grains and legumes in 2013, improvements in the worlds agricultural market. Factors which could potentially accelerate inflation in 2014 include a possible continuation of ruble depreciation and the effect of the transfer of the exchange rate into prices, the consequences of the depression in fruit and vegetables yield in 2013 and further increase in excise duties.

In general, the prospects for achieving the inflation target level (5%) in 2014 seem realistic, taking into account the current trends in the Russian economy and modifications of the interest rate policy of the Bank of Russia (the introduction of a key interest rate as a main instrument of the monetary policy, under the conditions of inflation targeting and completion of the interest rate corridor aimed at reducing the volatility of short-term interest rates in the interbank market).

A decision on the “freezing” of tariffs for the services of legal entities having natural monopolies and the use of a decreasing coefficient for the indexation of regulated prices and tariffs for the population in 2014 will also facilitate achievement of the inflation target.

2.1.3. Key measures in the sphere of monetary and FX policy

In 2013 under the condition of a gradual transition to inflation targeting, the Bank of Russia made a number of important decisions in the area of improving the system of its interest rate instruments and an increase in the flexibility of its exchange-rate regime.

Decisions in the field of the monetary policy

The most important decision made by the Bank of Russia in 2013 was the introduction of a key interest rate by unification of the interest rates on operations and the provision of liquidity absorption through an auction for the period of 1 week (5.50% per annum as of 13 September 2013). At the same time, the Bank of Russia completed the formation of the interest rate corridor. Interest rates on continuous transactions of the Bank of Russia for absorbance and provision of liquidity for 1 day constitute, respectively, the lower (4.5% per annum as of 13 September 2013) and upper (6.5% per annum as of 13 September 2013) limits of the interest rate corridor symmetrically in respect to the key interest rate (*Fig. 5*).

The choice of a key interest rate seems reasonable because the main source of attraction of liquidity for credit institutions on the part of the Bank of Russia are auctions for the period of one week (average value for January-December 2013 Rb 1.6 trillion), with indebtedness on overnight auctions (average value for January-December 2013 Rb 0.2 trillion) and long-term auctions (3, 12 months) being considerably lower than on weekly auctions (*Fig. 8*).

The regulator intends to use the key interest rate as the main indicator of the direction of the monetary policy. The Bank of Russia officially recognised the secondary part of the refinancing rate. From 1 January 2016 the refinancing rate will be adjusted to the level of the key interest rate, which will enable an increase in the transparency of the monetary policy, not only for economic agents within the country, but also abroad, increasing investors' trust in

signals from the Bank of Russia. Under the conditions of the inflation targeting regime, the main instrument of the monetary policy is the interest rate affecting the volume of loans, money supply and other macroeconomic indicators. Any change in the key rate may serve for economic agents as a potential signal of softening or toughening of the monetary policy directly affecting their expectations.

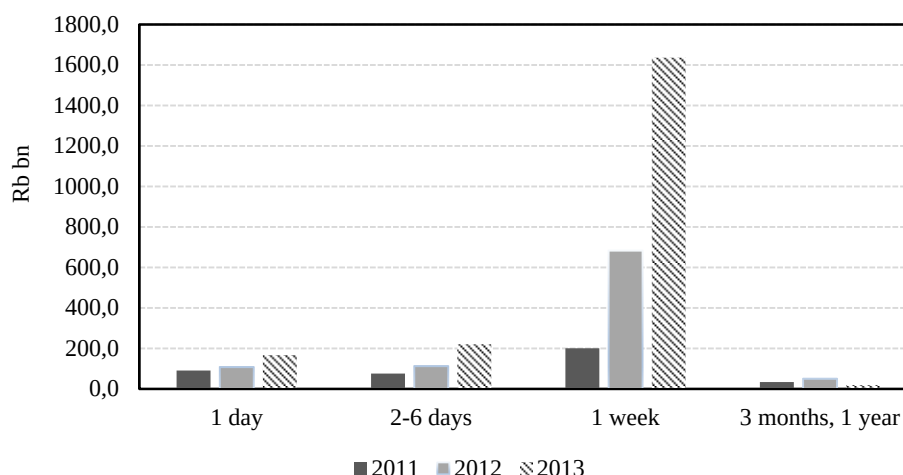


Fig. 8. Average debt of commercial banks to the Bank of Russia on repo transactions of different terms in 2011-2013

On 12 July 2013 the Bank of Russia announced the introduction of a new instrument of refinancing the banking system – auctions for the provision of loans secured by non-market assets or guarantees for a 12-month term. The introduction of the new instrument was aimed, not at the growth in the volume of refinancing, but at its redistribution in favour of instruments with longer terms. The minimum interest rate under the new refinancing instrument was 5.75% per annum, which is 0.25 p.p. higher than on direct repo auctions for a 1-day term. Based on the results of the first auction, held in late July 2013, the volume of funds loaned was Rb 306.8bn with the maximum allotment being Rb 500bn. One-year loans at the minimum interest rate of 5.75% were issued to the 31 borrowers which participated in the auction. The low level of interest in this new instrument of the Bank of Russia can be explained on technical grounds, since not all the banks willing to participate in the auction have received the regulator's approval. Another, and, in our opinion, more important reason for the low demand for the auction held, is that most banks lacked collateral of the required term (12 months) and the high alternative costs of the reduction of the collateral value of relevant credit institutions (lost opportunity to obtain short-term loans due to the deficit of available collateral value). We should note that the second of such auctions with the Rb 500bn limit that had been planned for 13 January 2014, did not take place due to an insufficient number of applications.

On 13 September the Bank of Russia announced a reduction of interest rates on overnight loans, and loans secured by non-market assets or guarantees for a 1-day term, to 6.50% per annum and the increase of the maximum interest rate on deposit transactions on an auction basis for 1-week period to 5.50% per annum. Interest rates on the remaining operations of the Bank of Russia and refinancing rates remained unchanged.

The Bank of Russia plans gradually to increase the average terms of liquidity provision, using overnight instruments only in emergency situations. In particular, from February 2014 onwards auction transactions for 1-day terms and transactions with fixed rates for a term longer than 1 day will cease. However, if necessary, the Bank of Russia will use point repo transactions on an auction basis for terms from 1 to 6 days. The regulator points out that interbank lending should start playing a major part in the redistribution of liquidity amongst market participants. Let us consider these measures in more detail.

Firstly, the reduction in the number of short-term transactions in the open market (up to 7 days) may result in decreased control over interest rates. As seen from the practice of developed countries, the regulation of interest rates on overnight interbank loans is possible precisely through one-day maturity repo transactions. The absence of this instrument may result in an increase in interest rates on short-term interbank loans and an increase in their volatility. The cancellation of auctions with fixed rates may also cause interbank loan interest rates to increase, because auctions with a floating interest rate are not limited to any maximum value.

Secondly, we should note that the interbank lending market in the RF is highly concentrated: as of 1 January 2014 the 10 largest market participants accounted for 71%, 20 commercial banks — for 83% and 50 banks — for 96% of the debt to credit institutions, the total amount of which was Rb 2.6 trillion¹. This means that the major proportion of small banks have very limited access to the interbank lending market.

We should note that an improvement to the system of refinancing instruments of the Bank of Russia is a necessary but not a sufficient condition for further development of the interbank lending market. To that end, measures must be taken to reduce the concentration of the interbank lending market.

However, in the mid-run, an increase in terms of liquidity provision by the regulator may incentivise credit institutions to carry out effective management of liquid assets, which, in the end, will create conditions for a reduction of the volatility of interest rates in the interbank market. At the same time, the formation of “long money” in any economy is not the central bank’s task but that of the entire fiscal system. Hence, issues relating to increasing the depth of the financial sector and the development of the institutional environment, remain relevant for the Russian economy.

In October 2013 the system of monetary policy instruments was supplemented by auctions for the provision of loans secured by non-market assets for a 3-month term with a floating interest rate. We should note that the results of this auction, held in October 2013, showed a high demand for this instrument of the Bank of Russia (the demand was Rb 563bn with a Rb 500bn limit). The benefits of a three-month repo secured by non-market assets are due to a lower floating rate compared to auctions with a fixed rate, and to one-year auctions with floating rate, secured by non-market assets. Participation in a three-month auction, in contrast to an equivalent one-year auction, enables banks to increase their available collateral value and to facilitate the provision of collateral of the required term.

In order to mitigate the shortage of liquidity for individual credit institutions, the Bank of Russia will continue to perform auction based transactions using not only securities but also other types of assets, including non-market ones. However, under the conditions of gradual reduction in the capacity to provide liquidity to banks and which is secured by collateral of proper quality, the Bank of Russia plans an active use of the purchase and sale of assets

¹ According to data of the Centre of Structural Research of Ye.T. Gaidat IEP.

(securities, gold, foreign currency) as an additional instrument of liquidity regulation. A higher diversity of the regulator's mechanisms for liquidity provision may facilitate stabilisation of the liquidity situation in the banking sector.

Among innovations adopted by the Bank of Russia at the meeting of the Board of Directors held on 13 September 2013, we should note the establishment of a target inflation level as a point, not an interval range, which potentially enables the Bank of Russia to transfer a strong signal regarding its target priorities to economic agents. The Guidelines for the Monetary Policy for 2014-2016 specify that the target change in consumer prices will be 5% in 2014, 4.5% in 2015 and 4% in 2016. However, in the case of unforeseen factors, the limits of tolerance of inflation upwards and downwards from the target value were established at the level of 1.5 p.p. In our opinion, taking into account the current trends in the Russian economy, the inflation range of 3.5-6.5% covers almost all possible scenarios in the next year. In other words, in the absence of global shocks, inflation will remain within this range with almost any course of the monetary policy of the Bank of Russia. We should note that, in 2012, 41% of countries applying inflation targeting used levels of tolerance ± 1 p.p., 18% of countries were oriented on point values, 11% of countries applied the range ± 1.5 p.p. and the remaining countries were characterised by a larger range or interval approach to the establishment target inflation values¹. We assume that the targeting interval in the Russian conditions should be narrower than ± 1.5 p.p., or the Guidelines should specify in more detail the actions of the Bank of Russia in the case of any notable deviation of the actual inflation value from the centre of the established interval.

In general, this last modification of the system of instruments of monetary policy will facilitate improvement of the functioning of the non-money market, increased control over interest rates, and the mitigation of inflation risks. The created interest rate corridor which, in prospect, can improve the predictability of interest rates in the money market will contribute to the workability of the interest channel. The use of target inflation values with narrower fluctuation ranges, acceptable for the regulator, and an explanation to economic agents of the peculiarities of the application of the instruments of the monetary policy in the mid-term, will increase their trust and stabilise expectations related to interest rates in the money market, which, in turn, will improve the operation of the entire transmission mechanism of the monetary policy.

Decisions in the field of FX policy

In 2013 the Bank of Russia proposed to improve the mechanism of the exchange-rate policy. All decisions made in the field of the FX policy were aimed at increasing the flexibility of the exchange-rate regime under the conditions of transmission to inflating targeting.

Within the framework of implementation of the exchange-rate policy the Bank of Russia used, as an operational landmark, the ruble cost of the dual currency basket consisting of 45 eurocents and 55 US cents. The range of values of the ruble cost of the dual currency basket acceptable for the Bank of Russia is established as a floating operational band, the boundaries of which are adjusted depending on the amount of FX interventions performed. Since 24 July 2012 the width of the interval has been 7 rubles. On 9 September 2013 the Board of Directors of the Bank of Russia passed a resolution on decreasing the amount of

¹ D. Hammond. Practice of Inflation Targeting - 2012 // Bank of England. Centre for Central Banking Studies. Guideline 29. 2012.

accumulated interventions resulting in an automatic movement of the boundaries of the operational band by 5 kopeks, to \$400m instead of the \$450m approved in the middle of 2012. From 10 December 2013 the accumulated amount of sale (purchase) of foreign currency by the Bank of Russia resulting in adjustment was again decreased, this time to \$350m.

From 1 October 2013 the Bank of Russia has performed adjustment of the exchange-rate policy mechanism. According to this adjustment, the parameters of the Bank of Russia FX sale and purchase operations in the domestic foreign exchange market are determined by taking account of the Federal Treasury operations for the accumulation or expenditure of funds of the Reserve Fund and National Wealth Fund. In particular, the amounts of the Bank of Russia FX operations on the domestic market, aimed at smoothing the rouble exchange rate volatility, may be increased or decreased by an amount equal to the Federal Treasury FX purchases (sales) with the Bank of Russia, related to the accumulation (expenditure) of sovereign funds in foreign currencies. Such an adjustment will allow smoothing of the ruble exchange rate fluctuations and the maintenance of stability of the FX and money market during periods of Federal Treasury FX operations. In order to increase the transparency of the exchange-rate regime, preliminary information on the volume and date of the performance by the Federal Treasury of its FX operations will be posted on its official website.

We should remember that, in order to smooth the ruble exchange rate volatility, the floating operational band is split into internal intervals, for each of which a particular amount of intervention is established (in \$ mn per day). In the central part of the floating operational band a “neutral” range is outlined, within which the Bank of Russia does not perform FX interventions aimed at smoothing the ruble exchange rate volatility. In 2013 the operational band of the cost of the dual currency basket in which the Bank of Russia performs FX interventions, was supplemented by an inner “technical” range. As in the neutral range, in the technical range the regulator will not implement any FX interventions, including those related to the Federal Treasury operations for the management of sovereign funds. As a result of the introduction of the “technical corridor” the range in which Russian ruble exchange rate is formed only by market factors, was expanded by Rb 0.1. Additionally, on 7 October 2013 the Bank of Russia performed a symmetrical expansion (from 1 to 3 rubles) of the “neutral” range of the floating operational band of acceptable cost of the dual currency basket. Thus, the FX corridor within which the Bank of Russia does not influence the dynamics of the Russian ruble exchange rate was increased to Rb 3.1 in 2013.

Important parameters in calculating the amount of operations performed by the Bank of Russia in the FX market, which causes movement of the boundaries of the operational band, are the target interventions. Implementation of target interventions is aimed mainly at neutralisation of the expectations of economic agents for ruble exchange rate fluctuations formed under the influence of existing foreign economic conditions. From 21 October 2013 onwards, the Bank of Russia reduced the amount of target FX interventions to \$60m per day whilst in September average daily FX sales amounted to \$104.3m and over 7m euro. This adjustment will result in an increased sensitivity of the boundaries of the operational band of the dual currency basket to the amount of interventions implemented by the Bank of Russia and aimed at smoothing excessive volatility of the ruble exchange rate. These changes, all other conditions being equal, will ensure a reduction of the direct presence of the Bank of Russia in the domestic FX market. From 1 January to 31 December 2013 the boundaries of the floating corridor of the dual currency basket changed 31 times. For example, on

31 December 2013 the boundaries of the corridor of the dual currency basket cost were Rb 33.05-40.05, while, as early as in the beginning of January 2013, their level was Rb 31.65-38.65. For comparison, in 2012 the boundaries of the operational corridor changed only 11 times from Rb 32.2-38.2 to Rb 31.65-38.65.

We should note that gradual increase in flexibility of the exchange-rate regime, and in the sensitivity of the boundaries of the operational corridor to the amount of interventions implemented by the regulator, create conditions for the adaptation of economic agents to exchange rate fluctuations and their learning to use the instruments of FX risk management. Given the above, the intention of the Bank of Russia, to retain the right to perform point operations in the FX market in order to maintain financial stability in the case of any external shock, seems reasonable, and is associated with the considerable dependence of the situation in the Russian economy on the world prices for energy resources and the high sensitivity of the condition of the capital account to the foreign economic and political environment.

2.1.4. Balance of payments and ruble exchange rate

In January-December 2013 unfavourable external conditions in the world's raw materials markets had a considerable impact on the formation of the balance of payments in the RF. The reduction in demand for raw material resources was driven, among other things, by the low growth rates of emerging economies and the implementation of budgetary policy measures by the governments of a number of developed countries. A substantial decrease in the current account balance and an outflow of funds from the financial account resulted in a reduction in the international reserves of the Bank of Russia, and in depreciation of the ruble. As was mentioned above, in 2013 the Bank of Russia, despite to its transition to the inflation targeting regime, increased its presence in the FX market. Based on the results of the 12 months of 2013 the net capital outflow from the country exceeded the 2012 figure, which reflects a high-risk assessment of investing in the Russian economy.

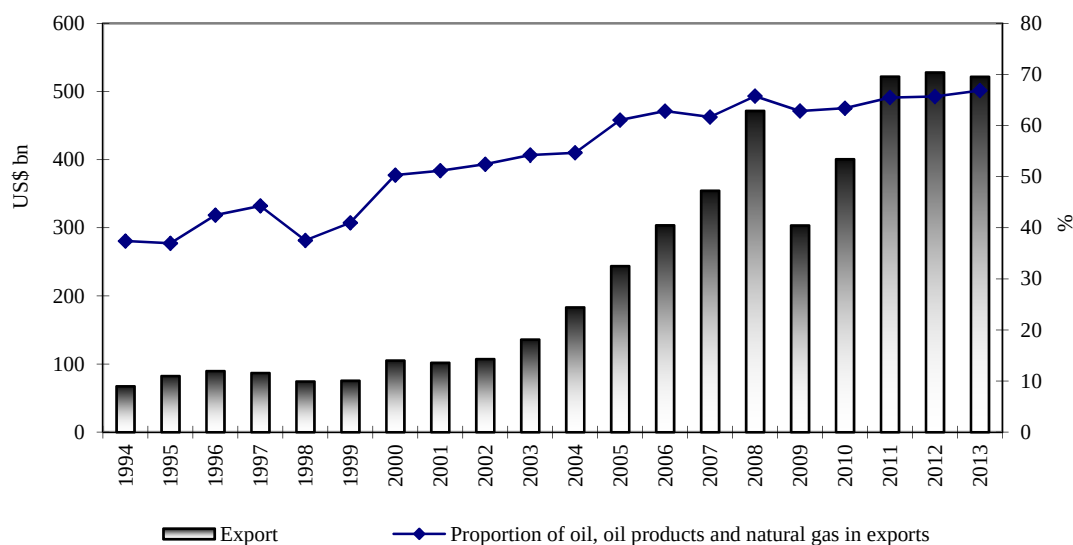
In accordance with the preliminary estimate of the RF balance of payments for January-December 2013 published by the Bank of Russia, the positive balance of the current account was \$33.0bn, having decreased by 54% compared to 2012 (*Table 5*). The positive trade balance decreased by 7.8% (from \$192.3bn to \$177.3bn), with the export of goods decreasing by 1.2% (c \$528bn to \$522bn) and the import of goods increasing by 2.6% (from \$335.7bn to \$344.3bn). The share of export of oil, oil products and natural gas was 66.9% of total exports, having increased by 1.2 p.p. compared to the corresponding period of 2012, despite an observed reduction in oil prices in 2013, on average by 2.8% to \$108.8/barrel (*Fig. 9*).

In the 2000s the main factor determining the current account balance in the Russian economy was the trade balance, which, in turn, depended on price fluctuations for hydrocarbons. This tendency continued in 2013 (see *Fig. 10*).

The services balance deficit in 2013 reached \$59.0bn and grew (in absolute terms) by 26.9% compared to the corresponding period of 2012. Services export was \$69.9bn, having increased by \$7.6bn (+12.2%) compared to the preceding year. Services import for the 12 months of 2013 exceeded the corresponding 2012 figure by 18.6% and reached \$129bn, and was primarily associated with the increased expenditure of Russian citizens on international travel. The balance of compensation of employees in January-December 2013 remained almost unchanged, amounting to \$-11.9bn (in 2012 it was \$-11.8 bn). The investment income balance deficit in 2013 compared to 2012 increased by 16.5%, having reached \$66.2bn. Receivable investment income has dropped by 2.8% from \$42.8bn to

\$41.6bn. Income payable to non-financial institutions has increased by 4.6% to \$86.2bn and to banks – by 23% to \$18bn, which determined a growth of total income payable by 8.2% to \$107.8bn. Rent balance¹ for 2013 was \$+0.9bn (\$+1bn in 2012). Based on the results of the 12 months of 2013 secondary income balance² was \$(-8.1)bn (in 2012 \$(-6.1)bn) and capital transfer balance was \$(-0.4)bn, (in 2012 – \$(-5.2)bn).

Thus, more than two-fold reduction of the current account surplus in 2013 was not only due to a decrease in trade balance but also to an increase in the deficit of services balance and the balance of primary and secondary incomes.



Source: Bank of Russia.

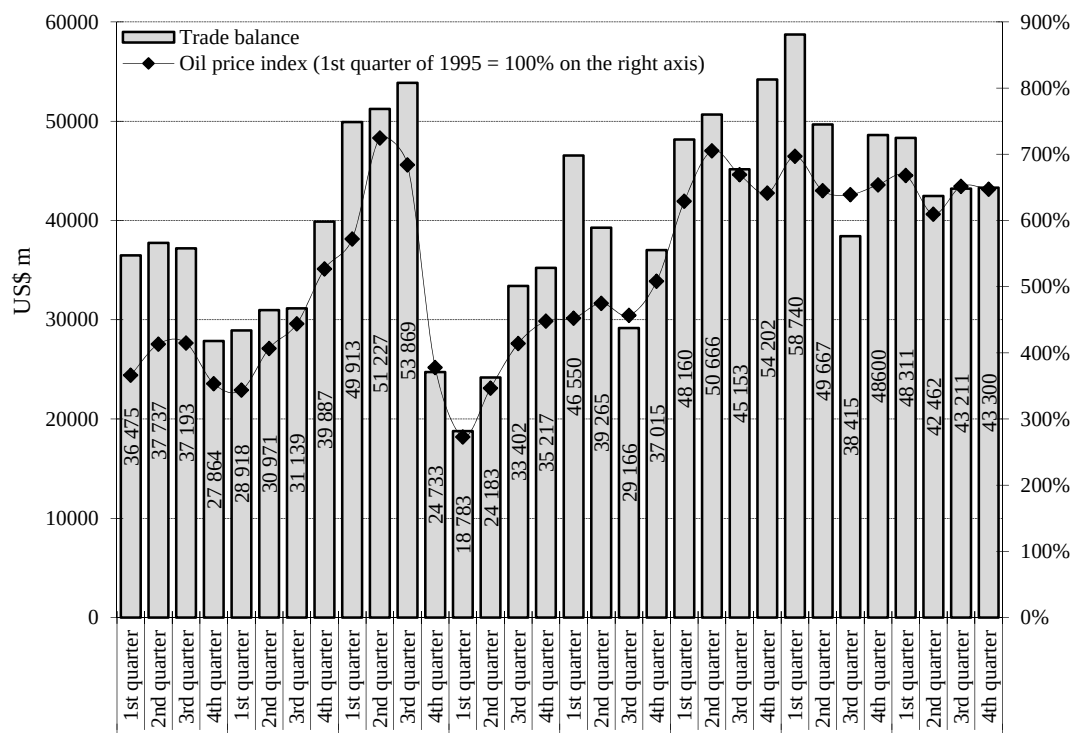
Fig. 9. Dynamics of export of goods and the proportion of fuel and energy products in 1994-2013

In 2013 the financial account deficit was \$-43.0bn (\$-26.5bn in 2012). The increase in the financial account deficit was associated with the outrunning growth of foreign assets against liabilities. The growth of liabilities of Russian economic agents to foreign economic agents based on the results of the 12 months of 2013 was \$141bn, which is 52.6% higher than in the preceding year (\$92.4bn). The external liabilities of federal administration bodies increased by \$11.3bn in 2013. Considerable money inflow in the state administration sector is associated with the acquisition by non-residents of Eurobonds issued by the Ministry of Finance of Russia. The external liabilities of constituent entities of the RF were \$0.2bn. The increase in liabilities of monetary authorities in 2012 was less than \$0.3bn. The liabilities of the banking

¹ Rent is income receivable for the provision of natural resources and the rights to dispose of any other institutional unit. Rent includes, for example, amounts payable for land use, mineral extraction, fishing rights, forest rights and rights of pasture.

² Formerly, current transfer balance. According to the Bank of Russia, current transfers increase the level of available income and consumption of goods and services of the recipient or decrease the available income and potential consumption opportunities of the donor, for example, humanitarian aid in the form of consumer goods and services. Transfers that are not current are, by definition, capital transfers. Capital transfers result in a change in the amount of assets and liabilities of the donor and recipient and are reflected in the capital account. If the donor and recipient are residents of different countries, capital transfer will result in a change in the level of national wealth of the economies which they represent.

sector to non-residents grew by \$20.2bn in 2013, while in 2012 the banks' liabilities increased by \$33.3bn. The liabilities of other sectors to non-residents in January-December 2013 increased by \$109.4bn compared to \$+39.8bn in 2012, with direct investment in other sectors amounting to \$78.4bn compared to \$42.8bn in 2012. We should note that a considerable part of this amount is associated with the completion of the takeover of TNK-BP by Rosneft in the 1st quarter of 2013.



Source: Bank of Russia; EIA; calculations of the Ye.T.Gaidar IEP.

Fig. 10. Trade balance of the Russian Federation and world oil price index in 2006-2013

In 2013 the outflow of portfolio investments from the non-financial sector of the RF in the amount of \$11.3bn was observed (\$-8.1bn in the preceding year). The decrease in portfolio investments in the non-financial sector of the RF illustrates the insufficient attractiveness of investments in it in terms of the risk-return ratio. The amount of loans and credits provided by non-residents grew in 2013 by \$42.4bn compared to \$+6.7bn in 2012.

The foreign assets of residents (the liabilities of economic agents to Russian economic agents) increased by \$184bn for the 12 months of 2013 (by \$118.9bn in 2012). At the same time, the foreign assets of monetary authorities increased by \$4.1bn (decrease by \$0.4bn in 2012). The foreign assets of the banking sector increased by \$26.3bn in 2013 (\$14.8bn in 2012). Capital withdrawal from other sectors compared to 2012 increased by 47.5%, amounting to \$154.1bn. Of this amount, \$97.4bn stood for direct and portfolio investments abroad (\$53.1bn more than in 2012).

The external debt of the RF increased by 15% in 2013 and as of 1 January 2014 was \$732bn. We should note that in 2013 the growth rates of external debt in the private sector continued accelerating (*Table 5*). Whilst in 2011 the external debt of banks and the non-

financial sector grew by \$58.4bn, in 2012 their debt grew by \$73.8bn and in 2013 – by \$86.4bn. The State external debt increased by \$9bn \$ in 2013, which is considerably less than in 2012 (\$19.7bn). In December 2013 Russia repaid its state external debt to the Czech republic, Finland and Montenegro in the total amount of \$3.6bn, almost entirely clearing “Soviet” debt, and forgave Cuban debt in the amount of \$29bn. In the mid-run we can expect continuing growth of both private and state external debt due to the lack and high cost of financial resources in the country and a deficit of the RF state budget.

Table 5

**Main items of the balance of payments and dynamics
of external debt in 2011-2013 (\$ bn)**

Indicator	2011					2012					2013				
	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year
Current and capital account balance	29.8	22.9	17.6	27.1	97.4	34.7	16.1	5.6	10.3	66.8	25.1	2.6	0.4	4.6	32.6
Financial account (excluding reserve assets)**	-17.3	-7.4	-19.0	-32.4	-76.1	-24.8	0.8	-4.0	1.6	-26.5	-12.8	-8.8	-6.6	-14.8	-43.0
Change in FX reserves ('+' – decrease, '-' – increase in reserves)	-10.1	-12.9	1.8	8.6	-12.6	-4.6	-15.0	-1.5	-8.9	-30.0	-4.9	4.4	7.4	15.2	22.1
Net errors and omissions	-2.4	-2.7	0.3	-3.3	-8.7	-5.3	-2.0	-0.1	-2.9	-10.3	-7.3	1.8	-1.2	-5.0	-11.7
Change in external debt of the RF ('+' – increase, '-' – decrease in debt)	20.7	29.2	-11.1	17.4	56.2	18.6	13.1	28.3	37.5	97.6	53.8	15.9	8.0	17.8	95.6
Change in state external debt of the RF	1.3	0.0	-2.7	-0.8	-2.1	1.7	5.1	5.0	7.9	19.7	3.1	-1.5	6.7	0.8	9.0
Change in private external debt of the RF	19.4	29.2	-8.4	18.1	58.4	16.5	8.0	21.7	27.6	73.8	46.8	18.1	2.8	18.6	86.4

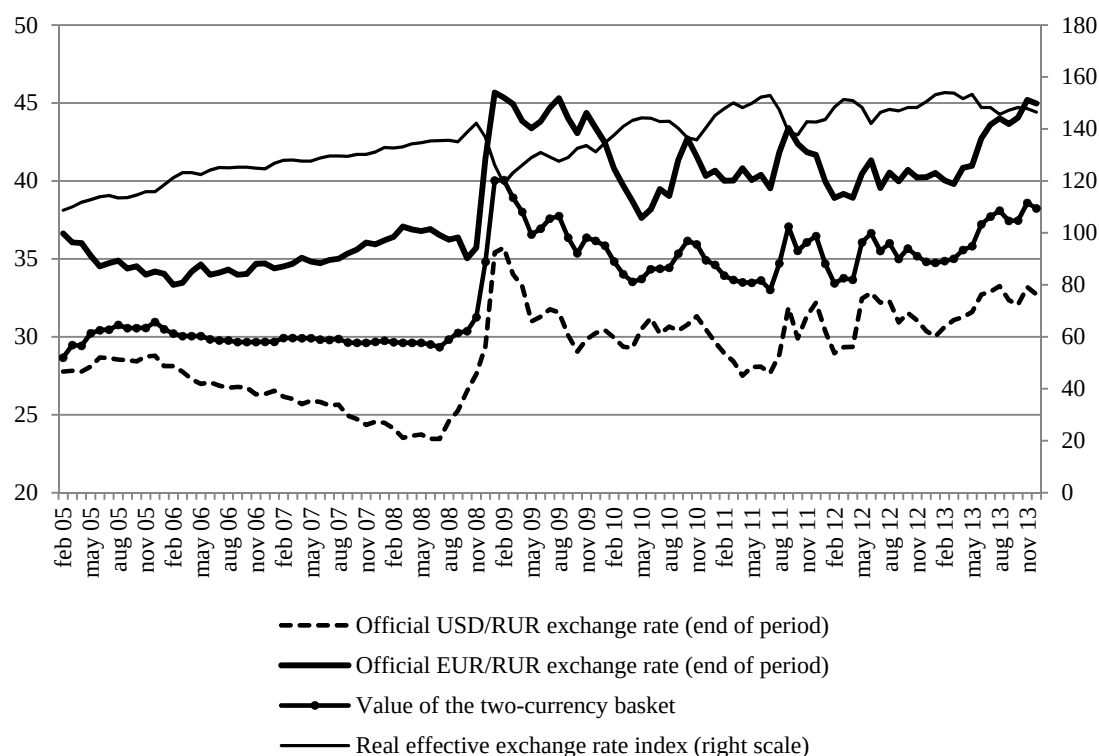
* – preliminary estimate; ** – excluding FX reserves.

Source: Bank of Russia.

The dynamics of the ruble exchange rate in 2013 were similar to those of emerging countries. The tendency of ruble weakening against the main world currencies that had started forming in the second quarter of 2013 continued in the third and fourth quarters due to the substantial decrease in the trade balance of the Russian economy, capital outflow from the country and a reduction of investors' risk tolerance due to the expected wind-down of the Quantitative Easing Program by the Federal Reserve System of the USA (US FRS) before the end of the year. Some ruble strengthening in nominal values at the end of the 3rd quarter of 2013 was partially due to FX interventions implemented by the Bank of Russia and the unfavourable geopolitical situation in the Middle East resulting in a rise in oil prices.

Owing to a certain decrease in prices for major Russian export commodities and moderate inflation in the RF the real effective ruble exchange rate decreased by 2.7% based on the results of 2013 (in 2012 a strengthening of 5.3% was recorded) (*Fig. 11*). The official USD to

RUB exchange rate in January-December 2013 increased by Rb 2,31: at the end of December the USD exchange rate was Rb 32.7 compared to Rb 30.4 as of 31 December 2012. The EUR to RUB exchange rate at the end of December was Rb 44.9, having increased by Rb 4.74 for the year. As a result, ruble depreciation against the dual currency basket was observed: the cost of the dual currency basket increased by Rb 3.43 (from Rb 34.8 to Rb 38.2) during the same period.



Source: Bank of Russia; calculations of the Ye.T.Gaidar IEP.

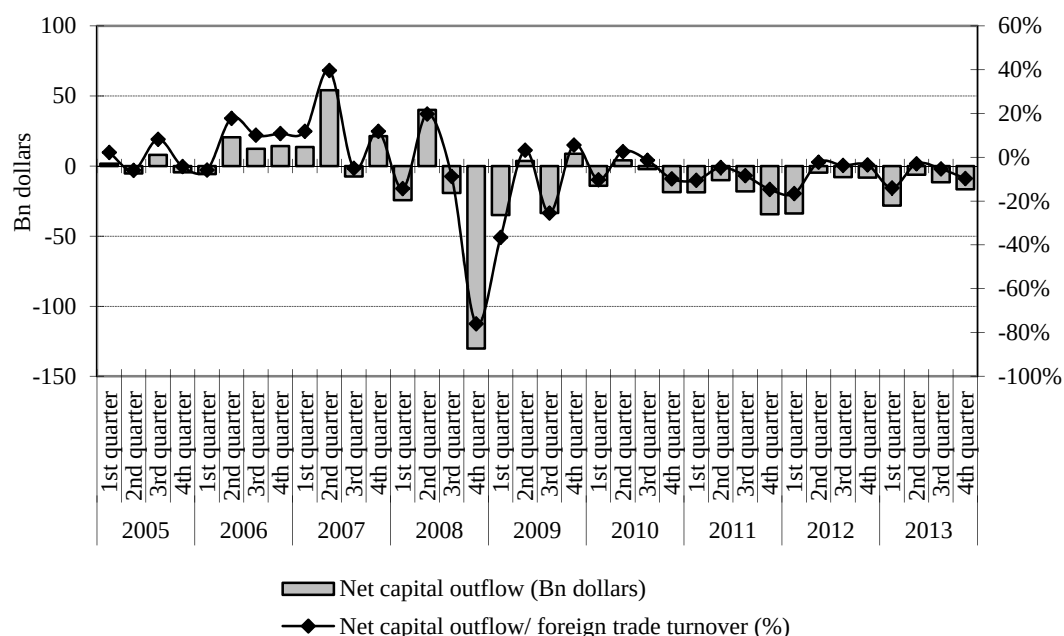
Fig. 11. Ruble exchange rates in the period from January 2005 to December 2013

According to preliminary estimates of the Bank of Russia, one of the critical tendencies in dynamics of the balance of payments figures in 2013 was the dynamics of a net flow of capital from the financial sector, which was \$64.7bn (\$10.1bn more than for the 12 months 2012). Capital outflow was observed during almost entire year, with the exception of June, when a net capital import by the private sector in the amount of \$9.6bn was observed.

For the period from January to December 2013 the net capital income by banks had reached \$5.2bn and by the private non-financial sector – \$59.7bn.

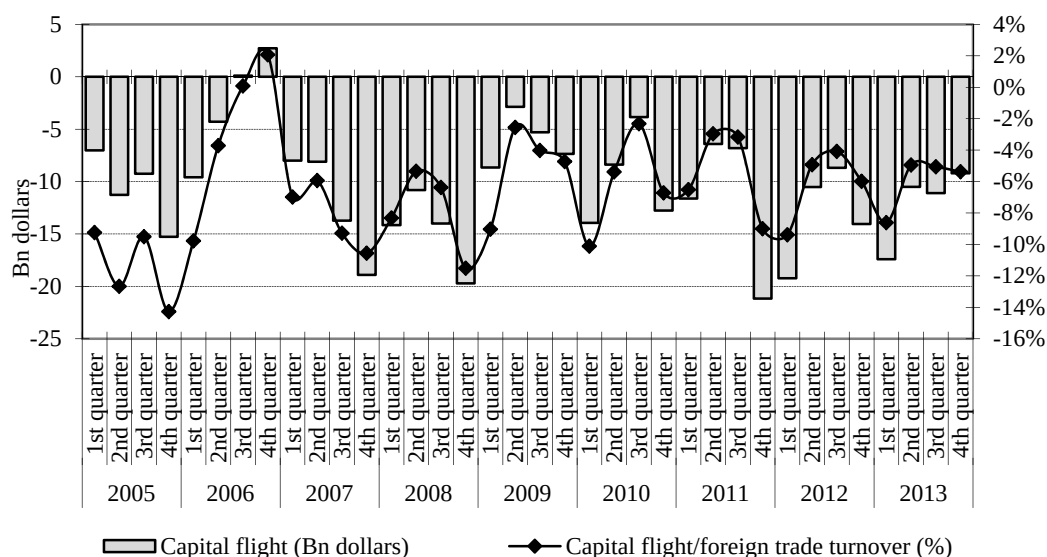
We should note that under the conditions of the unstable global and Russian economic situation, the high dependence of the Russian economy on the export of energy resources and the poor quality of the institutional environment, it is extremely difficult to achieve an increase in investments in the RF by non-residents or a reduction of the outflow of residents' funds abroad. As was noted before, one of the drivers of capital outflow from emerging markets in 2013 were the expectations of investors regarding the intentions of the US FRS to wind down the Quantitative Easing Program.

The increased capital outflow in 2013 was also associated with the continuing high level of the so-called “capital flight”¹. Based on the results of 2013 capital flight (see Fig. 12) was, according to our estimates, \$48.2bn (\$52.5bn in 2012) (Fig. 13).



Source: Bank of Russia; calculations of the Ye.T.Gaidar IEP.

Fig. 12. Dynamics of net capital outflow in 2005-2013



Source: Bank of Russia; calculations of the Ye.T.Gaidar IEP.

Fig. 13. Dynamics of capital flight in 2005-2013

¹ Capital flight was calculated by us using the IMF methodology and represents the sum of “trade credit and advances”, “non-receipt of export earnings and goods and services paid but not received under import contracts” and “net errors and omissions”.

We should note that further the prospects of the RF balance of payments are quite ambiguous. On the one hand, it is possible that the tendency towards a decrease in the current account balance that started forming in 2013 will continue in the mid-term. A possible decline in oil prices driven by the slowdown of economic growth in a number of countries that are the main consumers of raw materials, including China; the uncertain prospects for the global economy; a winding down the Quantitative Easing Program by US FRS; and a lower risk tolerance by investors will become the factors having a negative impact on the state of the balance of payments of the RF. On the other hand, a possible decline in the ruble nominal exchange rate will help to increase the trade balance surplus. However, in general, one should hardly expect any considerable improvement in the state of the Russian balance of payments in 2014.

2.2. State budget

In order to mitigate the influence of external factors, the federal budget for 2013, and for the period 2014-2015, had initially been formulated on the basis of budgetary rules aimed at decreasing the influence on it of the volatility of prices within the world market for energy resources. The aim was also to improve the accuracy of the long-term forecasting of revenues and expenditures within the budgetary system. However, in planning the main parameters of the federal budget, the possible changes in domestic factors related to social and economic development were underestimated; it was assumed that the key risks affecting the stability of the fiscal system would be created principally by external circumstances, such as the conditions in the world economy and hydrocarbon prices.

In 2013 the main cause of the reduction in budgetary revenues by 1.0% of GDP, as compared with the previous year, was not the decline in market-determined oil prices on the world markets, but the deterioration of the Russian economy¹. The shortage of non-oil-and-gas revenues to the federal budget were offset by the growth of oil and gas revenues which exceeded the forecasts and helped to keep the federal budget deficit at the low level of 0.5% of GDP (which was lower than the planned level of 0.8% of GDP) but only due to the reduced transfers to the Reserve Fund. With the difference between the actual average annual price for Urals oil in 2013 (\$107.9 per barrel) and the base price used in formulating the budget within the framework of the fiscal rules (\$91 per barrel), the amount of additional oil and gas revenues planned for transfer to the Reserve Fund in 2013 was estimated at Rb 1 trillion. However, based on the results of last year, only Rb 212.2bn of oil and gas revenues will be transferred to the Reserve Fund. Thus, although the actual share of oil and gas revenues within the federal budget did decrease slightly from 51.2% in 2012 to 50.8% in 2013, the considerable, originally planned change in budget structure, towards non-oil-and-gas revenues, did not take place.

It is also important to note that the increasing tension in budget implementation in 2013 exacerbated the problems related to imperfections in the state forecasting system, which, amongst other things, is supposed to ensure the reliability of budgetary revenue predictions. The first signs of a slowdown in the Russian economy appeared already in the second half of 2012, when federal budget tax revenues and the consolidated budgets of the constituent entities of the Russian Federation, in terms of GDP, began to decrease, compared with 2011². However, in autumn 2012 the Russian Ministry of Economic Development presented a

¹ For more information on this topic, see other sections of this work.

² See IEP's Monthly Overview "State Budget", August-November 2012.

forecast of social and economic development for the Russian Federation for 2013, pursuant to which GDP growth in 2013, according to the moderately optimistic scenario of development, was expected at a level of 3.7%. The ‘Guidelines for Budgetary Policy for 2013 and the Planning Period of 2014-2015’ also predicted an acceleration of growth rates: from 3.8% in 2013 to 4.7% in 2015. In 2013 the Ministry of Economic Development had to review its economic forecasts three times towards a considerable deterioration; and as a result, the expected GDP growth rates declared in December 2013 turned out to be substantially lower than the initial predictions: 1.4% versus 3.7% whilst the initial estimate by Rosstat (Federal State Statistics Service) had been 1.3%.

The manifest tendency towards stagnation of the Russian economy, combined with such factors as the lack of completeness of reforms in the budgetary, housing and utilities sectors, etc. evidences that the next few years may be very difficult in terms of the long term fiscal sustainability of the system.

2.2.1. Key trends in the development of the budgetary system of the Russian Federation in 2013

In 2013 the revenues of the budget of the enlarged government were Rb 24,082.4bn (36.1% of GDP), with budgetary system expenditure at Rb 24,931.1bn (37.4% of GDP) while the budgetary deficit was Rb 848.7bn (1.3% of GDP). The five-year dynamics of the key parameters of the budget of the enlarged government, in terms of GDP, show a growth of revenues from 35.0% of GDP in 2009 to 37.2% of GDP in 2011, with a subsequent decrease to 37.1% of GDP in 2012 and 36.1% of GDP in 2013 (see *Table 6*). Initially budgetary expenditure in terms of GDP decreased (in 2010-2011) compared with the previous year, this being mainly due to curtailing of the anti-recession programmes, but then it started to grow, by 1 p.p. in 2012 and by 0.7 p.p. in 2013. Thus 2012 marked the beginning of a new trend towards increased government spending whilst revenues were shrinking, ultimately leading to the budgetary surplus being replaced by a deficit.

Table 6

Revenues and expenditures of the budgetary system in 2009-2012

	2013		2012		2011		2010		2009		Deviation as p.p. of GDP, 2013 from 2012
	Rb bn	% of GDP	Rb bn	% of GDP	Rb bn	% of GDP	Rb bn	% of GDP	Rb bn	% of GDP	
	Federal budget										
Revenue	13,019.9	19.5	12,853.7	20.7	11,366.0	20.3	8,305.4	17.9	7,337.7	18.9	-1.2
Expenditure	13,342.9	20.0	12,890.7	20.7	10,935.2	19.5	10,117.5	21.8	9,660.9	24.9	-0.7
Deficit (-) / Surplus (+)	-323.0	-0.5	-37.0	-0.06	430.8	0.77	-1,812.1	-3.9	-2,322.3	-6.0	-0.4
	Consolidated budget of constituent entities of the Russian Federation										
Revenue	8,164.7	12.2	8,064.3	13.0	7,643.9	13.7	6,537.3	14.5	5,926.6	15.3	-0.8
Including inter- budget transfers	1,576.6	2.3	1,679.6	2.6	1,644.0	2.9	1,398.9	3.1	1,487.4	3.8	-0.3
Expenditure	8,806.7	13.2	8342.7	13.4	7,679.3	13.7	6,636.9	14.7	6,255.7	16.1	-0.2
Deficit (-)/ Surplus (+)	-642.0	-1.0	-278.4	-0.5	-35.4	-0.06	-99.6	-0.2	-329.0	-0.8	-0.5
	Budget of the enlarged government										
Revenue	24,082.4	36.1	23,088.7	37.1	20,853.7	37.2	15,715.9	33.9	13,420.7	34.6	-1.0
Expenditure	24,931.1	37.4	22,825.8	36.7	20,004.8	35.7	17,301.0	37.4	15,847.3	40.8	0.7
Deficit (-)/ Surplus (+)	-848.7	-1.3	262.9	,0.4	848.9	1.5	-1,585.1	-3.4	-2,426.7	-6.3	-1.7
For reference: GDP, Rb bn	66,755		62,218		55,967		46,309		38,807		-

Source: Rosstat, Ministry of Finance of the Russian Federation, calculations by IEP.

In 2013, in terms of the levels within the budgetary system, the revenues of the federal budget and of the consolidated budgets of the constituent entities of the Russian Federation decreased by 1.2 and 0.8 p.p of GDP, respectively, compared with the levels of the previous year, while the corresponding expenditure levels decreased by 0.7 and 0.2 p.p. of GDP. Thus, a major reduction of expenditure occurred within the federal budget while revenues decreased considerably both at the federal and at the regional levels. The result was that the expenditure of the budget of the enlarged government grew from 36.7% to 37.4% of GDP, but this was solely due to expenditure from state non-budgetary funds, primarily, the Pension Fund.

The situation with the cash performance of the federal budget and consolidated budgets of the constituent entities in respect of expenditure remained practically unchanged in 2013, compared with the previous year: the federal budget performance in respect of expenditure was 99.1% (in 2012 it was 98.9%), while the consolidated budget of the constituent entities of the Russian Federation achieved 91.2% (in 2012 it was 90.8%) of the approved annual volumes.

In 2013 the budget deficit of the enlarged government was Rb 848.7bn, being 1.3% of GDP, which was Rb 585.8bn (or 1.7 p.p. of GDP) higher than the 2012 level. However, the deficit had increased both at the federal level (from 0.06 to 0.5% of GDP) and at the level of the constituent entities of the Russian Federation (from 0.5 to 1.0% of GDP). As a result, despite the fact that the deficit in the budgets was still quite a long way from being critical, at the regional level it had already reached a substantial value, based on the results of 2013, and this reflected the tension with the performance of the consolidated budgets of the constituent entities of the Russian Federation.

As of 1 January 2014 the volume of the Reserve Fund was Rb 2,859.7bn (4.3% of GDP) and the volume of the National Wealth Fund was Rb 2,900.6bn (4.3% of GDP). In 2013 the oil and gas revenues contributed to the Reserve Fund amounted to Rb 713.5bn. The exchange differences on revaluation of the funds in the accounts with the Bank Russia for January-December 2013 were Rb 260.5bn for the Reserve Fund, and Rb 216.0bn for the National Wealth Fund. In December 2013, based on a separate resolution of the Government of the RF, \$3.0bn of the National Wealth Fund was placed in the debt obligations of Ukraine, without requiring a long-term credit rating of the issuer.

In 2013 attempts were made to change the approaches to the management and use of sovereign funds, in particular, in respect of investing them in long-term projects. Before 2012 the practice of the accumulation of funds placed in debt obligations in the form of securities issued by foreign governments, or foreign government agencies and central banks, had been maintained in order to create a “safety cushion” for the Russian economy, the social sphere and the entire financial system (Reserve Fund) and to provide co-financing of individuals’ voluntary pension savings thereby ensuring the balance (deficit coverage) of the budget of the Pension Fund (National Wealth Fund). After the end of 2012 proposals were put forward to change the policy of saving in sovereign funds, and areas for the use of the relevant funds were announced. Initially it was expected that Rb 450bn would be used to finance 3 major investment projects: the modernisation and expansion of the Baikal-Amur Mainline and Trans-Siberian railway, the development of high speed rail lines between Moscow and Kazan and the construction of highways in the Moscow region. In the second half of 2013 other proposals for investing these funds started to be discussed, including the realisation of infrastructure projects using the Russian Direct Investment Fund (for the implementation of energy efficiency and information technology, the construction of sea ports, roads and

pipelines and the development of the Moscow air hub). However, none of the projects discussed at meetings of the Russian President or in Government has obtained any funding from the National Wealth Fund. In many respects this situation reflects the fact that the efficacy of investing funds in the proposed projects is still highly questionable. It is also important to understand that, with the further slowdown of Russian economic growth and the uncertain prospects of replenishing the revenue part of the federal budget, it is hardly appropriate to use sovereign funds to initiate large-scale investment projects, which, would then, perhaps, have to be frozen in the case of a sharp deterioration of the situation for replenishing the budget.

2.2.2. Analysis of the main tax receipts to the budgetary system of the Russian Federation

In 2013, tax revenue decreased by 1.1 p.p. of GDP, or by 1.8% in real terms compared with 2012 (see *Table 7*), which evidences the deterioration in replenishment of the revenue part of the Russian fiscal system.

Table 7

Main tax receipts to the budget of the enlarged government of the Russian Federation in 2008-2013, % of GDP

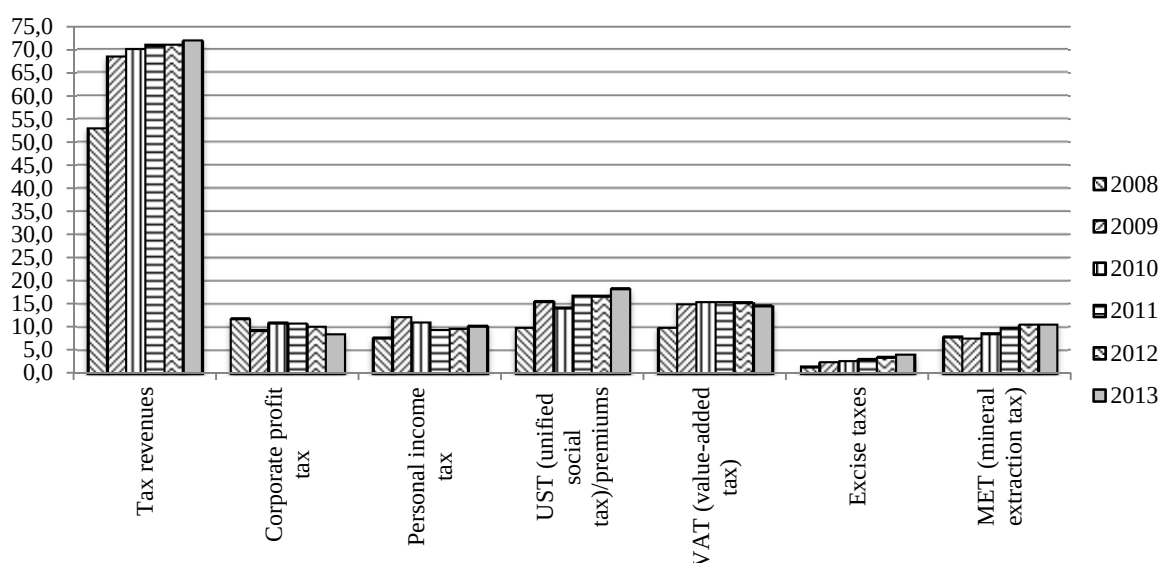
	2008	2009	2010	2011	2012	2013	Change in 2013 relative to 2012	
							as p.p. of GDP	real increase, %
Tax burden	35.7	30.8	31.1	34.9	34.6	33.5	-1.1	-1.8
Corporate profit tax	6.1	3.3	3.8	4.1	3.8	3.1	-0.7	-17.4
Personal income tax	4.0	4.3	3.9	3.6	3.6	3.7	0.1	3.8
UST (unified social tax)/insurance premiums*	5.1	5.5	4.9	6.3	6.3	6.7	0.4	7.7
VAT (value-added tax)	5.1	5.3	5.4	5.8	5.7	5.3	-0.4	-6.3
Excise taxes	0.8	0.9	1.0	1.2	1.4	1.5	0.1	14.0
MET (mineral extraction tax)	4.1	2.7	3.0	3.7	4.0	3.9	-0.1	-2.5
Customs duties and fees	8.6	6.8	6.8	8.3	8.0	7.5	-0.5	-5.2

* Since 2010 UST has been transformed into insurance premiums paid directly into non-budgetary funds.

Source: Ministry of Finance of the Russian Federation, Rosstat, calculations by IEP.

As seen from the data provided in *Table 7*, revenues in terms of GDP have decreased for many types of taxes. So, corporate profit tax collections were below even the crisis level of 2009, VAT collections decreased by 0.4 p.p. and MET collections decreased by 0.1 p.p. The exceptions were receipts from insurance premiums (6.7% of GDP in 2013 against 6.4% of GDP in 2012), from personal income tax (3.7% versus 3.6%) and from excise taxes (1.5% versus 1.4%). The growth in the volumes of insurance premiums was partially due to indexation raising the base, taxable at a rate of 30%, from Rb 512,000 to Rb 568,000¹. Receipts from insurance premiums and personal income tax were affected by increases in the salaries of employees in the public sector. The increase in excise tax collections was, also due to the indexation of rates. However, of particular concern is the fact that, under the conditions of a slowdown of economic activities, not only have the revenues from one of the most volatile taxes – corporate profit tax – decreased, but VAT receipts, which (together with personal income tax) had been quite stable in terms of GDP during the crisis period of 2009, are also decreasing.

¹ A 10% rate applies above this value and the relevant payments are received only into the Russian Pension Fund.

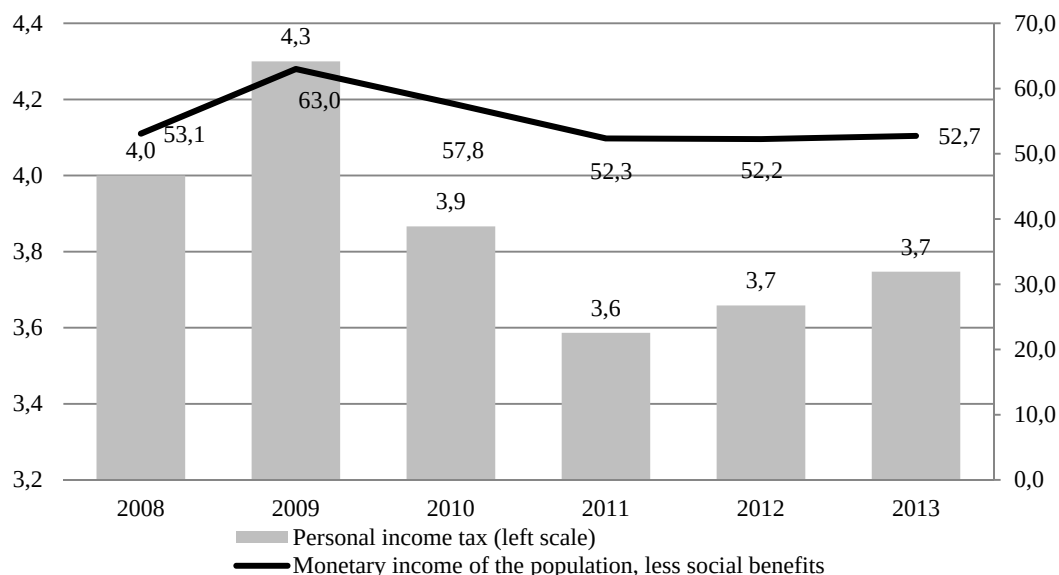


Source: Federal Tax Service of the Russian Federation.

Fig. 14. Share of tax receipts in the total revenue of the budget of the enlarged government in 2008-2013, %

As seen from *Fig. 14*, in 2013, the proportions of personal income tax, insurance premiums and excise taxes increased, whilst the proportions of VAT, and especially of corporate profit tax, decreased, compared with 2012. The share of MET remained almost unchanged.

Considering personal income tax receipts, it should be noted that, in 2013, there was a slight growth of monetary income less social payments for the population (see *Fig. 15*). Thus, the increased tax base drove a slight increase in receipts from personal income tax.



Source: Federal Tax Service of the Russian Federation, Rosstat.

Fig. 15. Comparison of the dynamics of personal income tax receipts with the dynamics of the monetary income of the population excluding social payments in 2008-2013, % of GDP

In terms of GDP, the oil and gas revenues of the federal budget decreased, compared with 2012 (see *Table 8*). The first component, the MET on hydrocarbons, decreased by 0.06 p.p. of GDP. The slight decrease in oil prices affected MET collections, despite a slight increase in oil production (523.5m tons, including gas condensate, in 2013 versus 516.8m tons in 2012) and a slight weakening of the ruble¹.

Table 8

Oil and gas revenues and MET in 2008-2013

	2008	2009	2010	2011	2012	2013
Oil and gas revenues, % of GDP	10.6	7.7	8.3	10.3	10.5	10.0
MET, % of GDP	4.1	2.7	3.0	3.6	3.83	3.77
Oil production, including gas condensate, m tons	488	494	507.2	509.4	516.8	523.5
Average annual level of prices for Urals oil, \$/barrel	94.0	60.7	78.1	109.6	110.7	108.4
Average annual ² official USD to RUB exchange rate of the Bank of Russia, Rb/\$	24.78	31.90	30.37	29.31	31.05	31.20

Source: Rosstat; Bank of Russia; Federal Tax Service of the Russian Federation; calculations by IEP.

The dynamics of the second component, the export duties on energy resources (at about 6% of GDP in 2013 versus 6.5% in 2012), became the decisive factor for the decrease in oil and gas revenues in terms of GDP. At the same time, revenues, mainly from the export of crude oil, decreased (*Table 9*). This was for two reasons. Firstly, in the first half of 2013 oil export duty rates were reduced. Secondly, according to the Ministry of Energy, crude oil exports declined by 5.44m tons, or by 2.3%, in 2013, compared with 2012. Thirdly, there was an increase in the proportion of oil coming from new deposits, which operate on preferential (lower) rates.

Table 9

Receipts of customs duties in 2008-2013, % of GDP

	2008	2009	2010	2011	2012	2013
Export duties:						
- on crude oil	4.3	3.1	3.6	4.2	4.0	3.5
- on natural gas	1.2	1.1	0.4	0.7	0.7	0.7
- oil products	1.3	1.0	1.3	1.7	1.8	1.8
Customs duties and fees, total	8.6	6.8	7.0	8.3	7.9	7.5

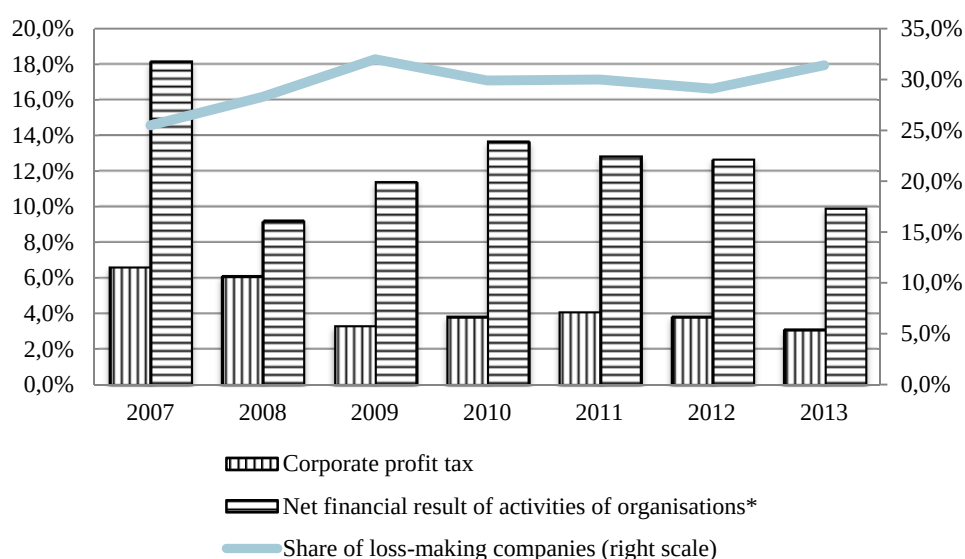
Source: Rosstat; data of Federal Treasury of Russia; calculations by IEP.

As noted above, in 2013, the revenues from corporate profit tax, in terms of GDP, were lower than even the 2009 receipts (see *Fig. 16*). The proportion of loss-making organisations in the Russian economy increased to 31.4% while the net financial result of the activities of companies and enterprises (excluding small businesses) reached its lowest level for the period 2009-2013, at 3.1% of GDP.

The decrease in VAT receipts resulted from the reduction in duties on both imported goods and those manufactured and sold in Russia (see *Table 10*). Taking into account, that in 2013, no significant changes in VAT taxation occurred and imports, according to Rosstat, grew by 3% in real terms, conclusions can be drawn regarding the deteriorating situation for VAT collection.

¹ MET rate for oil includes a coefficient characterising the dynamics of world oil prices (Kc) linked with the average USD to Rb exchange rate for the tax period.

² Calculated as a yearly average on the basis of the monthly data of the Bank of Russia.



* According to preliminary estimates of Rosstat.

Source: Federal Tax Service of the Russian Federation; Rosstat.

Fig. 16. Dynamics of corporate profit tax receipts to the budgetary system of the Russian Federation, the net financial result of the activities of companies and enterprises and the share of loss-making organisations in 2007-2013, as % of GDP

Table 10

Dynamics of end consumption, import and VAT receipts to the budgetary system of the Russian Federation in 2008-2013, % of GDP

	2008	2009	2010	2011	2012	2013
VAT revenues (without receipts from YUKOS)	5.2	5.3	5.4	5.8	5.7	5.3
VAT on goods manufactured and sold in the territory of the Russian Federation	2.4	3.0	2.9	3.1	3.0	2.8
VAT on goods imported into Russia	2.8	2.3	2.5	2.7	2.7	2.5
Effective VAT rate ¹ , %	8.4	7.6	8.2	9.3	8.3	7.4
Imports*	22.1	20.5	21.1	21.9	22.4	22.6

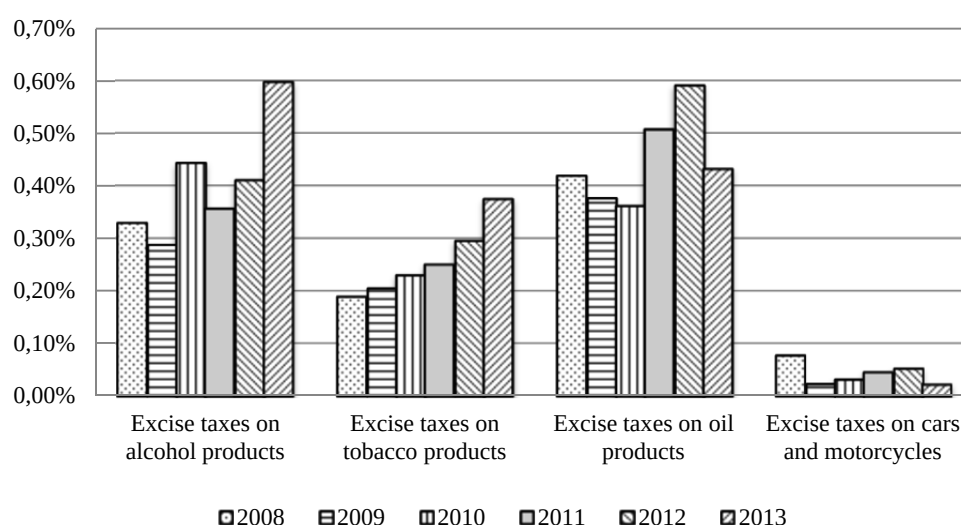
* The share of imports in GDP was determined as the ratio of import values to GDP, according to Rosstat.

Source: Rosstat; Ministry of Finance of Russia; calculations by IEP.

In terms of GDP, excise taxes showed a growth in receipts in 2013. As seen from *Fig. 17*, this growth was driven by the excise taxes on alcohol and tobacco products (from 0.4 and 0.3%, in 2012, to 0.6 and 0.4% of GDP in 2013, respectively), taking the first place in the overall structure of excise taxes, outstripping those on oil products.

The growth in revenues from excise taxes on alcohol and tobacco products resulted from indexation of rates above the level of inflation while there was a relatively low elasticity of demand, by price, on these goods subject to excise tax. At the same time, according to Rosstat, the consumption of all types of alcoholic products, especially vodka, liqueurs and beer, decreased. According to data from the Tabakprom Association, consumption of cigarettes and filter-cigarettes decreased by 3.8% (see *Table 11*). Thus, the increase in rates fully offset the possible losses from the reduction in the tax base.

¹ Ratio of Vat receipts to end consumption.



Source: Federal Tax Service of the Russian Federation.

Fig. 17. Excise tax receipts for 2008-2013 grouped by types of goods subject to excise tax, as % of GDP

Table 11

**Volume of consumption of alcohol and tobacco products
in the Russian Federation in 2008-2013**

Type of product	2008	2009	2010	2011	2012	2013
Vodka and liqueurs, m dL	177.2	166.1	157.8	159.0	159.8	140.9
Grape and fruit wines, m dL	102.9	102.5	103.4	103.0	95.6	91.2
Cognacs, m dL	10.8	10.6	11.1	12.0	12.5	12.4
Champagne and sparkling wine, m dL	26.0	25.5	27.3	29.8	30.1	28.8
Beer, m dL	1,138.2	1,024.7	1,004.0	1,077.5	1,055.7	1,005.6
Cigarettes and filter-cigarettes, bn pieces	393.6	394.3	370.6	366.1	366.8	353.0*

* Recalculation according to preliminary data from Tabakprom for January-September 2014

Source: Rosstat.

The decrease in excise taxes on oil products was due to a decrease in receipts from “internal” excise¹ taxes. Firstly, receipts of excise taxes on diesel fuel produced in Russia decreased considerably (Rb 48.5bn in 2013 versus Rb 97.2bn in 2012). Secondly, receipts of excise taxes on petrol produced in Russia decreased slightly (Rb 161.7bn in 2013 versus Rb 169.4bn in 2012). Thirdly, excise tax collections for straight-run gasoline produced in Russia also decreased (Rb 6.9bn in 2013 versus Rb 8.9bn in 2012). By contrast, the receipts of excise taxes on oil products imported into Russia increased slightly in nominal terms.

The reduction in collections of excise taxes on transportation vehicles was partially related to the introduction of ‘utilisation duty’ on imported cars. As a result, while “internal” excise taxes, in general, grew from Rb 12.7bn in 2012 to Rb 15.3bn in 2013, “external” excise taxes fell from Rb 20.3bn to Rb 18.0bn.

Considering the dynamics of indebtedness on taxes and duties, it should be noted that in 2013 this grew more slowly than the inflation (*Table 12*).

¹ “Internal” excise taxes mean excise taxes imposed on goods manufactured in Russia and “external” excises mean excise taxes imposed on goods imported into Russia.

Table 12

Indebtedness on tax and duties in 2008-2013

	2008	2009	2010	2011	2012	2013
Total indebtedness, as % of GDP	1.35	1.80	1.52	1.21	1.17	1.15
Total indebtedness, Rb bn	559.1	699.0	704.5	675.3	728.2	770.0
<i>Corporate profit tax</i>	107.6	144.8	176.7	160.8	175.0	165.6
<i>VAT</i>	242.9	327.1	313.2	305.0	319.7	333.5
Total indebtedness, real increase, %	85.83	114.91	92.64	90.34	101.15	99.30
<i>In corporate profit tax</i>	92.60	123.75	112.13	85.79	102.07	88.86
<i>In VAT</i>	85.87	123.80	88.01	91.77	98.33	97.96

Source: Federal Tax Service of the Russian Federation; Rosstat; calculations by the Gaidar Institute.

It is also worth mentioning that for such taxes as corporate profit tax and VAT (receipts of which decreased in 2013, both in terms of GDP and in real terms), the volumes of indebtedness also decreased in real terms. Thus, the reduction in relevant receipts to the budgetary system was not related to the growth in tax debt.

2.2.3. Budgetary expenditure

Overall, the total volume of budgetary expenditure of the enlarged government increased in 2013 by 0.66% of GDP (see *Table 13*). It is important to note that the tendency towards a reduction of expenditure in terms of GDP (due to a gradual curtailing of the anti-recession programmes and to the growth of GDP itself), outlined in 2010-2011, ceased in 2012. In 2012-2013 a steady increase in government expenditure exceeding the rate of growth of the economy could be observed. The highest growth was recorded in the following areas: “Social Policy” (+0.71 p.p.), “National Defence” (+0.24 p.p.), “Education” (+0.22 p.p.) and “National Security and Law Enforcement Activities” (+0.13 p.p.). Expenditure on social policy increased due to expenditure on state non-budgetary funds, mainly, the Pension Fund. Expenditure on education increased, mainly at a sub-national level due to the necessity to increase the salaries of employees in the basic and pre-school education sector in 2012-2013, in accordance with the requirements of the Presidential Decrees of 7 May 2012. The federal budget continued building up defence expenditure in line with decisions made by the country’s top leaders, while expenditure on law enforcement activities also increased.

In 2013, the enlarged government’s budgetary expenditure on the national economy (–0.34 p.p.), on housing and utilities (–0.15 p.p.) and healthcare and sports (–0.17 p.p.) decreased in terms of GDP. It should be noted, however, that within the “National economy” section there was an increase in some areas and a decrease in others. Expenditure in such large subsections as “Other issues relating to the national economy” (–0.30 p.p.) and “Transport” (–0.18 p.p.) decreased. At the same time, there was an increase in expenditure on road repairs and construction (+0.16 p.p.) and on agriculture (+0.10 p.p.).

If we compare the current structure of expenditure within the budget of the enlarged government with the pre-crisis one of 2008 the following changes emerge. In terms of shares of GDP, there was a considerable increase in expenditure on defence (+0.63 p.p.), on law enforcement activities (+0.59) and especially on social policy (+3.84). Expenditure on education (+0.29 p.p.) and the servicing of state and municipal debt (+0.20) also increased. There was a decrease in funding for the housing and utility sector (–1.21), for overall national issues (–0.37) and the “National economy” section (–0.54). Within the “National economy” section, during the post-crisis period, the volume within the subsection “Other matters relating

to the national economy” decreased substantially (–1.02 p.p.) while expenditure on the public road system and applied scientific research increased (+0.21 and +0.22, respectively).

Table 13

**Expenditures of the budget of the enlarged government
in 2008-2013, % of GDP**

	2008	2009	2010	2011	2012	2013	Deviation of 2013 from 2012	Deviation of 2013 from 2008
Expenditure, total	33.89	40.84	37.36	35.74	36.69	37.35	0.66	3.46
Overall national issues	2.66	2.72	2.54	2.44	2.31	2.29	-0.02	-0.37
Servicing of state and municipal debt	0.46	0.61	0.56	0.59	0.62	0.66	0.04	0.20
National defence	2.53	3.07	2.76	2.71	2.92	3.15	0.24	0.63
National security and law enforcement activities	2.65	3.21	2.89	2.71	3.10	3.23	0.13	0.59
National economy, including:	5.46	7.17	5.02	4.99	5.26	4.92	-0.34	-0.54
agriculture and fishing	0.58	0.72	0.57	0.48	0.44	0.54	0.10	-0.04
transport	0.70	0.96	1.00	0.89	1.00	0.82	-0.18	0.12
public road system	1.54	1.55	1.39	1.28	1.59	1.76	0.16	0.21
applied scientific research	0.18	0.29	0.27	0.32	0.37	0.40	0.03	0.22
other areas	1.91	2.88	1.16	1.45	1.19	0.89	-0.30	-1.02
Housing and public utility sector	2.78	2.59	2.31	2.14	1.73	1.58	-0.15	-1.21
Environment protection	0.08	0.08	0.06	0.07	0.07	0.07	0.00	-0.01
Education	4.03	4.58	4.09	3.99	4.11	4.33	0.22	0.29
Culture, cinematography and mass media	0.75	0.84	0.76	0.73	0.73	0.74	0.01	-0.01
Healthcare and sports	3.75	4.26	3.69	3.74	3.97	3.80	-0.17	0.05
Social policy	8.74	11.71	12.66	11.64	11.87	12.58	0.71	3.84

Source: Federal Treasury; calculations by IEP.

In our opinion, to date, the potential to increase government expenditure in the mid- and long-term is almost used up. As a result, the only possible solution is to search for and to create prerequisites for long-term economic growth, both by changing the structure of expenditure and by increasing its efficiency. Measures should be aimed at increasing the volume and quality of production factors (human and physical capital), to increase the factors affecting overall productivity, including the development of infrastructure, transport and communication and by improvements to public institutions. From this perspective it is important to consider the changes in “productive expenditures” (education, healthcare, production infrastructure) which ensure growth, and in “non-productive expenditure” (national defence, law enforcement activities, public administration) which promote little or no economic growth (above a specified limit)¹. Investments in the fields of education, healthcare and infrastructure cannot be interpreted as expenditure necessary for social reasons or as an addition to the provision of social services in the market. They should be considered as investments in long-term economic growth.

If we analyse the changes in the structure of expenditure in the budget of the enlarged government which occurred in 2012-2013 in terms of the above logic, the following can be noted. In 2013 “non-productive” areas of expenditure such as law enforcement activities and especially national defence have noticeably increased, while there has been a simultaneous reduction in expenditure on healthcare (from 3.67 to 3.47% of GDP, excluding expenditure on sport). At the same time, we must note the outlined increase in the financing of such

¹ For more information see: G. Idrisov, S. Sinelnikov-Murylev. ‘Budgetary Policy and Economic Growth’//Voprosi ekonomiki, 2013, No.8; G. Idrisov, S. Sinelnikov-Murylev. ‘Creation of Prerequisites of Long-Term Growth: How We Should Understand Them?’//Voprosi ekonomiki, 2014, No.3.

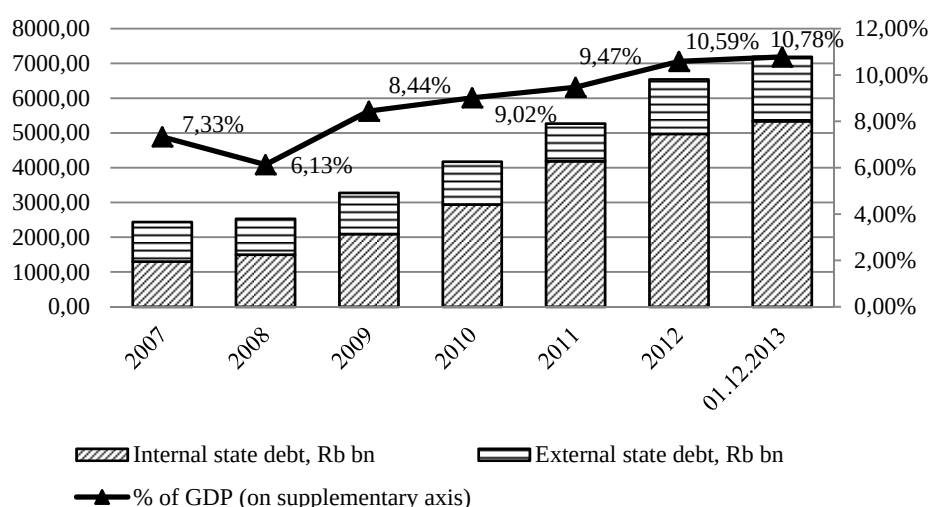
“productive expenditure” as that in the public road sector (related, amongst other things, to the restoration of the road fund) and in education (primarily, due to the increased salaries of employees in the pre-school and basic education sectors). However, one has to take into account that the increase in expenditure in the fields of education and healthcare, including the increase in salaries of employees in relevant sectors, should not be purely technical (simply an increase in the funding of the existing network and employees) but should be related to relevant reforms of the sectors in question, and aimed at improving the quality of the services provided. One must also keep in mind that the increase in expenditure on education in 2012-2013 resulted in a higher load on the consolidated regional budgets, while their income base actually declined. In this context, if the federal budget increases its “non-productive expenditure” (defence and law enforcement) the Federation may not have the financial resources to provide additional financial support to the regions.

In general, in 2012-2013, the increase in government expenditure occurred simultaneously with conflicting changes in their structure and under the conditions of increasing tension in the respective components of budget execution (especially at the regional level) which calls into question the financial stability of the budgetary system, and makes it difficult to create the conditions needed for increasing economic growth. Taking into account the limitations of the revenue component of the budgets it is necessary to rethink thoroughly the priorities both in budgetary policy and, in general, in the strategy for economic development and the reform of its key institutions.

2.2.4. State debt of the Russian Federation

As of 1 January 2014 the total state debt of the Russian Federation (of the federal budget) was 10.7% of GDP (Rb 7,135bn) (see *Fig. 18*), which is considerably lower than the value of 13.1% of GDP envisaged by the budget for 2013. However, since 2008, the tendency towards an increase in the level of debt has remained. In the total state debt, based on the results of 2013, the share of internal borrowings was 74.8% (Rb 5,338bn), while external borrowings stood at 25.2% (Rb 1,797bn). Since 2011 a trend towards an increase in external borrowings has been observed: in 2011 they were 20.5%, and in 2012, 23.9%. However, in 2013 the growth rates of both internal and external debt slowed down, compared with the previous year: 7.3% (2012: 18.6%) and 14.7% (2012: 45.2%), respectively.

The main driver for the growth of external debt in 2013 was the issue of Eurobonds, the amount of which in circulation increased by 16.5%. As of 1 January 2014 they also accounted for the largest proportion of the structure of state debt, at 72.8% (\$40.7bn). The domination of their share in the external debt structure is the natural result of the strategic objective of market development, and the improvement of conditions for borrowing. The remaining share falls on government guarantees in foreign currency, the rapid growth of which has been observed since late 2011 (\$1bn as of 1 December 2011). However, the volume of state guarantees, after a steep rise in 2012, then remained constant and has not changed much throughout the rest of the year: \$11.4bn as of 1 January 2014 (20.4% of the total external debt). The growth in government guarantees which took place has resulted in an increase in the share of the country's contingent liabilities and, hence, may lead to an additional burden on the federal budget in the case of the execution of guarantees. However, the main volume of guarantees in foreign currency is being provided to support the export of industrial products, which should therefore contribute to an increase in the share of non-oil products in Russian exports.



Source: E.T. Gaidar calculations by IEP on the basis of data from the Ministry of Finance. The average value of the exchange rate over 4 quarters was used in the calculation of annual data. This explains the difference between the amount of external state debt expressed in Rb bn and the data from the Ministry of Finance provided in 'Guidelines for the State Debt Policy of the Russian Federation for 2013-2015'.

Fig. 18. Dynamics of Russia's state debt

The total volume of internal state debt in securities, as of the end of 2013, was Rb 4,432.4bn, or 6.6% of GDP. The largest share within it is accounted for by federal loan obligations with a fixed coupon yield (OFZ-PD) of 61%. For the last three years the volume of traded OFZ-PD has increased twice: from Rb 1.3 trillion to Rb 2.7 trillion. This trend evidences that these securities are more attractive from the perspective of their non-dependence on the dynamics of the CPI or money market indicators. The remaining share is mainly represented by federal loan bonds with a debt amortization (OFZ-AD) of 24%. The volume of traded government saving bonds with fixed interest rates (GSO-PPS), issued for institutional investors in 2013, was adjusted after their observed continuous growth since 2007. There is also one issue of ruble Eurobonds circulating in the market, and issued in 2011, amounting to Rb 90bn. The absence of new issues of ruble Eurobonds can be explained by the recently observed increased ruble volatility.

In 2013 the main movement in the structure of governmental domestic borrowing was in the following two directions: OFZ-PD (increased by 19.6%) and government guarantees provided in Russian currency (increased by 42.3%). The estimate of the growth in the volume of government guarantees is ambiguous because the mechanism of transparent and objective selection of enterprises receiving the guarantees is not clear.

According to the regulations of various levels, government guarantees are provided to:

- strategically important enterprises;
- enterprises within the defence and industrial complex (OPK);
- commercial investment projects.

It should be noted that most of the companies included in the list of strategically important enterprises to receive government guarantees, are joint-stock companies with the government being, in the best case, a minority shareholder. As for a similar method to support the OPK enterprises, government guarantees are not the main, but rather the supplementary support instruments, along with budgetary targeted subsidies and contributions to the authorized

capital, and these are less orientated towards increased efficiency in the activities of these enterprises. First of all, it is necessary to review the list of strategically important enterprises, and to introduce stricter requirements in the criteria for the determination of the strategic importance of enterprises (for example, the inclusion of a requirement that there must be no offshore companies amongst the founders).

Based on the results of auctions conducted for the placement of government securities, the volume of bids offered by participants within the yield spread exceeded the supply volume, however, the level of placement of securities amongst investors was not high, only 70% of the expected volume. The continuation of this situation may become an obstacle for the implementation of the borrowing plans of the Russian Ministry of Finance for 2014-2016.

In the structure of OFZs with fixed coupon yields, long-term issues (over 5 years) dominate, at 62.8% as of January 2014. The remaining part is accounted for mid-term issues (1 to 5 years). In 2013 no issue of short-term OFZ-PD (up to 1 year) was carried out. The termed nature of the issues is in compliance with the issuance policy of the Russian Ministry of Finance, pursuant to which, the priority area is the issue of mid- and long-term securities, while the issue of short-term instruments is possible only “under very unfavourable market conditions”¹. This tendency is contributing to the increase of liquidity of government securities, due to which the OFZ yield curve becomes attractive for private borrowers. In 2013 the duration² of the OFZ-PD portfolio increased by 7%: from 3.72 to 3.98 years. The maximum value was recorded in April at 4.12 years. It should be noted that the ‘Guidelines for the Debt Policy for 2013-2015’ provide for the “achievement and maintenance of target duration of 5 years for the OFZ portfolio”.

In 2013 the average weighted yield of long-term OFZ issues changed within the range from 6.54 to 8.00% and that of mid-term issues, from 4.55 to 6.57%. In 2013 the dynamics of the long-term OFZ yield was characterized by incremental growth. In contrast, the dynamics of the mid-term OFZ yield in 2013 lacked any pronounced trends: most of the time the yield fluctuated around 6% per annum.

In 2013 the share of non-residents in the OFZ market grew from 19.9 to 23.9%. From July to December their share stabilised at a level of 25%. It should be noted that in the countries of Eastern Europe the share of non-residents in the sovereign securities market is considerably higher (*Table 14*).

Table 14

Participation of non-residents in sovereign debt markets of Eastern European countries in 2010

Country	Share of non-residents
Slovenia	64.8
Hungary	48.7
Poland	41.8
Slovakia	36.4
Czech Republic	29.7

Source: E.T. Gadar calculations by IEP on the basis of OECD data.

In 2013 the sovereign credit ratings of Russia did not change. By Standard and Poor’s scale, Russia’s local currency rating is “BBB+”, and its foreign currency rating is “BBB”. During the year, in both June and December, S&P’s affirmed the sovereign credit ratings on

¹ Guidelines for State Debt Policy of the Russian Federation for 2013-2015, p. 33.

² Duration means an average term until payments are made under securities, taking into account coupon payments weighted by the volumes in circulation (Bank of Russia).

the basis of “strong fiscal and external indicators”¹ with a stable outlook. In March 2013 Moody’s agency also affirmed a sovereign foreign currency credit rating at “Baa1” with a “stable” outlook on the basis of “sustainably high budgetary and financial indicators of external debt in comparison to the corresponding indicators of other countries in the same rating category”².

2.2.5. Analysis of the main parameters of the federal budget of the RF in 2009-2013 and for the period 2014-2016

The main parameters of the federal budget for 2014-2016 compared with the corresponding data for 2008-2013 are presented in *Table 15*. For 2014-2016, reductions in both federal revenue and expenditure in terms of GDP are predicted. Revenues will continue the trend in line with the reduction that has been observed since 2013. Revenues of the federal budget decreased from 20.7% of GDP in 2012, to 19.5% of GDP in 2013, with further decreases being forecast: to 18.5% of GDP in 2014 and to 18.3% of GDP in 2015-2016. Expenditure, which has decreased from 20.7 to 20.0% of GDP in 2013, will continue decreasing to 19.0% in 2014, should then grow a little in 2015 to 19.3% but decrease again to 18.9% in 2016. It is planned that the deficit for 2014 will remain at the 2013 level of 0.5% of GDP, with a subsequent increase to 1.0% in 2015 followed by a decrease to 0.6% in 2016.

It is important to note that a considerable change in the structure of the revenues of the federal budget is planned due to a substantial reduction in oil and gas revenues from 9.9% of GDP in 2013 to 7.9% of GDP in 2016, which will result in a decrease in their share from 50.8% in 2013 to 43.2% in 2016. At the same time, non-oil and gas revenues are expected to grow from 9.6% of GDP in 2013 to 10.4% in 2016. It is important to note that the observed reductions in non-oil and gas revenues from 10.1% of GDP in 2012 to 9.6% in 2013, and, in particular, the decrease in VAT receipts, arouses doubts that the above forecast for growth in non-oil and gas revenues to the federal budget will actually take place.

Table 15

Actual and expected performance of revenues and expenditures of the federal budget for 2008-2016 (% of GDP)

	Actual performance						Federal Law on the Federal Budget for 2014-2016			Deviation of 2016 from 2013, p.p. of GDP
	2008	2009	2010	2008	2009	2010	2008	2009	2010	
Revenues Including:	22.5	18.9	17.9	20.3	20.7	19.5	18.5	18.3	18.3	-1.2
oil and gas revenues	10.8	7.8	8.3	10.2	10.6	9.9	8.9	8.6	7.9	-2.0
non-oil and gas revenues	11.6	11.1	9.7	10.1	10.1	9.6	9.6	9.7	10.4	0.8
Expenditure	18.3	24.8	21.8	19.5	20.7	20.0	19.0	19.3	18.9	-1.1
Including nominally approved	0	0	0	0	0	0	0	0.5	0.9	0.9
Deficit (-)/surplus (+)	4.1	-6.0	-3.9	0.8	-0.06	-0.5	-0.5	-1.0	-0.6	-0.1
Non-oil and gas deficit	-6.7	-13.7	-12.2	-9.5	-10.6	-10.1	-9.4	-9.6	-8.4	1.7
GDP, Rb bn	41,276	38,809	46,308	55,967	62,218	66,755	73,315	79,660	86,837	-

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

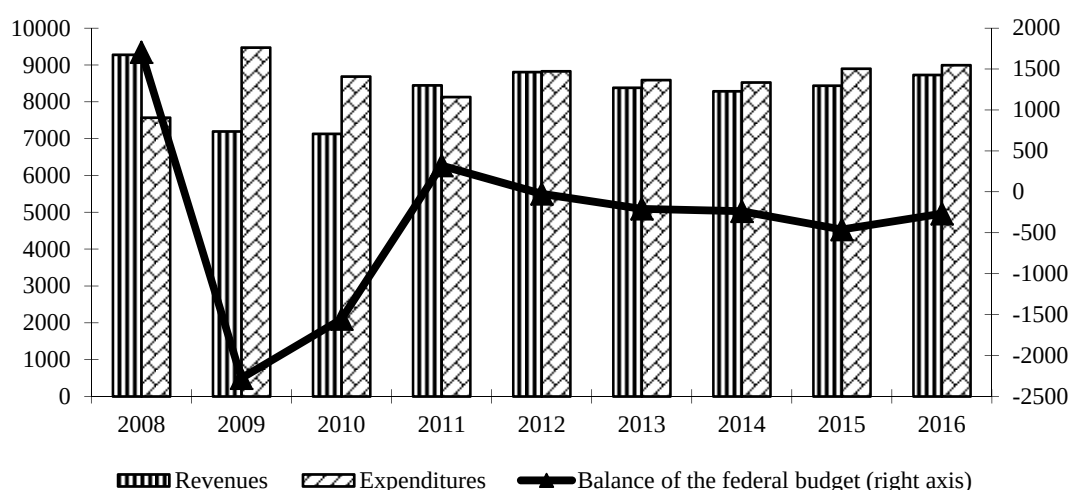
¹ <http://www.standardandpoors.com/prot/ratings/entity-details/ru/ru/?sectorCode=SOV&entityID=308102>

² https://www.moody.com/researchdocumentcontentpage.aspx?docid=PBC_151971

Thus, for 2014-2016 a reduction is planned in the dependency of revenues to the federal budget on the foreign economic environment, mainly on the situation in the global oil market. The major part of the reduction in the volumes of oil and gas revenue is accounted for by the reduction in export customs duties, the decrease in which is associated not only with changing macroeconomic indicators (export volumes, USD to ruble exchange rates, etc.) but also, to a large extent, with changes in customs legislation¹.

Additional oil and gas revenues², which could be received if the actual global oil price exceeded its base value, are estimated by the Ministry of Finance at: Rb 615.6bn, in 2014, Rb 384.9bn in 2015, and Rb 381.9bn in 2016. In 2014 a part of the additional oil and gas revenue is expected to be allocated to the Reserve Fund in the amount of Rb 343.5bn whilst the remaining amount of Rb 272.1bn will be used to increase the expenditure part of the federal budget to a maximum volume of Rb 13,869.1bn in accordance with clauses 3-6 of Article 199 of the Budgetary Code of the RF. In 2015 all additional oil and gas revenues will be allocated to the budget and in 2016, to the Reserve Fund.

At 2008 prices, revenues to the federal budget in 2014-2016 are comparable with the revenues of 2013 and are lower than revenues in 2008. Expenditures within the budget in 2014-2016 are comparable with the expenditure of 2013, and lower than the 2009 level but considerably higher than the pre-crisis values of 2008 (see *Fig. 19*).



Source: Russian Ministry of Finance, calculations by IEP.

Fig. 19. Dynamics of revenues, expenditures and deficits of the federal budget, Rb bn, at 2008 prices

It should be noted that in the formulation of the key parameters of the federal budget for 2014-2016 the macroeconomic indicators used for the calculation of the key parameters of the budgetary system were reduced, compared with the indicators in Federal Law No.216-FZ ‘On the Federal Budget for 2013-2015’ and formerly used in the ‘Guidelines for the Budgetary

¹ Decrease in the maximum oil export customs duty rate from 60 to 59% in 2014, to 57% in 2015, and to 55% in 2016. Decrease in the maximum export customs duty rate for “light” petroleum products from 66 to 65% of the oil duty rate in 2014, to 63% in 2015, and to 61% in 2016.

² “Additional” within the framework of the budgetary rules effective from 2013.

Policy for 2014-2016' (published on the website of the Ministry of Finance in July 2013). For example, Federal Law No.216-FZ forecast GDP growth at 4.3-4.5% in 2014-2015 while the 'Guidelines for the Budgetary Policy for 2014-2016' forecast it at 3.7-4.1% and the new budgetary projections are based on GDP growth estimates of only 3.0 and 3.1%, respectively. However, taking into account the increasing problems in the Russian economy and with GDP growth of only 1.3%, based on the results for 2013, even the relatively low figures of the adjusted forecast seem very optimistic, so this raises questions regarding the execution of the federal budget revenue plan as early as 2014 (especially, with respect to non-oil and gas revenues).

In 2014-2016 some changes are planned in the structure of expenditure of the federal budget (*Table 16*).

Table 16

Expenditures of the federal budget in 2013-2016 (% of GDP)

	2013	2014	2015	2016	Changes between 2016 to 2013
Total	20.0	19.0	19.3	18.9	-1.1
<i>Nominally approved</i>	<i>0.0</i>	<i>0.0</i>	<i>0.5</i>	<i>0.9</i>	<i>0.9</i>
Total (excluding nominally approved)	20.0	19.0	18.8	17.9	-2.1
<i>Including:</i>					
General national issues	1.3	1.4	1.3	1.2	-0.1
National defence	3.2	3.4	3.8	3.9	0.7
National security and law enforcement activities	3.1	2.8	2.6	2.4	-0.7
National economy	2.8	3.1	2.7	2.3	-0.5
Housing and public utility sector	0.3	0.2	0.1	0.1	-0.2
Environment protection	0.0	0.0	0.0	0.0	0.0
Education	1.0	0.8	0.8	0.7	-0.3
Culture, cinematography	0.1	0.1	0.1	0.1	0.0
Healthcare and sports	0.8	0.6	0.5	0.5	-0.3
Social policy	5.7	4.8	5.1	5.0	-0.7
Physical culture and sports	0.1	0.1	0.1	0.1	0.0
The media	0.1	0.1	0.1	0.1	0.0
Servicing of state and municipal debt	0.5	0.6	0.6	0.7	0.2
General inter-budget transfers	1.0	0.9	0.9	0.8	-0.2

Source: Russian Ministry of Finance, calculations by IEP.

As can be seen from *Table 16*, with a general reduction of expenditure in terms of GDP, it is planned to increase expenditure on national defence from 3.2 to 3.9% of GDP and expenditure on servicing state and municipal debt from 0.5 to 0.7% of GDP. The increase of expenditure on defence should result in a growth in the share of this expenditure in the total amount (excluding nominally approved expenditure) from 15.8% in 2013 to 21.8% in 2016. At the same time, the greatest reduction, in terms of GDP, is planned for the sections "National security and law enforcement activities" (−0.7 p.p. of GDP), "Social policy" (−0.7 p.p.), "National economy" (−0.5 p.p.), "Education" (−0.5 p.p.) and "Healthcare" (−0.5 p.p.). From the perspective of the above-mentioned concept of "productive" and "non-productive" expenditures, the reduction in expenditure on law enforcement activities deserves a positive evaluation whilst the increase in expenditure on defence and the reductions in education and healthcare funding deserve a negative one.

In general, one can see that the budgetary projections do not correspond to the "budgetary manoeuvre" proposed by the IEP experts¹ within the framework of the entire budgetary

¹ For more information see: G. Idrisov, S. Sinelnikov-Murylev. 'Budgetary Policy and Economic Growth'//Voprosi ekonomiki, 2013, No.8; G. Idrisov, S. Sinelnikov-Murylev. 'Creation of the Prerequisites for Long-Term Growth: How We Should Understand Them?'//Voprosi ekonomiki, 2014, No.3.

system (with the important caveat, that in this section, only those expenditures of the federal budget have been analysed). The “budgetary manoeuvre” should be conducted within 3-5 years, which would mean an increase in productive expenditures of the budget of the enlarged government by 3 p.p. These additional expenditures would be allocated to increase the quality of the business and investment climate in the country, to improve the human potential and to create a modern transport and engineering infrastructure. At the same time, “non-productive” expenditures should be reduced by 3 p.p. of GDP. It is feasible to increase the expenditure of the budget of the enlarged government on education by 1.2 p.p. of GDP, on healthcare by 1.0 p.p., and on the public road system by 0.8 p.p. of GDP. At the same time, it is necessary to decrease expenditure on law enforcement activities by 0.9 p.p. of GDP, on defence by 1.1 p.p., on the national economy and on housing and public utilities (excluding the public road system) by 1.0 p.p. of GDP¹.

In accordance with amendments made to the budgetary legislation, the federal budget for 2014-2016 is presented in a programme cost structure that previously had only an “analytical” status (*Table 17*). State programmes are grouped in 5 major directions: “New quality of life” (12 programmes), “Innovation development and modernisation of the economy” (17 programmes), “National security” (1 programme), “Balanced regional development” (5 programmes), “Effective state” (4 programmes).

Table 17

Federal Budget allocations² in 2013-2016, allocated for the implementation of state programmes, Rb bn

	2013 (Law No.216- FZ)*	2014			2015			2016		
		Passport**	Draft Federal Law on Federal Budget	Deviation	Passport**	Draft Federal Law on Federal Budget	Deviation	Passport**	Draft Federal Law on Federal Budget	Deviation
1	2	3	4	5=4-3	6	7	8=7-6	9	10	11=10-9
1	2	3	4	5	6	7	8	9	10	11
Total federal budget expenditure	13,387.3		13,960.1			14,977.5			15,572.6	
Out of which:										
Total expenditure on implementation of state programmes of the RF	7,733.2	7,633.9	8,161.1	527.2	7,723.6	8,422.6	698.9	8,138.5	8547.9	409.4
Share in the total amount, %	57.8		58.5			56.2			54.9	
Including in the areas:										
I. New quality of life (12 programmes)	3,349.9	3,230.0	3,408.2	178.2	3,196.5	3,410.2	213.7	3,276.5	3,422.5	145.9
II. Innovation development and modernisation of the economy (17 programmes), excluding a closed part	1,872.0	1,896.7	2,034.4	137.7	1,881.3	2,085.8	204.6	1,923.6	2,057.0	133.4

¹ Quantitative parameters are calculated on the basis of the structure of expenditure within the budget of the enlarged government in 2012.

² Open part.

Cont'd

1	2	3	4	5	6	7	8	9	10	11
III. National security (1 programme), excluding closed part	9.1	7.6	2.3	-5.3	5.7	1.5	-4.2	1.6	1.5	-0.1
IV. Balanced regional development (5 programmes)	678.1	627.8	740.2	112.3	604.4	778.6	174.2	761.4	787.1	25.7
V. Effective state (4 programmes)	1,084.3	1,137.4	1,115.1	-22.3	1,198.6	1,193.8	-4.8	1,205.8	1,239.7	33.8
Expenditure on implementation of state programmes of the RF (closed part)	739.7	734.4	861.0	126.6	837.2	952.7	115.5	969.6	1,040.2	70.6
Expenditure on non-programme activities	5,654.1		5,799.0			6,555.0			7,024.7	
Share in the total amount, %	42.2		41.5			43.8			45.1	
Including:										
Financial support of development of the pension system	2,850.3		2,307.4			2,776.0			3,058.3	
Closed expenditure, including ensuring the country's defence capability	2,242.4		2,556.8			3,028.7			3,310.9	
Other non-programme expenditure	561.4		934.8			750.3			655.6	

* Analytical distribution in accordance with Federal Law dated 3 December 2012 No.216-FZ (in original revision).

** In accordance with the basic option (without taking into account proposals for additional budgetary allocations)

Source: Ministry of Finance of Russia, calculations by IEP.

Considering the issues of formulating the federal budget for 2014-2016 in accordance with the programme principles, the following should be noted. Firstly, no state programmes have been adopted on such important and large expenditure items as defence and the pension system. As a result, in 2014 the share of programme expenditure is at 58.5% and its share is even planned to decrease to 54.9% by 2016 (if relevant state programmes are not adopted). Secondly, as seen from the data presented in *Table 17*, the parameters of the federal budget for 2014-2016 differ substantially from the corresponding ones envisaged by the passports of the state programmes. As a result, a situation is shaping where the budget is not being adopted on the basis of state programmes, but the passports of the state programmes have to be adjusted in accordance with the adopted law on the budget. As a result of all of the above, an unambiguous conclusion can be drawn: state programmes have not yet become a real tool for the formation of budgetary policy, and the distribution of funds amongst the state programmes still has a rather “analytical” nature.

When considering the other programme-target instruments of budgetary policy one can note that, out of total expenditure, the shares of federal budget expenditure allocated for implementing federal target programmes are to be reduced from 7.5% in 2013 to 6.8% in 2014-2015 and to 5.9% by 2016. In 2014 both the number of federal target programmes and the volumes of their budgetary funding will be reduced compared with the previous year: from 49 to 46 programmes and from Rb 1,009.9bn to Rb 956.5bn, respectively. Furthermore, from 2014, new programmes which have previously been implemented were accepted for

funding, these include: “Scientific and Scientific-Pedagogical Human Resources of Innovative Russia in 2014-2020”, “Research and Development in Priority Areas of the Scientific and Technological Complex of Russia for 2014-2020”, “Sustainable Rural Development in 2014-2017 and in the period until 2020”, together with a number of other programmes¹. At the same time, the largest volume of funding in 2014-2016 is to be allocated for the implementation of programmes for the development of transport infrastructure and high technology: 39.9 and 29.8% of the total funding for federal target programmes. The volume of investment expenditure in the form of capital investments funded within the framework of the Federal Address Target Programme is Rb 2,419.7bn in 2014-2016, peaking in 2015 at Rb 868.7bn.

According to an estimate by the Ministry of Finance: at the end of 2016, the volume of the Reserve Fund will be Rb 3,710.2bn, or 4.3% of GDP, which is Rb 850.5bn, or 0.1 p.p. of GDP higher than the 2013 figure. The volume of the National Wealth Fund will be Rb 2,990.4bn, or 3.4% of GDP, which is Rb 90.2bn higher than the 2013 level, and by the end of 2016, the volume of the National Wealth Fund will be reduced by 1.0 p.p. of GDP, compared with the 2013 level.

Taking into account the 2014-2016 forecasts for reductions in the growth rates of such indicators as the volume of industrial production, the real disposable income of the population and the possible reduction of import volumes, it can be admitted that the decrease in federal expenditure in terms of GDP for 2014-2016 is a justified measure from the point of view of ensuring the financial stability of the country’s budgetary system. However, the structure of expenditure should be adjusted towards an increase in the “productive” and a decrease in the “non-productive” areas.

2.2.6. Prospects for the fiscal policy in 2014-2016

1. Budgetary rules and government expenditure policy. Due to the increasing uncertainty in the world, both geopolitical and financial, together with possible changes in key trends of social and economic development in Russia, it is impractical to revise the budgetary rules in the medium term. It is necessary to continue to restrict the deficit of the federal budget at the level of 1% of GDP and to calculate budgetary revenues based on average annual oil prices. Given the lack of sources of revenue we need to define more clearly the public spending priorities in the light of the concept of “productive/non-productive expenditures” and the above-mentioned “budgetary manoeuvre”.

2. New public procurement procedures for goods and services. On 1 January 2014 Federal Law dated 5 April 2013 No.44-FZ ‘On the Contractual System in the Field of Public Procurement of Goods, Works and Services for State and Municipal Needs’ became effective (Federal Contractual System — FCS). The transitional period for certain provisions will stretch as far as 2017. For example, chapter 2 (‘Planning’) will become effective only in 2015. This is, perhaps, the only principal innovation of the FCS compared with the former Federal Law No.94-FZ which the expert community will adopt without major controversies. Law No.94-FZ concerned only the stage of state procurement. Hence, the former purchasing legislation focused on combating the type of corruption which was manifested in overpricing a particular group of goods, works or services. However, this approach does not consider the situation of ineffective (unjustified) expenses where the economic feasibility of the choice

¹ “Development of agricultural lands in Russia in 2014-2020”, “South of Russia (2014-2020)”, “Development of a unified state system for registration of rights and cadastral accounting for real estate (2014-2019)”.

(ahead of placement of an order) of object being procured, itself, raises doubts. Many stories about the manner in which purchases of executive-class cars or other “luxury articles” have been conducted, can serve as examples of the above situation. Measures which could potentially promote the efficiency of budgetary spending at the planning stage include the introduction of limitations on needs (relevant regulation has not been adopted yet), an almost complete prohibition on purchasing outside of the schedule (the customer places an order with goszakupki.gov.ru), public discussion of purchases (this requirement was optional until the FCS came into force in 2014 when it became obligatory for purchases of Rb 1bn and more), substantiation of the choice of the initial maximum price (the Ministry of Economic Development has developed relevant recommendations) and the type of procurement procedure (Law No.94-FZ did not specify any such constraints whatsoever).

However, in 2014 the FCS is already providing more freedom to customers at the stage of order placement (chapter 3 of the FCS). This is expressed in the extension of the list of purchasing procedures (two-stage tendering, tenders with prequalification, and invitations to tender, were introduced) and in the appearance of a new limit on the cost of ownership as a criterion for bid selection (for the creation of infrastructure objects). Such empowering of the customer, on the one hand, reduces the risk that the tender is won through unfair performance of the state contract procedure but, on the other hand, increases the risk of corruption. However, the expansion of the list of purchasing procedures concerns only a small circle of purchasing objects (*Table 18*).

The lists of goods, works and services which must be placed through an electronic auction and may be purchased from a single supplier have remained almost unchanged (with the exception of the withdrawal of invitations to tender and the inclusion of the purchase and leasing of real estate). The lists for new purchasing procedures appear to correspond with the ideas envisaged when they were introduced. For example, the list of purchases through an invitation to tender is actually a withdrawal of a small part of the grounds for purchasing from a single supplier which were included in Federal Law No.94-FZ. A final aspect worth noting is the potential for criticism of the inclusion of the provision of food services in public institutions into the list where the use of a tender with prequalification (also known as a tender with limited participation) is permissible.

Table 18

New purchasing procedures (Federal Law No.44-FZ)

Purchasing procedure	Scope	List of goods, works, services
Two-stage tender	Where it is necessary to find out the features of the purchasing object which are the best fit for the relevant need	Creation of culture and art objects Conduct of research and development works
Tender with prequalification	Where improper performance may endanger the life and health of individuals Or where damage can be caused to the property, resulting in irreparable loss of important features of the object	Creation of expensive infrastructure The creation of, and work with, nomenclature related to the atomic industry and energy sector Provision of food services in public sector institutions Preservation of cultural heritage
Invitation to tender	Where criteria which are not included in the list of acceptable criteria may be significant	Sports gear and equipment, sports outfits, necessary for the preparation of sports teams of the Russian Federation for Olympic and Paralympic sports Medical treatment of a Russian citizen abroad Medications for a particular patient Craftwork items Services of professionals in legal proceedings abroad

2.3. Inter-budget relations and sub-national finances

2.3.1. Analysis of the main features of the consolidated budgets of constituent entities of the Russian Federation

The main trends in the relations between different levels of government are reflected in the structure of revenue and expenditure in the consolidated budget of the Russian Federation. *Table 19* presents data reflecting the shares of tax revenues and expenditure of the constituent entities of the RF in the relevant indicators of Russia's consolidated budget.

Table 19

Proportions of some indicators in the sub-national budgets within Russia's consolidated budget in 1997-2013, %

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Tax revenues	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	33.2	33.0	33.1
Tax revenues excluding resource payments and customs duty	59.5	59.9	55.0	49.0	42.6	40.1	41.9	47.5	49.1	52.0	50.5	53.7	54.8	57.1	56.9	56.5	56.7
Expenditure	48.1	54.1	51.9	54.4	51.2	49.3	50.0	50.8	49.5	50.0	48.4	49.2	43.4	43.2	45.3	42.6	42.8

Source: Federal Treasury, calculations of the E.T. Gaidar IEP.

The data presented here show that the share of tax revenues of the sub-national budgets in Russia's consolidated budget had grown from 33.2% in 2008 to 36-37% in 2009-2010, but then, in 2011-2013, this indicator returned to its pre-crisis level of 33%. At the same time, the share of tax revenues of the consolidated regional budgets, excluding resource payments and customs duties, having increased from 53.7% to 55-57% in 2009-2010, stabilised in 2011-2013 at a level considerably higher than the pre-crisis one – 56.5-56.9%. The substantial change in this ratio precisely since 2010, compared with the pre-crisis level, was mainly due to the following factors. From 2009 the corporate profit tax rate was reduced from 24 to 20% for the account of federal account component, while 0.5% of the federal rate was transferred to the regions. As a result, in 2009, under the conditions of reduced profits of Russian enterprises, this redistribution of tax income did not have a particularly noticeable effect, however, in 2010 when the Russian economy was gradually recovering, the share of regional tax revenue, excluding resource payments and customs duties, increased considerably. Meanwhile, the share of sub-national budget expenditure in the expenditure of the Russian consolidated budget, having decreased in 2009-2010 due to the accumulation of “anti-crisis” federal budget expenditure, then increased in 2011 (along with the curtailing of anti-recession programmes), stabilising in 2012-2013 at a level of 42.6-42.8%, which is noticeably lower than the pre-crisis level of 49.2%. However, one should bear in mind that the reduction of the gap between the share of income and the share of expenditure of the sub-national budgets in 2012-2013 was largely due to increasing federal budget expenditure and its convergence with the deficit despite the relatively high global oil prices (while in the pre-crisis period a part of the revenues of the federal budget had accumulated in sovereign wealth funds).

Let us consider the revenue part of the sub-national budgets in more detail. The dynamics of the main components of revenues of the consolidated budgets of the constituent entities of the Russian Federation are presented in *Table 20*.

Table 20

**Revenues of the consolidated budgets of the constituent entities
of the Russian Federation in 2008-2013 (in Rb bn)**

	Revenue volume (in nominal terms), Rb bn						Real growth*, %					
	2008	2009	2010	2011	2012	2013	2009/ 2008	2010/ 2009	2011/ 2010	2012/ 2011	2013/ 2012	2013/ 2008
Revenues, total	6,196	5,924	6,537	7,644	8,064	8,165	-12.1	1.4	10.2	-1.0	-4.9	-7.6
Tax and non-tax revenues	4,912	4,243	4,980	5,827	6,385	6,588	-20.6	7.9	10.3	2.8	-3.1	-5.9
including tax revenues	4,384	3,792	4,520	5,273	5,800	5,967	-20.5	9.6	10.0	3.2	-3.4	-4.5
corporate profit tax	1,752	1,069	1,520	1,928	1,980	1,720	-43.9	30.6	19.6	-3.7	-18.4	-31.2
personal income tax	1,666	1,665	1,790	1,996	2,261	2,499	-8.1	-1.2	5.1	6.3	3.8	5.2
tax on aggregate income	161	152	179	215	272	293	-13.6	8.5	13.4	18.4	1.2	27.4
property tax	493	570	628	678	785	901	6.1	1.4	1.7	8.7	7.7	28.0
excise tax	189	246	327	372	442	491	19.2	22.5	7.1	11.4	4.4	81.9
Transfers	1,131	1,486	1,398	1,644	1,624	1,515	20.7	-13.5	10.8	-7.3	-12.4	-6.1
Other revenues	153	195	159	173	56	62	17.4	-25.1	2.5	-69.7	3.9	-71.7

*Taking into account CPI.

Source: Federal Treasury, calculations of the authors.

As shown in *Table 20*, in 2013 the overall revenues of the consolidated budgets of the constituent entities of the Russian Federation decreased by 4.9% in real terms compared with the 2012 level (in nominal terms there was a growth of 1.2%). The real term reduction in the total level of revenues in 2013 was due to two main factors. Firstly, a slowdown in the growth of the economy¹ and a reduction in the income of Russian companies, which resulted in a reduction of corporate profit tax revenues (-18.4% in real terms compared with the 2012 level). This led to a decrease of tax and non-tax revenues by 3.1%. Secondly, the volume of transfers decreased from Rb 1,624bn in 2012 to Rb 1,515bn in 2013 (a decrease of 12.4% in real terms). This considerable reduction was due to the cessation, in 2013, of the 2011-2012 allocation of transfers from the Federal Compulsory Medical Insurance Fund to the programmes and activities for modernisation of the health care system. Moreover, transfers from the federal budget decreased in real terms (for more information see the following section).

It should be noted that the dynamics of the two main taxes – corporate profit tax and personal income tax (which account for over 70% of the tax revenues of the consolidated regional budgets) – differed considerably. While the growth of revenues from personal income tax in the period in question was 10.5% in nominal terms (3.8% in real terms), corporate profit tax revenues decreased substantially, both in nominal and in real terms (-13.1 and -18.4%, respectively). As a result, the structure of the tax revenues of sub-national budgets also changed noticeably. Whilst in 2012, personal income tax and corporate profit tax accounted for 39.0% and 34.1% of tax revenues, respectively, in 2013 these indicators stood at 41.9% and 28.8%. Corporate profit tax is one of the most volatile taxes, and in periods of worsening macroeconomic situation revenues from it are some of the first to respond the changing economy.

Having considered the dynamics of tax and non-tax revenues in general at sub-national level we shall now consider, in greater detail, the situation with the tax revenues of the constituent entities of the Russian Federation (see *Table 21*).

¹ According to preliminary estimates by Rosstat (Federal State Statistics Service) GDP in 2013 increased only by 1.3%, whilst in 2012 it had grown by 3.4%.

Table 21

**Grouping of regions on the basis of changes in the main types of tax
and non-tax revenues of the consolidated budgets of the constituent entities
of the Russian Federation**

	Number of constituent entities of the RF showing changes in their main types of tax and non-tax revenues in the consolidated budget of the Russian Federation					
	increase by more than 25%	increase by 10 to 25%	increase by less than 10%	decrease by less than 10%	decrease by 10 to 25%	decrease by more than 25%
in nominal terms						
Tax and non-tax revenues, total	0	16	52	12	1	1
Corporate profit tax	3	3	10	16	31	19
Personal income tax	1	54	26	0	0	1
in real terms						
Tax and non-tax revenues, total	0	3	28	44	5	2
Corporate profit tax	1	2	7	13	36	23
Personal income tax	0	5	69	7	0	1

Note: Arkhangelsk region and Nenets Autonomous District are presented in calculations as a single constituent entity.

Source: Federal Treasury, calculations by the authors.

As the above data show, in the majority of the Russian regions the situation with regard to the tax revenues of the sub-national budgets was quite unfavourable. In 51 constituent entities of the Russian Federation, based on the results for 2013, a reduction of income in real terms was recorded, although in 44 of these the reduction did not exceed 10%. Corporate profit tax revenues, in real terms, decreased by more than 25% in 23 regions. Those with the greatest reductions in this tax were: the Chukotka Autonomous District (–60.4%), the Kamchatka region (–41.4%), the Tyumen region (–41.5%), the Republic of Ingushetia (–51.5%), the Vologda region (–48.8%) and the Republic of Karelia (–61.0%). Personal income tax revenues increased in almost all regions. The exception to this was the Republic of Kalmykia (–56.3%). This can be explained by the fact that, in 2012, one major taxpayer contributed a relatively high tax amount to the budget of Kalmykia, which caused significant fluctuations in the personal income tax revenues of the region in 2011–2013.

Overall, personal income tax currently ensures relative stability of tax revenues in almost all the Russian regions. In contrast, the dynamics of corporate profit tax revenues remain a destabilising factor. Of greatest concern are the regions which are drivers of the Russian economy – those with a high level of fiscal capacity where corporate profit tax accounts for a significant proportion of the total tax revenues.

Let us now consider the changes which have occurred in the expenditure component of the consolidated budget of the constituent entities of the Russian Federation in 2013 (*Table 22*). In 2013, total expenditure decreased compared with the previous year, both in real terms (–0.9%) and in shares of GDP (by 0.29 p.p. from 13.50% to 13.21%).

In analysing the changes in regional budgetary expenditure in particular areas the following should be noted. The biggest reduction of expenditure in 2013, compared with the previous year, was observed in the field of “Healthcare” (–7.9% in nominal and –13.5% in real terms). As a result, the proportion of total expenditure on healthcare for the year decreased from 16.3% to 14.2%. However, this reduction was mainly associated with a redistribution of costs between the budgets of the constituent entities and territorial CMI (Compulsory Medical Insurance) Funds, due to the transfer of emergency medical assistance

to the CMI system. The reduction of expenditure on housing and public utilities (by 3.9%) and on social policy (by 3.2%) in real terms also should be noted.

Table 22

**Expenditures of the consolidated budgets of the constituent entities
of the Russian Federation in 2012-2013**

	% of the total		% of GDP		Increase, %	
	2012	2013	2012	2013	in nominal terms	in real terms
General national issues	6.1	6.2	0.83	0.82	7.0	0.5
National security and law enforcement activities	1.1	1.2	0.15	0.16	12.7	5.8
National economy, including:	19.2	19.6	2.60	2.59	7.8	1.2
agriculture and fishing	2.9	3.4	0.39	0.45	23.5	16.0
transportation	3.5	3.4	0.48	0.45	0.8	-5.4
public road system (road funds)	7.7	8.3	1.05	1.10	13.1	6.2
other aspects of the national economy	2.9	2.5	0.39	0.32	-11.4	-16.8
housing and public utility sector	10.6	10.2	1.43	1.35	2.3	-3.9
environmental protection	0.3	0.3	0.04	0.04	13.6	6.7
Education, including:	24.5	26.5	3.31	3.50	14.0	7.0
pre-school education	5.6	6.7	0.75	0.89	27.6	19.8
primary and secondary education	14.1	15.0	1.90	1.98	12.2	5.3
vocational education	1.5	1.6	0.20	0.21	11.6	4.8
other aspects of education	1.7	1.6	0.22	0.22	4.5	-1.9
culture, cinematography	3.1	3.3	0.42	0.43	12.1	5.3
healthcare	16.3	14.2	2.20	1.88	-7.9	-13.5
social policy	15.3	14.9	2.06	1.97	3.0	-3.2
physical culture and sports	1.9	1.9	0.25	0.26	9.3	2.6
the media	0.5	0.5	0.06	0.06	5.8	-0.6
servicing of state and municipal debt	0.9	1.0	0.12	0.14	22.2	14.7
Expenditure, total	100.0	100.0	13.50	13.21	5.6	-0.9

Source: Federal Treasury, calculations by the authors.

At the same time, again based on the 2013 results, certain sections of expenditure within the consolidated budgets of constituent entities of the RF showed increases. Expenditure on the large “Education” component increased considerable (by 14% in nominal and 7.0% in real terms). The expenditure on education increased in all key areas: “Pre-school education” (27.6% in nominal and 19.8% in real terms), “Primary and secondary education” (12.2% in nominal and 5.3% in real terms) and “Vocational education” (11.6% in nominal and 4.8% in real terms). This growth was primarily caused by federal requirements, as early as in 2012-2013, to increase the salaries of employees in the educational field to the average of the region’s economy¹. Given the necessity to increase salary-related expenditure, the regions had to decrease investment expenditure (in fixed assets and shares in capital) in the face of shrinking revenues. Whilst in 2011 investment expenditure increased by 19% in real terms during the post-crisis recovery of the economy and the improvement of the situation for regional finances, during 2012 they decreased by 5.6% and in 2013 by 8.7% in real terms compared with the previous year.

In 2013 expenditure on national economy increased by 1.2% in real terms. As a result, the share of this section in total expenditure increased by 0.4 p.p. to 19.6%. The growth in expenditure aimed at developing the national economy was the result of increases in expenditure in areas such as: “Agriculture and fishing” (increase by 16.0% in real terms compared with 2012) and the “Public road system (road funds)” (by 6.2%). A considerable

¹ Decree of the President of the Russian Federation dated 7 May 2012 No.597 on Measures to Implement State Social Policy.

growth in real expenditure was also observed in “National security and law enforcement activities” (by 5.8%) and “Culture and cinematography” (5.3%).

The growth of expenditure on servicing state and municipal debt should also be noted. Over the year, expenditure on debt servicing increased by 14.7% in real terms (from 0.12% of GDP to 0.14% of GDP)¹. In general, however, despite their growth, the expenditure volumes are still far from critical levels.

It is also important to consider the shares in GDP of the consolidated budgets of the constituent entities of the Russian Federation and the principal features of their dynamics (see *Table 23*).

Table 23

**Revenue and expenditure of the consolidated budgets of constituent entities
of the Russian Federation in 2007-2013, % of GDP**

	2007	2008	2009	2010	2011	2012	2013
Revenues	14.56	15.02	15.27	14.12	13.74	13.05	12.24
including:							
Corporate profit tax	4.60	4.24	2.76	3.28	3.46	3.20	2.58
Personal income tax	3.81	4.04	4.29	3.87	3.59	3.66	3.75
Transfers from the Federal Budget	1.88	2.65	3.81	2.98	2.60	2.33	2.23
Expenditure	14.45	15.15	16.12	14.33	13.80	13.50	13.21
Deficit (+)/Surplus(-)	0.12	-0.13	-0.85	-0.22	-0.06	-0.45	-0.96
For reference only: GDP, Rb bn	33,248	41,277	38,807	46,309	55,644	61,811	66,689

Source: Federal Treasury, calculations by the authors.

The above data show that, since 2009, the revenues of the sub-national budgets of the constituent entities of the Russian Federation have been tending to decline in relation to GDP. Whilst, in 2009, the revenues of the sub-national budgets were at a level of 15.27% of GDP, in 2013 they had fallen to 12.24% of GDP. There are several reasons for this trend.

Firstly, the structure of the revenues is changing. Before 2009 corporate profit tax revenues had been the main source of income (2007: 4.6% of GDP, 2008: 4.24% of GDP), and this was higher than personal income tax revenues by 0.79 p.p. and 0.20 p.p., respectively. Then, in 2009, the situation changed. Personal income tax, being more stable, has become the main source of tax income for the sub-national budgets. This tax has been increasing in the last three years — from 3.59% of GDP in 2011 to 3.75% of GDP in 2013, particularly as a result of the growth of salaries in the public sector. By contrast, corporate profit tax revenues in this period have been decreasing, from 3.46% of GDP to 2.58% of GDP, which is a negative signal for the Russian economy that seems to have exhausted all the possibilities of the former growth model. Secondly, in the period in question there was a decrease in the volume of inter-budget transfers allocated from the federal budget. Whilst, in 2009, the constituent entities of the Russian Federation received transfers amounting to 3.81% of GDP, in 2013 the transfers were by 1.58 p.p. less, at 2.23% of GDP. It is important to note that, in 2010-2011, federal aid declined as own revenues of the constituent entities of the Russian Federation recovered, thereby reducing their budget deficits, however, in 2012-2013 the continuing trend towards reduction in the transfers drove an increase in the deficit of the consolidated regional budgets.

Next, we shall consider the situation regarding the performance of the consolidated budgets of the constituent entities of the Russian Federation (*Table 24*). In general, based on the results of 2013, the consolidated budget of the constituent entities of the Russian

¹ For more information on the situation with debt see section 2.3.3 of this overview.

Federation was reduced, so that there was a deficit of Rb 642bn (0.96% of GDP), which is considerably greater than the 2012 indicator (0.44% of GDP).

Table 24

**Performance (deficit/surplus) of the consolidated budgets
of the constituent entities of the Russian Federation in 2008-2013**

Year	Numbers of constituent entities of the Russian Federation performed their budgets in:	
	deficit	surplus
2008	45	39
2009	62	21
2010	63	20
2011	57	26
2012	67	16
2013	77	6

Source: Federal Treasury.

The above data show that the performance of the consolidated budgets of the constituent entities of the Russian Federation turned out to be worse than in 2012. Whilst in 2012 only 67 regions performed their budgets with a deficit, in 2013 there were 77 such regions. In 2013 twelve constituent entities of the Russian Federation which had had a surplus in 2012 converged their budgets with a deficit. In 11 out of those 12 regions the observed growth in expenditure exceeded the average Russian level (5.6% in nominal terms), which casts some doubt on the effectiveness of the budgetary policy conducted in these regions. However, not all constituent entities of the Russian Federation showed an increase in expenditure when compared with 2012. By contrast, in 9 regions the expenditure decreased even in nominal terms compared with the level of the previous year level: Moscow (−0.4%), Krasnodar krai (−3.1%), Volgograd region (0.6%), Chechen Republic (−15.3%), Republic of Mordovia (−7.0%), Republic of Tatarstan (−2.2%), Tyumen region (−12.7%), Yamal-Nenets Autonomous District (−4.8%), Kemerovo region (−0.3%). The constituent entities of the Russian Federation that have reduced their expenditure can be divided in two groups of regions. The first group includes regions with a sufficiently high fiscal capacity (above or close to 1), for which corporate profit tax is one of the key revenue sources (Moscow, Krasnodar krai, Republic of Tatarstan, Tyumen region, Yamal-Nenets Autonomous District and Kemerovo region). The second group includes those constituent entities of the Russian Federation where their structure is characterised by a considerable proportion of transfers from the federal budget and significantly high level of state (municipal) debt (Chechen Republic, Republic of Mordovia). This grouping does not include the Volgograd region, characterised by low fiscal capacity but a relatively small proportion of transfers in its revenues.

In general, when summing up the results of the analysis of the key features of the sub-national budgets in 2013, the following should be noted. The situation in the field of regional and municipal finances has become even more tense, compared with 2012. The number of regions with budget deficits and the volume of borrowings have increased while own revenues have been reduced with no additional financial assistance from the federal budget. Special concern is aroused by there being a reduction in investment activities on the part of the sub-national governments, where the expenditure in their budgets is under pressure due to the necessity to increase salaries in the public sector.

2.3.2. Financial assistance from the federal budget

In 2013 the total amount of funds transferred from the federal budget to sub-national budgets decreased in real terms by 3%, compared with the level in 2012 (*Table 25*).

Table 25

Transfers to Russian regions from the federal budget in 2008-2009 and 2012-2013

	2008		2009		2012		2013		Increase in 2013 on the 2012 level, %	
	Rb bn	% of the total	Rb bn	% of the total	Rb bn	% of the total	Rb bn	% of the total	nominal	real
Transfers to regions, total	1,094.7	100.0	1,480.3	100.0	1,440.2	100.0	1,487.9	100.0	3.3	-3.0
Non-targeted subsidies	390.4	35.7	578.3	39.1	524.0	36.4	609.1	40.9	16.3	9.2
Including:										
non-targeted subsidies to align fiscal capacity	328.6	30.0	374.0	25.3	397.0	27.6	418.8	28.1	5.5	-0.9
non-targeted subsidies to support measures to ensure balanced budgets	46.0	4.2	191.9	13.0	117.2	8.1	177.8	12.0	51.7	42.5
Targeted subsidies	435.9	39.8	530.0	35.8	570.9	39.6	515.6	34.7	-9.7	-15.2
Including:										
targeted subsidies for development of the national economy	181.2	16.5	214.3	14.5	276.2	19.2	268.3	18.0	-2.8	-8.8
Subventions	153.2	14.0	284.4	19.2	284.2	19.7	273.7	18.4	-3.7	-9.6
Other inter-budget transfers	115.2	10.5	87.6	5.9	61.1	4.2	89.5	6.0	46.5	37.6

Source: Federal Treasury, calculations of the E.T. Gaidar IEP.

However, for certain types of transfers oppositely directed dynamics could be observed, leading to a restructuring of financial aid. For example, there were increases in 2013, compared with 2012, for transfers such as non-targeted subsidies (increased by 9.2%) and other inter-budget transfers (37.6%). At the same time, the volumes of targeted subsidies and subventions decreased by 9.7% and 3.7%, respectively. It is important to note that non-targeted subsidies grew mainly due to their use to support measures to balance the budgets (increased by 42.5%). The increase in this type of transfer was mainly associated with the necessity for constituent entities to implement the Decrees of the President of the Russian Federation dated 7 May 2012. Meanwhile, the volume of non-targeted subsidies used to align fiscal capacities decreased in real terms by 0.9%.

As a result, by the end of 2013 the structure of transfers has changed. The share of non-targeted subsidies in the total volume of transfers had increased, reaching 40.9% (in 2012 it was 36.4%) and the share of other inter-budget transfers was 6% (in 2012 it was 4.2%). By contrast, the share of targeted subsidies decreased from 39.6% in 2012 to 34.7% in 2013 and the share of subventions decreased from 19.7% to 18.4%.

In general, the tendency to increase the share of non-targeted transfers is envisaged by all key documents in the field of fiscal policy, including the adopted law on federal budget for 2014-2016¹. For example, in 2016 the share of targeted subsidies is expected to decrease to 18.5% of the total volume of transfers with the proportion of non-targeted subsidies rising to

¹ Federal Law dated 2 December 2013 No.349-FZ 'On the Federal Budget for 2014 and the Planning Period until 2015 and 2016'.

50.8%. However, it should be noted that the share of non-targeted transfers is currently increasing, mainly due to the use of non-targeted subsidies to balance budgets and this instrument is one of the least transparent mechanisms in the system of inter-budget relations in Russia. It should also be borne in mind that the share of non-targeted subsidies allocated to implement the Presidential Decrees of May (2012) in reality does not constitute non-targeted subsidies but actually represents targeted subsidies. As a result, such changes in the structure of federal financial aid only distort the inter-budget relations and make them less transparent.

When analysing the process of the allocation of federal government transfers to the regions it is important to consider how federal aid affects income inequalities of constituent entities, i.e. to evaluate the levelling properties of financial assistance provided from the federal budget (*Table 26*).

Table 26

**Coefficient of variation of the revenues of consolidated regional budgets
(per capita, taking into account BEI*) in 2008-2013, %**

Year	Tax revenues	Tax revenues and non-targeted subsidies to align fiscal capacity	Tax revenues, non-targeted subsidies and targeted subsidies
2008	90.6	80.4	71.5
2009	78.3	66.5	54.5
2010	74.2	63.9	57.8
2011	77.8	68.4	61.6
2012	66.1	57.8	51.9
2013	63.7	55.3	48.1

*BEI – budgetary expenditure index calculated using the method of distribution of non-targeted subsidies to align fiscal capacity.

Source: Federal Treasury, calculations of the E.T. Gaidar IEP.

As can be seen from the data provided in *Table 26* the allocation of non-targeted subsidies to align fiscal capacity in 2013 continued influencing the reduction of income inequalities in the sub-national budgets. However, it should be noted that the extent of this influence has been gradually decreasing since 2010. This has mainly been due to the declining proportion of non-targeted subsidies used to align fiscal capacity in the total amount of transfers allocated from the federal budget. Whilst, in 2008, the share of these non-targeted subsidies had been 30.1%, in 2011-2013 it was already 27-28%. We can also note a considerable decrease in the share of non-targeted subsidies to align fiscal capacity in shares of GDP from 0.86% in 2010 to 0.63% in 2013 (in 2008 it was 0.80%). The volume of tax revenues of the consolidated budgets of the constituent entities in terms of GDP also decreased in the period in question but at a lower rate: from 9.8 to 8.9% of GDP (in 2008 it had been 10.6%). As a result, in 2013, the coefficient of variation of regional revenues after the allocation of non-targeted subsidies to align fiscal capacity decreased only by 8.4 p.p., although in 2008-2010 this indicator was consistently greater than 10 p.p. Thus, one can conclude that it is necessary to increase the volume of non-targeted subsidies in order to align the fiscal capacity of the constituent entities of the Russian Federation. The total of the non-targeted subsidies (including non-targeted subsidies used to align fiscal capacity) and of targeted subsidies ultimately reduced the differentiation of regional revenues by 15.6 p.p., which is better than in 2012 (14.1 p.p.) but much lower than that of the pre-crisis level of 2008 (19.1 p.p.).

It should be noted that in 2013 there was a decrease in the uniformity of provision of transfers to sub-federal budgets. For example, for the first 9 months of 2013 the approved annual plan was performed only by 71.6%, which is 3.6 p.p. lower than the performance of the cash plan in the corresponding period of 2012 (75.2%) (*Table 27*).

Table 27

**Transfers to regions from the federal budget
for the first 9 months of 2012 and 2013**

	For 9 months of 2012		For 9 months of 2013		Plan, Rb bn		Changes compared with the plan, %
	Performed, Rb bn	% of performance	Performed, Rb bn	% of performance	2012	2013	2013
Transfers, total	1,023	75.2	1,036	71.6	1,360	1,446	2.8
Non-targeted subsidies	377	75.0	441	73.8	502	597	2.0
Targeted subsidies	360	70.2	319	63.1	513	506	1.9
Subventions	246	83.3	226	80.4	295	281	-2.7
Other inter-budget transfers	40	81.4	50	80.6	49	62	30.7

Source: Federal Treasury, E.T. Gaidar IEP.

In general, the slowdown in the provision of financial assistance was observed for all types of transfers. Targeted subsidies were characterised by the greatest lack of uniformity. Whilst 70.2% of all targeted subsidies were provided in the first 9 months of 2012, in the corresponding 9 months of 2013 the figure was only 63.1%. Moreover, 23% of the targeted subsidies were allocated in December 2013, which rendered impossible their full utilisation by the regions. As a result, in January 2014 Rb 176.9bn of remaining targeted transfers were returned to the federal budget, which accounted for about 12% of the total volume of the transfers provided to regions in 2013. Thus, on average, the provision of transfers in 2013 became much less uniform than in 2012, with subventions and other inter-budget transfers being the most uniformly distributed during the financial year, just as in the year before.

The experience of 2013 once again showed that the actual volumes of transfers from the federal budget could differ considerably from the initial plan. So, by the end of 2013 total transfers had increased by 2.8% compared with the plan, with the allocation of targeted subsidies being 1.9% greater than initially planned, non-targeted subsidies 2.0% greater, other inter-budget transfers 30.7% greater. By contrast, the volume of subventions decreased by 2.7% compared with the plan.

Note that, in 2013, additional funding (not envisaged by the plan) was provided to 23 regions in the form of non-targeted subsidies¹. However, the total amount of this funding was relatively small, only Rb 13bn, out of which:

- Rb 529.9m aimed at partial compensation of the reduction in the volume of non-targeted subsidies, to align the fiscal capacities of the constituent entities of the Russian Federation, where there will be a greater than 20% reduction in the volumes of specified non-targeted subsidies in 2014 compared with 2013 and the share of non-targeted subsidies in the forecast volume of tax and non-tax revenues of the consolidated budgets of the constituent entities of the Russian Federation in 2013 exceeded 10% (Stavropol krai, Amur region);
- 6 Rb bn aimed at partial compensation for the reduction in corporate profit tax revenues to the budgets of the constituent entities of the Russian Federation, where such a reduction in tax revenues for the first 10 months of 2013 exceeded 10%, with negative dynamics of both tax and non-tax revenues (Republic of Karelia, Republic of Komi, Republic of Khakassia, Krasnoyarsk krai, Arkhangelsk region, Belgorod region, Bryansk region,

¹ <http://government.ru/announcements/8892> — Official website of the Government of the Russian Federation.

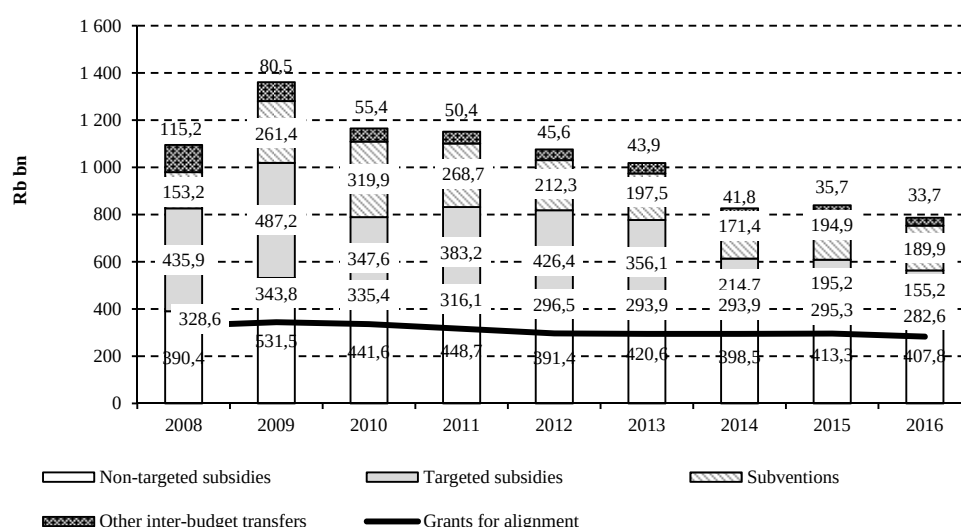
Vologda region, Irkutsk region, Kemerovo region, Novgorod region, Orenburg region, Saratov region and the Chukotka Autonomous District);

- 6 Rb bn aimed at partial compensation for the reduction in corporate profit tax revenues to the budgets of the constituent entities of the Russian Federation (due to the creation of consolidated groups of taxpayers) where this reduction exceeded 1% of the tax and non-tax revenues (Republic of Karelia, Krasnoyarsk krai, Perm krai, Belgorod region, Bryansk region, Volgograd, Nizhny Novgorod region, Samara region, Tambov region and the Tomsk region);
- Rb 400m aimed at providing a non-targeted subsidy to the Vladimir region in relation to a reduction in its tax revenues.

The remaining constituent entities of the Russian Federation were not included as recipients of the non-targeted subsidies, because, according to federal government estimates, they had lower risks of unbalanced regional budgets based on the results for the year.

It is important to note that since 2010 a gradual reduction in the volume of federal transfers allocated to sub-national budgets has been observed (*Fig. 20*).

As shown in *Fig. 20*, in real terms, the total volumes of transfers are tending to decrease. Whereas, in 2008 Rb 1,094.1bn was allocated, in 2013 the figure was Rb 1,018.1bn, and by 2016 it is expected to be only Rb 786.5bn for transfers from the federal budget (at 2008 prices). The targeted subsidies will be reduced the most. It should be noted that the reduction in the number (consolidation) and the decrease in the share of targeted subsidies in the total volume of federal financial aid is, in principle, a reasonable goal, aimed at improving the structure of inter-budget transfers and the efficiency of the process of allocation of financial aid. However, the reduction of targeted subsidies makes sense only if there is a corresponding increase in non-targeted financial assistance, mainly, in the form of non-targeted subsidies to align fiscal capacity. The reduction in the total volume of transfers in real terms, where there is a reduction in own revenues, in fact discredits the process of reforming targeted subsidies, as perceived by regional governments: consolidation becomes a synonym for the reduction of financial support from federal government.



Source: Federal Treasury, Federal Law dated 2 December 2013 No.349-FZ 'On the Federal Budget for 2014 and the Planning Period until 2015 and 2016', calculations of the authors.

Fig. 20. Transfers to regions from the federal budget for 2008-2016 (at 2008 prices)

Therefore note that, in 2013, taking into account the non-uniformity of provision of financial assistance during the financial year, the increase in the volume and share of non-targeted subsidies to align fiscal capacity, meant a decrease in the efficiency of the mechanism of provision of transfers to regions from the federal budget. Questions are also raised regarding the further planned decrease in the volumes of financial assistance where there is increasing tension over the performance of the consolidated budgets of the constituent entities of the Russian Federation.

2.3.3. Analysis of state and municipal debt

Data on the dynamics of the volumes of state debt of the constituent entities of the Russian Federation and of municipal debt from 2010 to 1 January 2014 are laid out in *Table 28*.

Table 28

State and municipal debt of the sub-national budgets in 2010-2014

	as of 1 January 2011	as of 1 January 2012		as of 1 January 2013		as of 1 January 2014	
	volume, Rb bn	volume, Rb bn	increase (%)	volume, Rb bn	increase (%)	volume, Rb bn	increase (%)
Total for regional budgets	1,096.0	1,171.8	6.9	1,355.0	15.6	1,737.5	28.2
Total for regional budgets (excluding Moscow and the Moscow region)	649.9	831.6	28.0	1,068.7	28.5	1,474.1	37.9
Total for municipal budgets	169.8	215.5	26.9	245.3	13.8	288.9	17.8
Volume of regional debt as % of GDP	1.64	1.76	7.3	2.03	15.3	2.61	28.6

Source: Ministry of Finance of Russia, calculations by the authors.

As can be seen from *Table 28*, the situation with the volume of debt of regional and municipal budgets in 2013 has changed substantially, showing a considerable increase in the amount of debt. The increase in the level of state debt of the constituent entities of the Russian Federation was 28.2%, whilst, excluding Moscow and the Moscow region, it was 37.9%. However, in general, the total volume of debt is not yet large, being about 2.6% of GDP. At the same time, as in the previous year, a considerable volume of borrowing occurred in December. So, in just that one month the volume of state debt increased by 16.5% in nominal terms (by Rb 245.9bn, from Rb 1,491.5bn to Rb 1,737.5bn) and municipal debt increased by 15.8% (by Rb 39.4bn, from Rb 249.4.2bn to Rb 288.9bn). In December 2012 state debt increased by 16.4% (by Rb 190.7bn, from Rb 1,164.2bn to Rb 1,355.0bn) and municipal debt by 14.8% (by Rb 31.7bn, from Rb 213.2bn to Rb 245.3bn).

It should be noted that whereas the major part of regional debt had previously been accounted for by only 2 constituent entities of the Russian Federation – Moscow and the Moscow region (with 40.7% of the total volume of regional debt, as of 1 January 2011), on 1 January 2014 they accounted for only 15.1% of the total debt. In 2013 data on the constituent entities of the Russian Federation showed a decrease in the level of state debt by 8% (principally by the of Moscow region).

At the moment, the main borrowers (by volume of accumulated debt) are Moscow (Rb 179bn), Krasnodar krai (Rb 119bn), the Republic of Tatarstan (Rb 85bn) and the Moscow region (Rb 84bn). It should be noted that Krasnodar krai has become the first constituent entity of the Russian Federation after Moscow, whose debt obligations have increased above

Rb 100bn. In 2013 this region increased its debt obligations by 61.3%, compared with its debts at the beginning of the year.

In general, the increase in debt burden in many constituent entities of the Russian Federation is evidenced by the regional data (*Table 29*).

Table 29

**Dynamics of changes in state debt of the budgets of constituent entities
of the Russian Federation in 2008-2013**

	Numbers of constituent entities of the Russian Federation with respect to the dynamics of state debt (in nominal terms) in the corresponding periods of different years					
	increase by more than 50%	increase by 15 to 50%	increase by less than 15%	decrease by less than 15%	decrease by 15 to 50%	decrease by more than 50%
2008	21	20	10	6	12	9
2009	37	18	11	6	4	2
2010	29	24	8	11	7	0
2011	21	27	13	14	6	0
2012	18	29	14	8	10	1
2013	31	36	8	6	1	0

Source: Ministry of Finance of Russia, calculations by the authors.

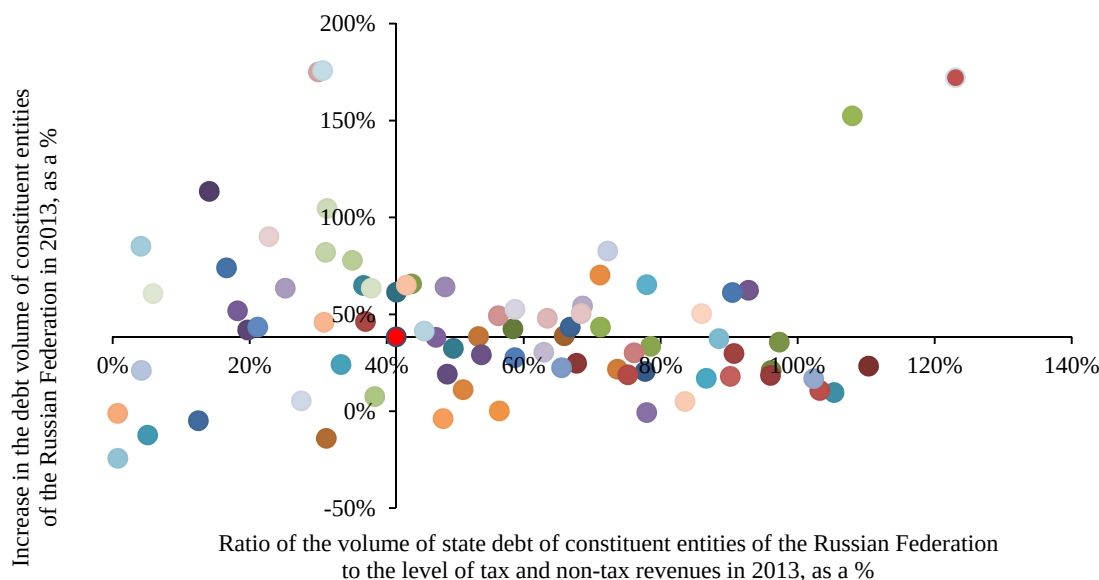
In 2013, the volume of state debt increased in 75 out of 82 constituent entities of the Russian Federation, with a considerable increase in the volumes of debt (by more than 15%) being observed in 67 regions. In 31 constituent entities of the Russian Federation the debts increased by more than 50%. A considerable increase was observed in the Vladimir region (114%), Republic of Ingushetia (152%), Khanty-Mansi Autonomous District (431%), Yamal-Nenets Autonomous District (175%), Novosibirsk region (105%), Primorsky krai (1867%), Khabarovsk krai (176 %) and Chukotka Autonomous District (172%).

Of particular concern are those constituent entities of the Russian Federation which, in 2013, not only considerably increased debt volumes but also substantially raised their debt burden (the ratio of the volume of state debt to the level of tax and non-tax revenues of the constituent entity of the Russian Federation¹) (*Fig. 21*). In 2013 the average debt burden for the Russian regions was 41.4% (excluding Moscow and the Moscow region), whilst in 2012 it was 30.4%.

Fig. 21 shows that 23 out of 82 constituent entities of the Russian Federation are in the “troubled sector”: here the growth of state debt and debt burden are higher than the Russian average. It should be noted that in 7 constituent entities of the Russian Federation the level of the debt burden exceeds the amount of their tax and non-tax revenues: Republic of Mordovia (172.1%), Chukotka Autonomous District (123%), Belgorod region (110.3%), Republic of Ingushetia (108%), Vologda region (105.3%), Republic of North Ossetia-Alania (103.2%) and Saratov region (102.3%). A few other constituent entities (Kostroma region, Ryazan region, Smolensk region, Republic of Karelia, Pskov region, Krasnodar krai and Republic of Mari El) are close to the critical level (with debt levels over 90% of their own revenues). Among the above constituent entities particularly alarming situations exist in the Chukotka Autonomous District (the debt burden as of the end of 2013 was 123%, an increase during

¹ Before 1 January 2017 the maximum volume of state debt of a constituent entity of the Russian Federation (municipal debt) can exceed the limitations set forth in clauses 2 and 3 of Article 107 of the Budgetary Code of the Russian Federation (100% of budgetary revenues excluding non-repayable transfers) within the limit of the state debt volume of the constituent entity of the Russian Federation (municipal debt) in the form of budgetary loans (Federal Law dated 9 April 2009 No.58-FZ (as revised on 30 November 2011)), the provision of which is determined at federal government level.

2013 of 172%), Republic of Ingushetia (108% and 152%), Pskov region (93% and 62%) and Krasnodar krai (90% and 61%).



Note: 1) The axes intersect at the point where the debt burden and the increase in the debt volume of the constituent entities of the Russian Federation in 2013 are equal to the average Russian values (excluding Moscow and the Moscow region) (41.4% and 38.4%, respectively).

2) The diagram does not include: Khanty-Mansi Autonomous District (9.6%, 430.7%), Primorsky krai (16.7%, 186.7%) or Republic of Mordovia (172.1%, 10.1%).

Source: Federal Treasury, Ministry of Finance of Russia, calculations by the authors.

Fig. 21. Debt burden and changes in state debt of the constituent entities of the Russian Federation in 2013 (%)

In general, one can say that the situation with regional and municipal debt is continuing to worsen. However, in most regions which are actively accumulating borrowing the debt burden has remained at a relatively safe level.

2.3.4. Conclusions with regard to the allocation of inter-budget transfers to other levels of the budgetary system provided by the Federal Law dated 2 December 2013, No.349-FZ 'On the Federal Budget for 2014 and the Planning Period until 2015 and 2016'

The total volume and dynamics of inter-budget transfers from the federal budget to the budgets of constituent entities of the Russian Federation in accordance with Federal Law dated 2 December 2013 No.349-FZ 'On the Federal Budget for 2014 and the Planning Period until 2015 and 2016' are laid out in *Table 30*.

In parallel with the total volume of inter-budget transfers, it seems reasonable to include the indicator of the total volume of inter-budget transfers excluding subventions in the analysis, because it reflects the financial performance by the relevant authorities of their own powers.

Table 30

Inter-budget transfers in 2013-2016

Indicator	2013	2014		2015		2016		
	Rb bn	Rb bn	as % of the previous year	Rb bn	as % of the previous year	Rb bn	as % of the previous year	as % of 2013
Inter-budget transfers	1,488	1,233	82.9	1,308	106.1	1,281	98.0	86.1
Non-targeted subsidies	609	594	97.5	644	108.4	664	103.1	109.0
<i>including non-targeted subsidies to align fiscal capacity</i>	419	440	105.0	462	105.0	462	100.0	110.3
<i>non-targeted subsidies to support measures to balance budgets</i>	178	141	79.2	170	120.5	190	111.8	106.7
Targeted subsidies	516	320	62.0	304	95.0	253	83.1	49.0
Subventions	274	256	93.4	304	118.9	309	101.8	112.8
Other inter-budget transfers	89	62	69.7	56	89.2	55	98.6	61.8
Inter-budget transfers excluding subventions	1,214	977	80.5	1,004	102.8	972	96.8	80.1
<i>For reference: Inter-budget transfers as % of GDP</i>	2.23	1.68		1.64		1.48		66.4

Source: Federal Treasury, Federal Law dated 2 December 2013 No.349-FZ 'On the Federal Budget for 2014 and the Planning Period until 2015 and 2016', calculations by the authors.

With the exception of slight growth in 2015, the total volume of inter-budget transfers has a generally downward trend for 2014-2016: over the 3 years the volume decreases to 80.1% of the 2013 volume excluding subventions. This overall decrease can be seen in the targeted subsidies (from 2014-2016 the annual decreases will be 38%, 5% and 16.9%, respectively), the increase in subventions (–6.6%, 18.9% and 1.8%), the non-targeted subsidies and support measures to balance the budgets of constituent entities of the Russian Federation (–20.8%, 20.5% and 11.8%) and in the non-targeted subsidies to align the fiscal capacities of the constituent entities of the Russian Federation (5.0%, 5.0% and 0%).

The decrease in the total volume of inter-budget transfers is not offset by the transfer of additional sources of income at regional or local level or by the transfer of expenditure obligations from regional or local levels to the federal level.

As shown in *Table 31*, the decrease in the nominal volume of financial assistance to the lower level budgets is not the result of the forecast of negative GDP growth rates nor the general decrease of revenues and/or expenditure in the federal budget. Indeed, the ratio of the total volume of inter-budget transfers (both including and excluding subventions) to GDP and to the total volume of expenditure of the federal budget monotonously decreases over the period in question. The same conclusion is true for main inter-budget transfers unrelated to the transfer of particular powers of the Russian Federation to the regions: the non-targeted subsidies to align the fiscal capacities of the constituent entities of the Russian Federation, and the targeted subsidies.

It is unlikely that the decrease in the volume of inter-budget transfers to the constituent entities of the Russian Federation will be offset by a faster growth of tax and non-tax revenues for their budgets (*Table 32*). Indeed, the increase in revenues of the consolidated budgets of the constituent entities of the Russian Federation in 2012-2013 did not exceed the corresponding indicators of the federal budget. In particular, in 2012 the increase in revenues of the federal budget exceeded the increase in revenues of the consolidated budget of the

constituent entities of the Russian Federation by 7.6 p.p., and in 2013 the growth rates of the revenues of both were almost equal at 1.2-1.3%.

Table 31

Dynamics of inter-budget transfers in 2013-2016

Indicator	Measurement unit	2013	2014	2015	2016
GDP	Rb bn	66,689	73,315	79,660	86,837
Expenditure of the federal budget	Rb bn	13,343	13,960	15,362	16,392
Inter-budget transfers, total	Rb bn	1,488	1,233	1,308	1,281
Non-targeted subsidies	Rb bn	609	594	644	664
Non-targeted subsidies to align fiscal capacity	Rb bn	419	440	462	462
Non-targeted subsidies to balance budgets	Rb bn	178	141	170	190
Targeted subsidies	Rb bn	516	320	304	253
Subventions	Rb bn	274	256	304	309
Other inter-budget transfers	Rb bn	89	62	56	55
Inter-budget transfers excluding subventions	Rb bn	1,214	977	1,004	972
Inter-budget transfers, total	% of GDP	2.23	1.68	1.64	1.48
Non-targeted subsidies	% of GDP	0.91	0.81	0.81	0.76
Non-targeted subsidies to align fiscal capacity	% of GDP	0.63	0.60	0.58	0.53
Non-targeted subsidies to balance budgets	% of GDP	0.27	0.19	0.21	0.22
Targeted subsidies	% of GDP	0.77	0.44	0.38	0.29
Subventions	% of GDP	0.41	0.35	0.38	0.36
Other inter-budget transfers	% of GDP	0.13	0.09	0.07	0.06
Inter-budget transfers excluding subventions	% of GDP	1.82	1.33	1.26	1.12
Inter-budget transfers, total	% of expenditure	11.15	8.83	8.51	7.82
Non-targeted subsidies	% of expenditure	4.57	4.26	4.19	4.05
Non-targeted subsidies to align fiscal capacity	% of expenditure	3.14	3.15	3.01	2.82
Non-targeted subsidies to balance budgets	% of expenditure	1.33	1.01	1.11	1.16
Targeted subsidies	% of expenditure	3.86	2.29	1.98	1.54
Subventions	% of expenditure	2.05	1.83	1.98	1.89
Other inter-budget transfers	% of expenditure	0.67	0.45	0.36	0.33
Inter-budget transfers excluding subventions	% of expenditure	9.10	7.00	6.54	5.93

Source: Federal Treasury, Federal Law dated 2 December 2013 No.349-FZ ‘On the Federal Budget for 2014 and the Planning Period until 2015 and 2016’, calculations by the authors.

Table 32

Revenues of the federal and consolidated budgets of the constituent entities of the Russian Federation in 2011-2016

Indicators	Measurement unit	2011	2012	2013	2014	2015	2016
Federal budget	Rb bn	11,368	12,856	13,019	13,571	14,565	15,906
	As % of the previous year	-	113.1	101.3	105.2	107.3	109.2
Consolidated budgets of constituent entities of the Russian Federation							
Revenues, total	Rb bn	7,641	8,061	8,164	8,765	9,491	10,310
	As % of the previous year	-	105.5	101.2	108.3	107.6	108.5
Revenues excluding inter-budget transfers	Rb bn	5,874	6,382	6,649	7,532	8,183	9,029
	As % of the previous year	-	108.7	104.2	111.3	108.6	110.3

Source: Federal Treasury, Federal Law dated 2 December 2013 No.349-FZ ‘On the Federal Budget for 2014 and the Planning Period until 2015 and 2016’, calculations by the authors.

It should be noted that the reduction in the volume of targeted subsidies corresponds to the goals of the State Programme of the Russian Federation “The Creation of Conditions for Effective and Responsible Management of Regional and Municipal Finances and Increase of

Stability of the Budgets of the Constituent Entities of the Russian Federation” approved by Decree of the Government of the Russian Federation dated 18 March 2013 No.376-r. As development priorities the Programme indicates a reduction in the share of targeted transfers and a transition to predominantly non-targeted financial support in the system of inter-budget relations. Therefore, one of the indicators of achievement of the goals set in the Programme is the proportion of non-targeted subsidies in inter-budget transfers. *Table 33* demonstrates the simultaneous reduction of the share of targeted subsidies and the increase in the share of non-targeted subsidies, with the proportion of non-targeted subsidies actually being considerably higher than the one specified in the Programme (according to the Programme the share of non-targeted subsidies in 2014-2016 should be 38%, 39% and 40%, respectively).

Table 33

Structure of inter-budget transfers in 2013-2016, Rb bn

Indicator	2013	2014	2015	2016
Inter-budget transfers	1,487.9	1,233	1,308	1,281
including:				
Non-targeted subsidies, including:	41.6	48.2	49.3	51.8
<i>non-targeted subsidies to align fiscal capacity</i>	28.1	35.7	35.3	36.0
<i>non-targeted subsidies to balance budgets</i>	12.0	11.4	13.0	14.8
Targeted subsidies	34.7	26.0	23.3	19.7
Subventions	18.4	20.7	23.2	24.1
Other inter-budget transfers	6.0	5.1	4.2	4.3
Inter-budget transfers excluding subventions	1,214.2	977.0	1,004.0	971.7
including:				
Non-targeted subsidies, including (%):	50.2	60.8	64.2	68.4
<i>non-targeted subsidies to align fiscal capacity</i>	34.5	45.0	46.0	47.5
<i>non-targeted subsidies to balance budgets</i>	14.6	14.4	16.9	19.5
Targeted subsidies	42.5	32.8	30.3	26.0
Other inter-budget transfers	7.4	6.4	5.5	5.6

Source: Federal Treasury, Federal Law dated 2 December 2013 No.349-FZ ‘On the Federal Budget for 2014 and the Planning Period until 2015 and 2016’, calculations by the authors.

However, the non-targeted subsidies to balance the budgets are, essentially, almost indistinguishable from targeted subsidies, because they have a particular purpose and are provided on condition of co-financing. These can include the following (within the framework of a sub-programme “Sustaining the Performance of the Budgets of the Constituent Entities of the Russian Federation and Local Budgets” within the aforementioned State Programme):

- a non-targeted subsidy to balance the budget of the Omsk region;
- a non-targeted subsidy to balance the budget of the federal city of Saint-Petersburg;
- non-targeted subsidies as partial compensation for the additional expenditure arising from the increase in salaries of public sector employees.

Hence, referring to inter-budget transfers which have a particular purpose (in this case the ‘target’ does not relate to the destination of the transferred funds but to achieving targeted quality results) as non-targeted subsidies is very questionable and casts doubt on achieving the stated aims related to the proportion of non-targeted financial assistance provided to the budgets of constituent entities of the Russian Federation.

One of the indicators of the quality of the three-year budgetary planning is the extent of deviation from the newly approved budget parameters found in the next financial year and in the first year of the planning period when compared with the corresponding values approved for these same years in the previous budget Law. A comparison of the volumes of the inter-budget transfers (*Table 34*) shows that the volumes of all types of inter-budget transfers have been adjusted upwards: for non-targeted subsidies and targeted subsidies in 2014 the average

adjustment is 3-6%, for 2015 it is 10-13%. The positive adjustment of the volumes of inter-budget transfers has helped to avoid further imbalance in the consolidated budgets of the constituent entities of the Russian Federation. At the same time, the considerable adjustment of the volumes of subventions and other inter-budget transfers shows that the parameters of the regional budgets for the planning period are highly dependent on newly made federal decisions, and this therefore does not eliminate the issue of the stability of regional finances.

Table 34

**Inter-budget transfers approved in the federal budget
for 2013-2015 and in the federal budget for 2014-2016, Rb bn**

Indicator	2014			2015		
	216-FZ	349-FZ	Increase, %	216-FZ	349-FZ	Increase, %
Inter-budget transfers	1,184	1,233	4.1	1,168	1,308	12.0
Non-targeted subsidies	592	594	0.3	582	644	10.6
<i>including non-targeted subsidies to align fiscal capacity</i>	419	440	5.0	419	462	10.2
<i>including non-targeted subsidies to balance budgets</i>	161	141	-12.5	151	170	12.6
Targeted subsidies	300	320	6.8	287	304	5.9
Subventions	244	256	4.7	254	304	19.4
Other inter-budget transfers	47	62	31.4	44	56	26.0

Source: Federal Law dated 2 December 2013 No.349-FZ 'On the Federal Budget for 2014 and the Planning Period until 2015 and 2016', Federal Law dated 3 December 2012 No.216-FZ 'On the Federal Budget for 2013 and the Planning Period of 2014 and 2015', calculations by the authors.

The major part of the volume of non-targeted subsidies to balance the budgets (Rb 120, 130 and 150bn for 2014-2016, respectively, which represent about 30% of the total volume of non-targeted subsidies to align the fiscal capacities of the constituent entities of the Russian Federation) is related to the financial support for implementation of the Presidential Decrees of 7 May 2012. In this case, it constitutes additional financial support for the current expenditure obligations of a permanent nature. At the same time, financial support of the current expenditure obligations is being performed by the provision of non-targeted subsidies to align the fiscal capacities of the constituent entities of the Russian Federation. The difficulty in application of this mechanism under the current conditions is due to its failure to provide transfers to constituent entities of the Russian Federation, whose fiscal capacity level is in the interval from 1 to 2, and due to the fact that the method of distribution of non-targeted subsidies to align the fiscal capacities was not adjusted to take into account any need to increase salaries across a major part of the public-sector funded organisations to the average level for the economy of the respective constituent entity of the Russian Federation. However, it could be possible to provide relevant assistance to regions-donors in the form of targeted subsidies while the remaining regions receive non-targeted subsidies to align their fiscal capacities.

Among the priority goals for development within the system of inter-budget relations set in the State Programme of the Russian Federation "The Creation of Conditions for Effective and Responsible Management of Regional and Municipal Finances and Increase of Stability of the Budgets of Constituent Entities of the Russian Federation" are the reduction of the number of targeted subsidies that will take place through their consolidation within the framework of Russian Federation state programmes (the target values for 2014-2016 are 80, 70 and 60, respectively) and the increase in the share of targeted subsidies from the federal budget to the budgets of constituent entities of the Russian Federation, the distribution of which amongst

these entities has been approved by annexes to the Law on Federal Budgets for the next financial year and the planning period (the target values for 2014-2016 are 25%, 30% and 35%, respectively). Based on the number of target items for which it is planned to provide targeted subsidies to the budgets of constituent entities, in accordance with the Law on Federal Budgets in 2014-2016 the number of targeted subsidies is 82 for 2014, 73 for 2015 and 62 for 2016. In turn, the estimated proportion of distributed targeted subsidies for 2014 is 20.7%. Thus, the decrease in the number of targeted subsidies to the budgets of constituent entities of the Russian Federation and the increase in the share of distributed targeted subsidies are a little behind the target values, so additional effort will be required in this direction.

In general, in respect of the provision of inter-budget transfers Federal Law dated 2 December 2013 No.349-FZ 'On the Federal Budget for 2014 and the Planning Period of 2015 and 2016' shows a general commitment of state budgetary policy to the set priorities. At the same time, there exist high risks that real financial support for the budgets of the constituent entities of the Russian Federation will decrease and that lack of achievement of the overly-optimistic estimates of revenue growth rates for the consolidated budgets of the constituent entities will have a particularly unfavourable effect on the total balance of budgets at the sub-federal level and will cast doubt on the possibility of implementing the Presidential Decrees of 7 May 2012. There are still some reservations over the opportunity to increase the efficiency of the structure of the inter-budget transfers and to improve the method of distribution of the non-targeted subsidies to align the fiscal capacities of the constituent entities of the Russian Federation. It also seems necessary to intensify work on the consolidation of inter-budget targeted subsidies and to increase the share of targeted subsidies, the distribution of which amongst the constituent entities of the Russian Federation has been approved by an annex to the Law on Federal Budgets for the next financial year and the planning period.

Section 3. Financial markets and financial institutions

3.1. Post-recession stock market recovery

3.1.1. Comparing the parameters of two crises in Russia

By January 2014 the Russian market recovered but its stock indices were still below the highest ones recorded shortly before the crisis in 2008. Unlike the crisis in 1997–1998 after which the market saw a V-shaped recovery, the dynamics of the RTS Index after 2008 showed a W-shaped trend, to be more precise. The RTS Index passed through a second downtrend phase within this contour in 2013, declining from 2044,2 points in March 2011 to 1301,0 points in January 2014.

The crisis in 2008–2009 resembled the crisis in 1997–1998 in depth and duration of tumbling stock indices (see *Table 1*). At the end of the 1990s, the RTS Index declined 91.3% while the MICEX Index slid down by 73.0%; in the period of 2008 thru 2009 both stock indices dropped as deep as 78.2% and 68.2% respectively. In 1997–1998 the RTS Index was falling within 14 months, while the MICEX Index within 13 months; in the period of 2008 thru 2009 both indices were falling within 8 and 6 months respectively.

Table 1

Financial crises in Russia in 1997–1998 and 2008–2009 and subsequent market recovery (as of January 31, 2014)

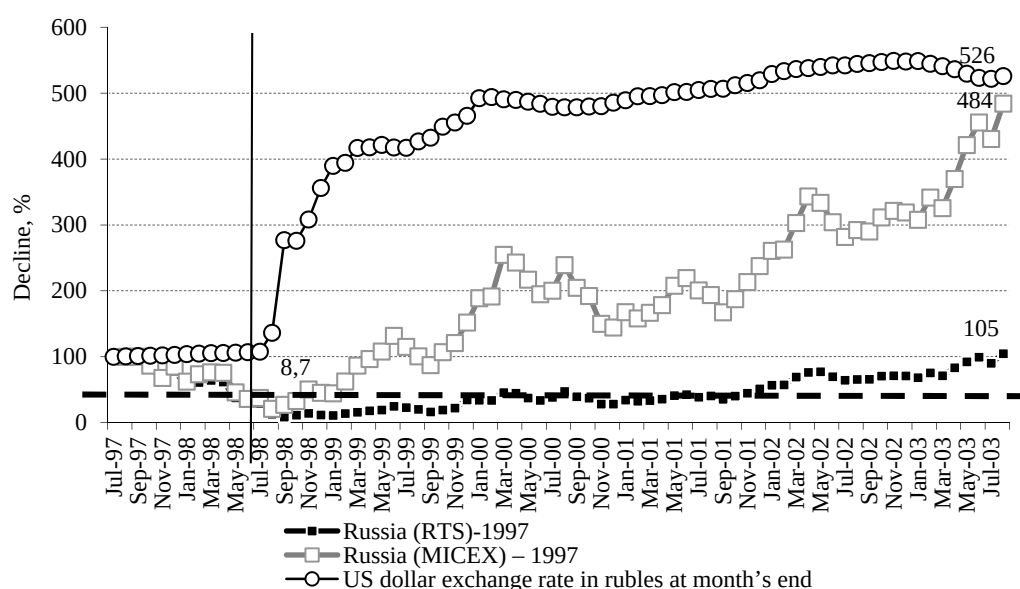
	1997–1998 crisis	2008–2009 crisis
1. Fall from peak		
1.1. Depth, %		
RTS Index	–91.3	–78.2
MICEX Index	–73.0	–68.2
1.2. Duration, in months		
RTS Index	14	8
MICEX Index	13	6
2. Recovery, in months		
RTS Index	58	60
MICEX Index	8	62

Source: based on the data supplied by the Moscow Exchange.

However, because of a fivefold devaluation of the ruble after 1998 it took just eight months for the MICEX Index to recover to its peak pre-recession value while the RTS Currency Exchange Index recovered within 58 months. The ruble devalued only by 50% after the crisis in 2008. The currency exchange rate in the period of May 2008 thru January 2014 saw a W-shaped trend, thereby making the RTS and MICEX indices follow the same dynamics. As a result of “controlled” devaluation in the period of May 2008 thru February 2009 the US dollar

got stronger against the ruble, from Rb 23,74 to Rb 35,72, or by 50.5%. As the financial system subsequently recovered, the ruble strengthened against the US dollar, reaching Rb 27,50 per US dollar in April 2011. Devaluation of the ruble has recovered since May 2011. In January 2014, the ruble-to-dollar exchange rate reached Rb 35,24 per US dollar, increasing 48.4% above the exchange rate recorded in May 2008. Moderate devaluation of the ruble as a result of the crisis in 2008 against the effects of the 1998 crisis preconditioned slower recovery of the two key stock indices in the current period.

The differences in ruble devaluation between the crises in 1997–1998 and 2008–2009 show different recovery dynamics for the RTS and MICEX indices. More than fivefold devaluation of the ruble¹ in 1998 allowed the MICEX Index to subsequently recover at a faster rate than the RTS Index (see *Fig. 1*), because the MICEX Index portfolio is denominated in rubles while the RTS Index portfolio in US dollars. The MICEX Index managed to recover to its pre-recession peak as early as by May 1999, i.e. only eight months after passing through the “bottom line” of the crisis. It took 58 months for the RTS Index to recover after reaching its lowest level during the crisis.



Source: based on the data supplied by the Moscow Exchange and the Bank of Russia.

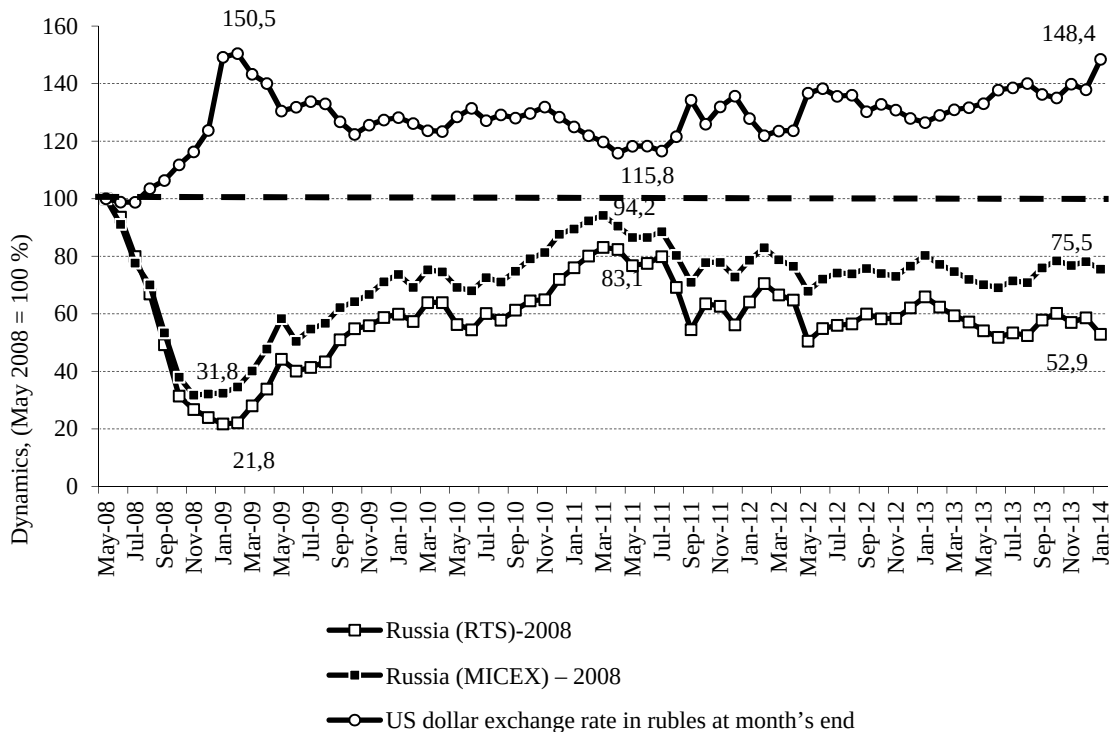
Fig. 1. Changes to the US exchange rate, the RTS and MICEX indices during the crisis of 1997–1998 (July 1997 = 100%)

During the crisis between 2008 and 2009 the ruble saw the highest devaluation of 50% (see *Fig. 2*). By April 2011 the ruble exchange rate recovered, devaluing only by 15.8% of the pre-recession period. However, in May 2011 the US dollar resumed to strengthen and by January 2014 the ruble devalued near 50%. It is in May 2011 when a new stage of withdrawing money from foreign foundations investing in Russian stocks² began. Because of a more moderate, vs. the 1998 crisis, devaluation of the ruble, the latest recovery of the RTS and MICEX indices was almost the same, except that the MICEX Index recovered a bit faster.

¹ Within the period of 1998 thru 2003.

² The reasons for this phenomenon are described in detail in section 3.3.2.

In January 2014, the RTS Index reached 52.9% while the MICEX Index showed 75.5% of the peak value of these indices recorded in May 2008.



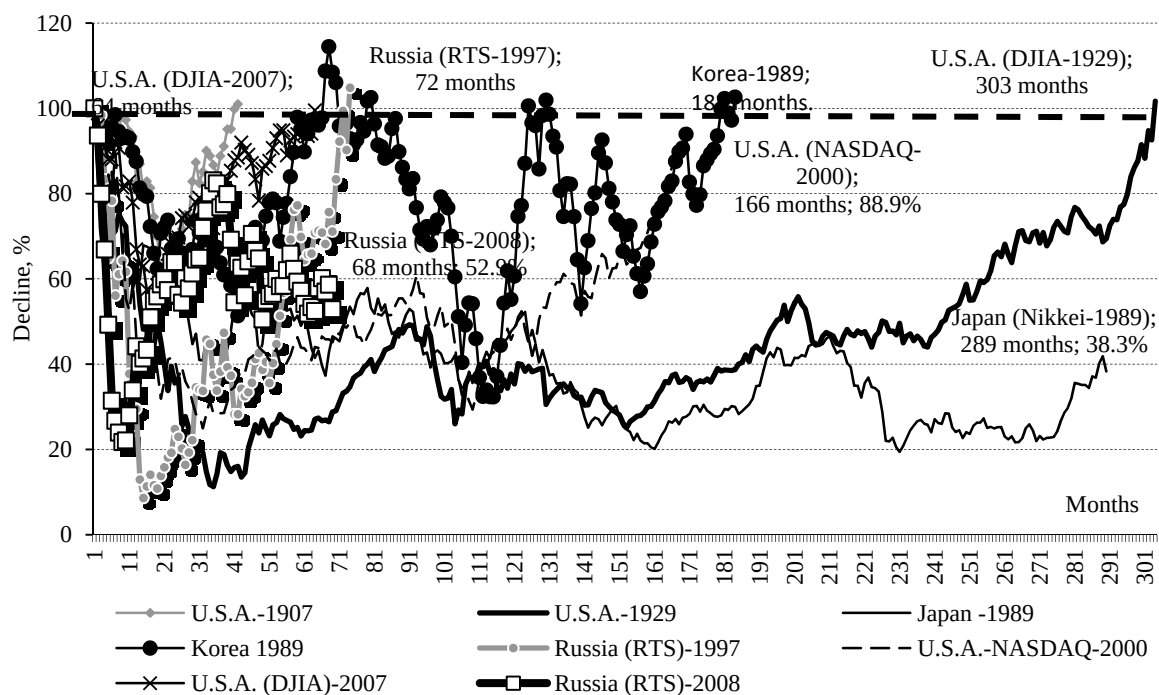
Source: the estimations are based on the data supplied by the Bank of Russia and the Moscow Exchange.

Fig. 2. Changes to the US exchange rate, the RTS and MICEX indices in the period of May 2008 thru January 2014 (May 2008 = 100%)

3.1.2. Long-term and short-term financial crises

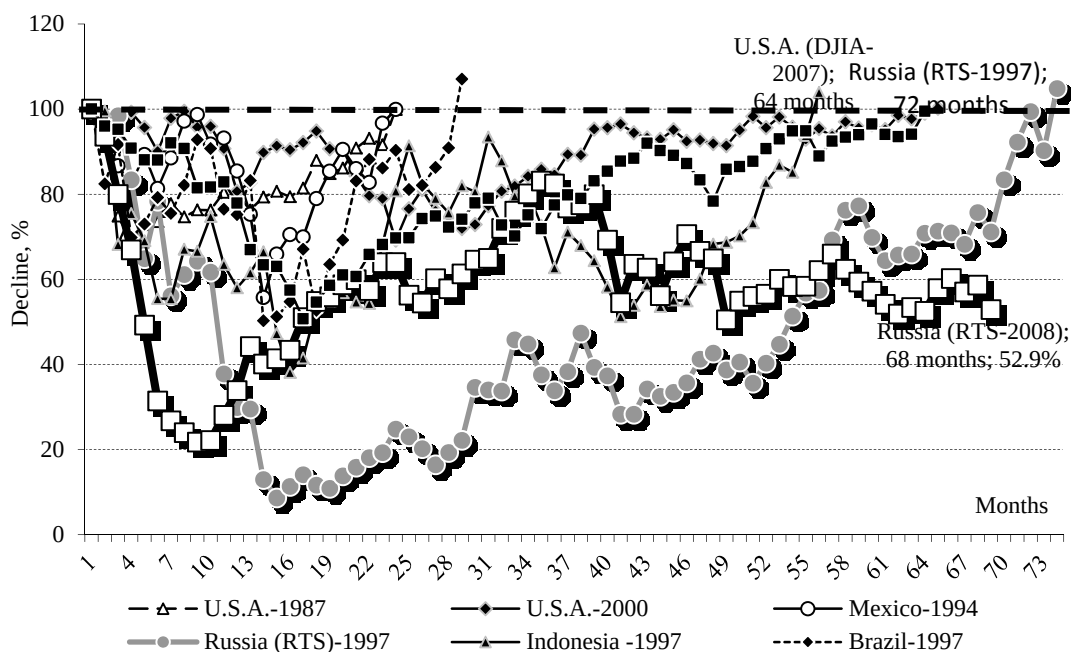
The current financial crisis in Russia is short-term as compared with the major long-term financial crises of the latest century (see *Fig. 3*). The RTS Index has been recovering only 68 months between May 2008 and January 2014. It took 183 days for the Korean stock index to recover after the crisis in 1989, while the US stock index recovered within 303 months after the onset of Great Depression in 1929. The Japanese NIKKEI-225 hasn't yet recovered after 289 months since 1989 while the NASDAQ-Composite has still been recovering within 166 months since 2000. Despite record gains of 22.9% in 2012 and 56.7% in 2013, the Japanese stock index has only 14 months to go in recovery to beat the world's longest recovery records established by the Dow Jones Industrial Average (DJIA) after the depression in 1929.

The Russian crisis in 2008–2009 is distinguished by a deeper and longer period of recovery as compared with the best known short-term financial shocks that took place in the United States in 1987, 2000 and 2007, in Mexico in 1994, Indonesia in 1997, and Brazil in 1997 (see *Fig. 4*). Furthermore, the DJIA, in contrast with the Russian stock market indicators, managed as early as January 2013 to recover reaching its peak recorded in 2007. This implies that slow recovery rates in the Russian market can be explained by the factors peculiar to a few large emerging market, as well as specific features.



Source: based on the data supplied by the Moscow Exchange and www.finance.yahoo.com.

Fig. 3. Depth and duration of long-term financial crises worldwide as of January 31, 2014 (peak = 100%)

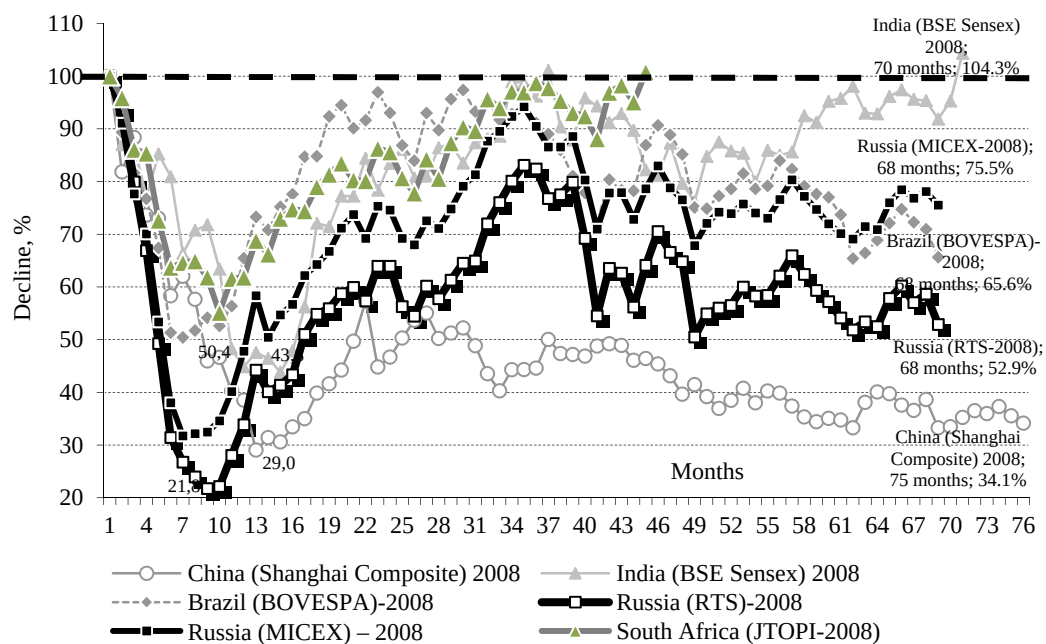


Source: based on the data supplied by the Moscow Exchange and www.finance.yahoo.com.

Fig. 4. Depth and duration of short-term financial crises worldwide as of January 31, 2014 (peak = 100%)

3.1.3. Market recovery specific features in the BRICS countries

Among the BRICS countries (Brazil, Russia, India, China, South Africa), only the Johannesburg Stock Exchange (JTOPI) and Bombay Stock Exchange (BSE Sensex) indices managed after the crisis of 2007–2008 to catch up with the pre-recession peaks within 44 and 70 months respectively (see Fig. 5). The indices of the rest BRICS countries showed delay in recovery. The Brazilian Bovespa Index reached within 68 months just 65.6% of the pre-recession highest value; the Shanghai Stock Exchange (China) index within 75 months reached only 34.1% of its peak value. At the same time, like the Brazilian and Chinese indices showed a W-shaped trend, like the dynamics of the Russian MICEX and RTS indices did. Moreover, the BRICS countries were found to be the least appealing for global investors at the stage of recovery in the global economy.



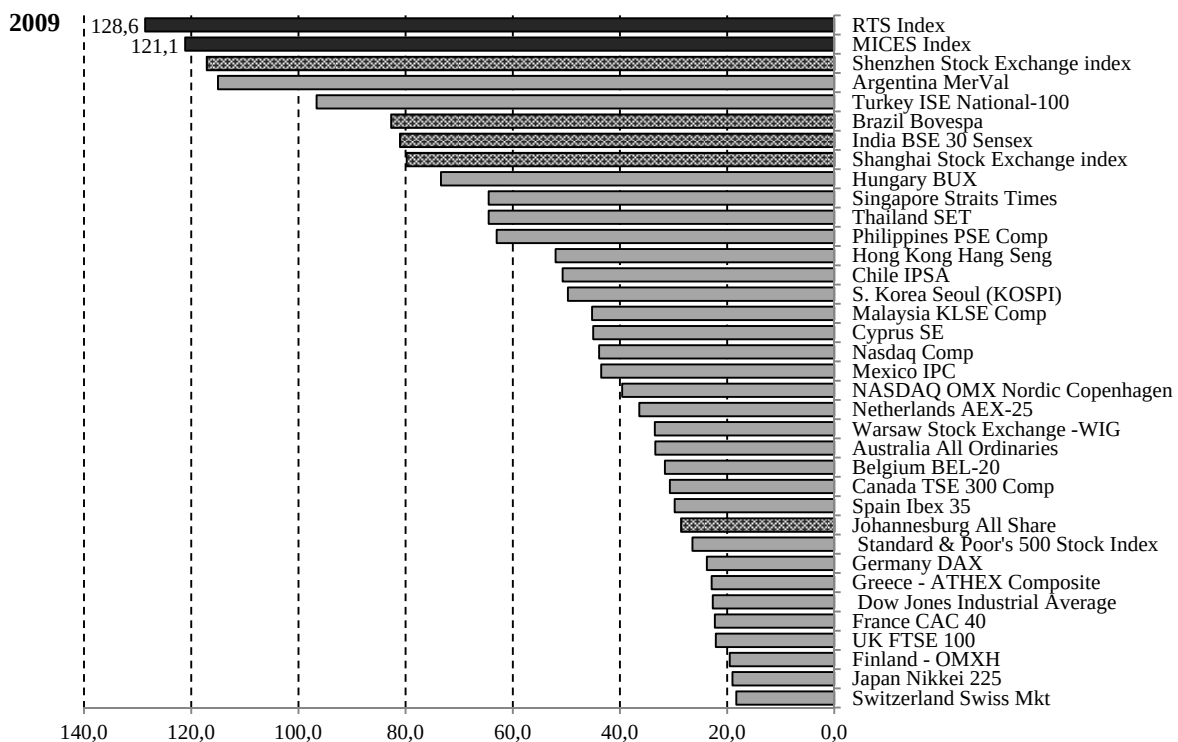
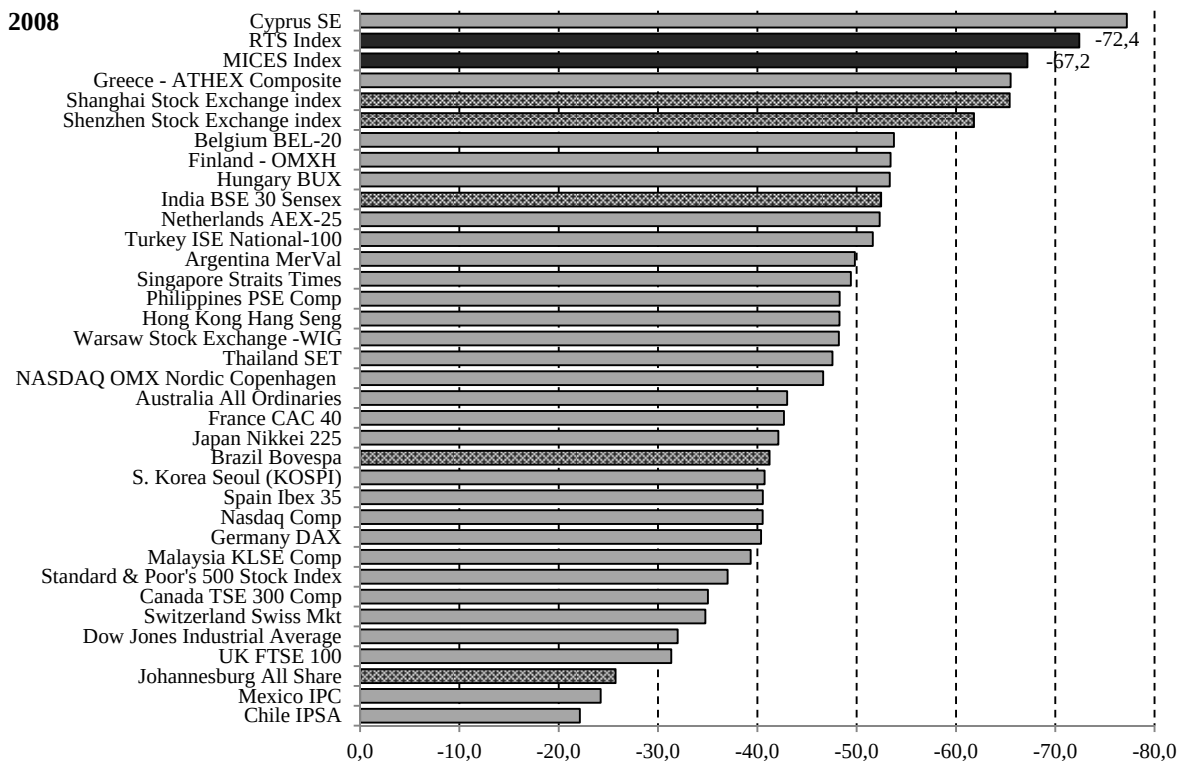
Source: the estimations are based on the data supplied by Thomson Reuters Eikon.

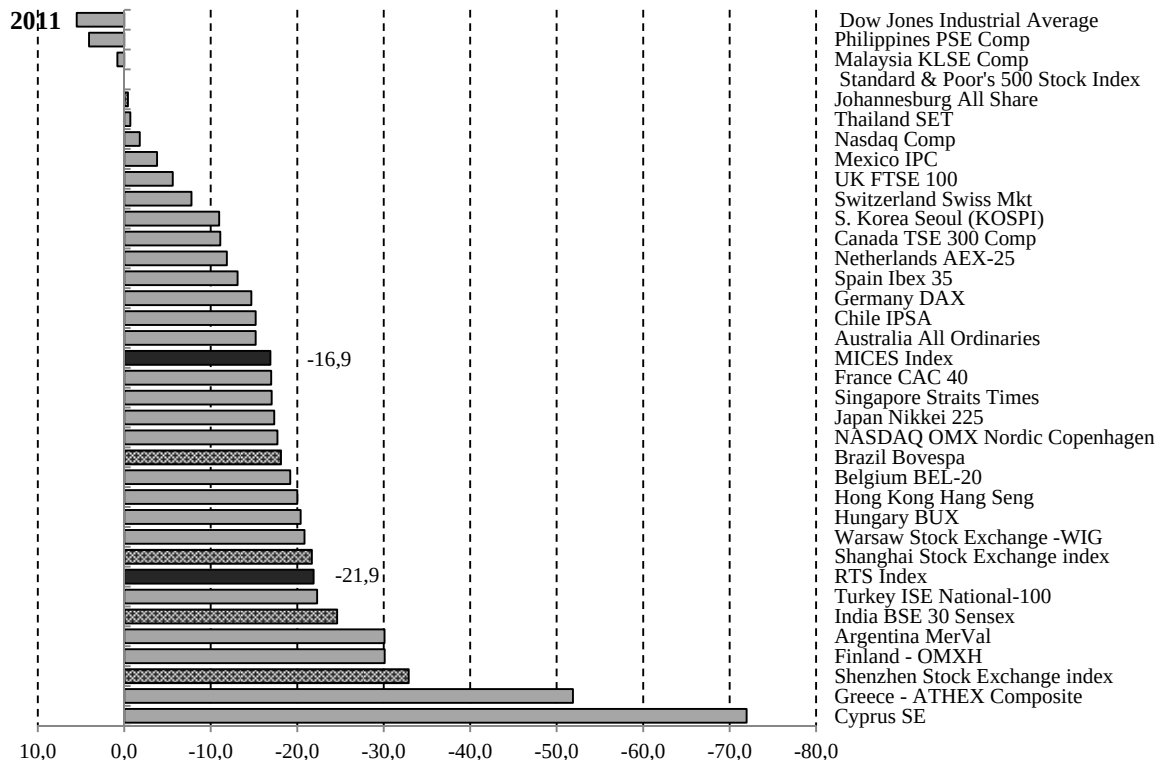
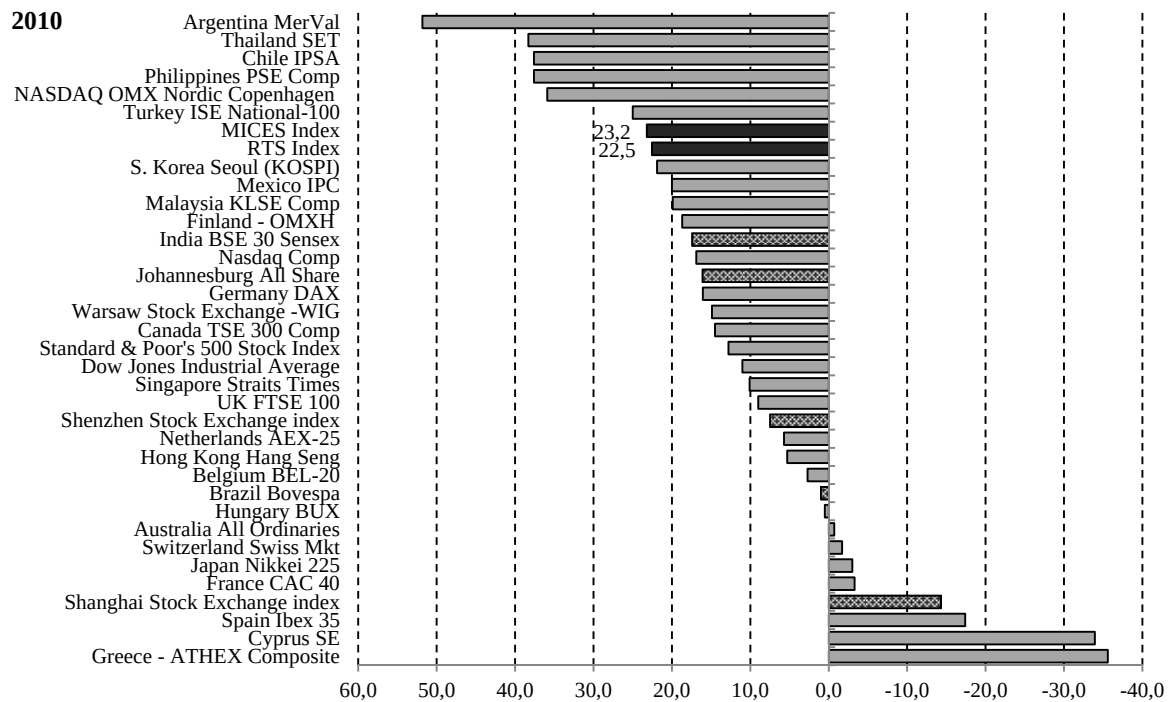
Fig. 5. Depth and duration of the current financial crisis in the BRICS countries as of January 31, 2014 (peak = 100%)

The BRICS's stock markets have been remaining unattractive for investment over the last three years (see Fig. 6 and Table 2). In 2011 they saw a deeper decline than stock market indices in other countries. In 2012, Chinese, Brazilian, and Russian markets were found to be in the group of outsiders in terms of yield growth. In 2013, most of the BRICS's indices demonstrated either very low positive or even negative yield against the backdrop of impressive growth in indices in many developed and developing countries. The Russian MICEX and RTS indices dropped 16.9% and 21.9% respectively in 2011; gained 5.2% and 10.5% respectively in 2012; the MICEX Index gained 2.0%, whereas the RTS Index lost 5.5% in 2013.

RUSSIAN ECONOMY IN 2013

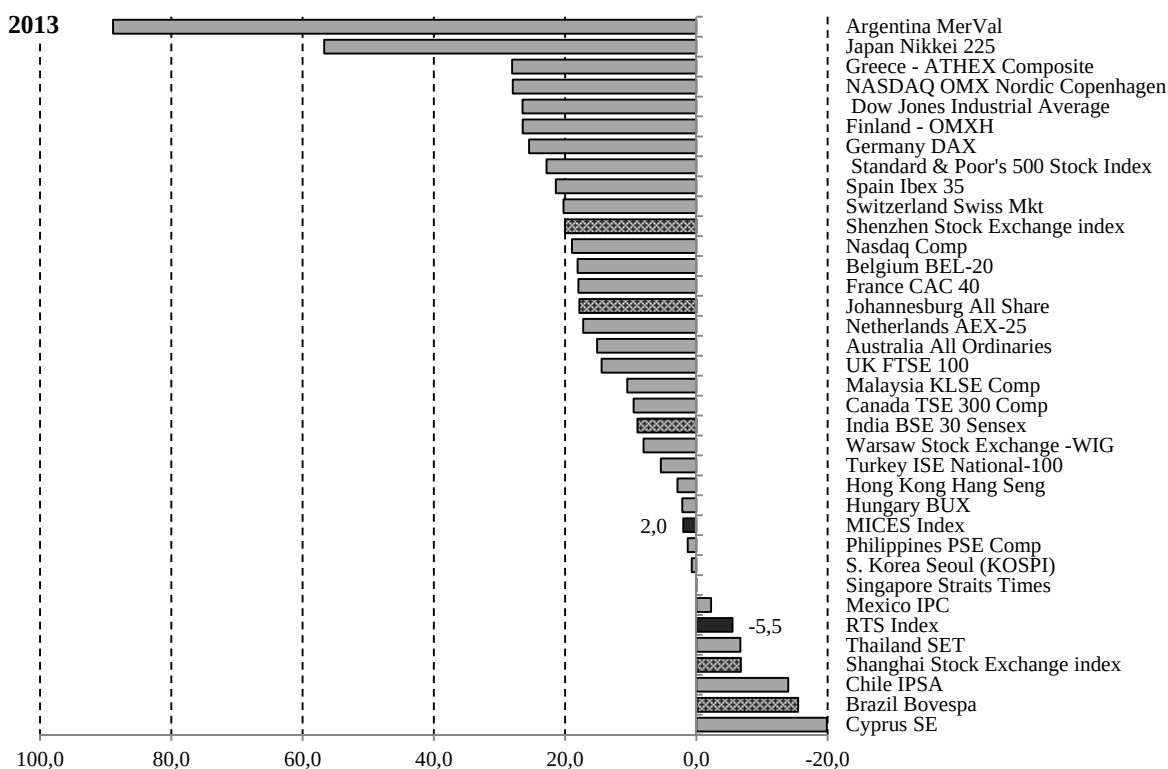
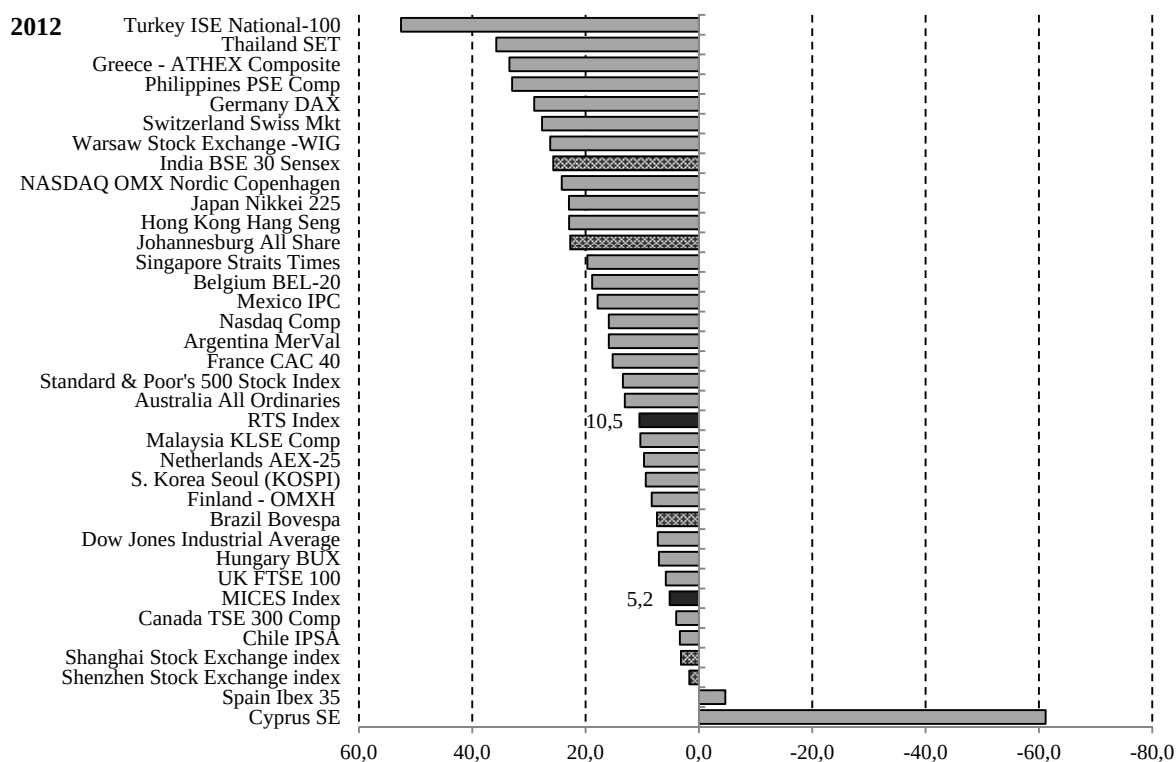
trends and outlooks





RUSSIAN ECONOMY IN 2013

trends and outlooks



Source: the estimations are based on the data supplied by Thomson Reuters Eikon.

Fig. 6. Global stock indices performance in 2008–2013, %

BRICS's stock markets have been facing challenges of similar nature, i.e. they have been out of traditional economic growth drivers, their national currencies have weakened, they cannot compete with other developing countries for offering best investment climate and business environment. According to economist N. Roubini, in 2014 economic growth rates in Brazil, Russia, South Africa are expected to be less than in the United States. India and China have been facing substantial economic slowdown. Brazil and South Africa are facing a double deficit including budget deficit and current account deficit. China is showing growth in toxic assets in banks, off-the-books banking sector, bad debts owed by local government authorities and state-run companies¹.

Table 2

Global stock indices performance in 2008–2013, %

	2008	2009	2010	2011	2012	2013
Turkey ISE National-100	-51.6	96.6	25.0	-22.3	52.6	5.4
Thailand SET	-47.6	64.5	38.3	-0.7	35.8	-6.7
Greece – ATHEX Composite	-65.5	22.9	-35.6	-51.9	33.4	28.1
Philippines PSE Comp	-48.3	63.0	37.6	4.1	33.0	1.3
Germany DAX	-40.4	23.8	16.1	-14.7	29.1	25.5
Switzerland Swiss Mkt	-34.8	18.3	-1.7	-7.8	27.7	20.2
Poland –Warsaw Stock Exchange WIG	-48.2	33.5	14.9	-20.8	26.2	8.1
India BSE 30 Sensex	-52.5	81.0	17.4	-24.6	25.7	9.0
Denmark – NASDAQ OMX Nordic Copenhagen (All shares of stock)	-46.6	39.6	35.9	-17.7	24.2	28.0
Japan – Nikkei 225	-42.1	19.0	-3.0	-17.3	22.9	56.7
Hong Kong – Hang Seng	-48.3	52.0	5.3	-20.0	22.9	2.9
South Africa – Johannesburg All Share	-25.7	28.6	16.1	-0.4	22.7	17.8
Singapore – Straits Times	-49.4	64.5	10.1	-17.0	19.7	0.0
Belgium – BEL-20	-53.8	31.6	2.7	-19.2	18.8	18.1
Mexico – IPC	-24.2	43.5	20.0	-3.8	17.9	-2.2
U.S.A. – Nasdaq Comp	-40.5	43.9	16.9	-1.8	15.9	19.0
Argentina MerVal	-49.8	115.0	51.8	-30.1	15.9	88.9
France – CAC 40	-42.7	22.3	-3.3	-17.0	15.2	18.0
Australia – All Ordinaries	-43.0	33.4	-0.7	-15.2	13.1	15.1
U.S.A. – Standard & Poor's 500	-37.00	26.5	12.8	0.0	13.4	22.8
Russia – RTS Index	-72.4	128.6	22.5	-21.9	10.5	-5.5
Malaysia – KLSE Comp	-39.3	45.2	19.9	0.8	10.3	10.5
The Netherlands – AEX-25	-52.3	36.4	5.7	-11.9	9.7	17.2
The Republic of Korea – KOSPI	-40.7	49.7	21.9	-11.0	9.4	0.7
Finland – OMXH	-53.4	19.5	18.7	-30.1	8.3	26.5
Brazil – Bovespa	-41.2	82.7	1.0	-18.1	7.4	-15.5
U.S.A.– Dow Jones Industrial Average	-32.0	22.7	11.0	5.5	7.3	26.5
Hungary – BUX	-53.3	73.4	0.5	-20.4	7.1	2.2
Great Britain – FTSE 100	-31.3	22.1	9.0	-5.6	5.8	14.4
Russia – MICEX Index	-67.2	121.1	23.2	-16.9	5.2	2.0
Canada – TSE 300 Comp	-35.0	30.7	14.5	-11.1	4.0	9.6
Chile – IPSA	-22.1	50.7	37.6	-15.2	3.4	-14.0
China – Shanghai Stock Exchange index (SSE)	-65.4	79.8	-14.3	-21.7	3.2	-6.7
China –Shenzhen Stock Exchange index	-61.8	117.1	7.5	-32.9	1.7	20.0
Spain – Ibex 35	-40.6	29.8	-17.4	-13.1	-4.7	21.4
Cyprus – Cyprus SE	-77.2	45	-33.9	-72.0	-61.2	-19.9

Source: the estimations are based on the data supplied by Thomson Reuters Eikon.

¹ Roubini N. The Trouble with Emerging Markets. Project Syndicate, 03/02/2014, <http://www.social-europe.eu/2014/02/trouble-emerging-markets/>.

3.2. Russian stock market's competitiveness

3.2.1. Stock markets' liquidity

Repositioning of stock market liquidity centers became one of the effect of the 2008 crisis. For the first time over many decades, the recovery to the pre-recession values of stock indices in major global markets was not accompanied by recovery in trading volumes in stock exchanges (see *Table 3*). In 2013, stock trading volumes in U.S. stock exchanges accounted for as little as 54.3% of the level recorded in 2007. Likewise, stock trading volumes in the London Stock Exchange, Euronext (Europe), and the German stock exchange accounted for 51.7%, 36.7% and 39.7% respectively. At the same time, there are two trends towards total stock trading volumes globally, i.e. growth in the share of high-speed trading (HST) and growth in the share of off-market transactions. For example, in the United States, the share of HST in stock trading volumes increased from 35% in 2007 to 51% in 2012¹. Additionally, according to Tabb Group, the share of off-market trading systems based on the dark pools principle in the U.S. stock market increased from 3% in 2007 to 15% in 2012². Stock transactions that left the market constitute a big share of these volumes.

A six year, after 2007, lasting trend towards shrinkage in volumes of on-market trading, despite growth in HST, can be attributed to a set of factors including investors fleeing risk assets, disposing of shares of pension funds and mutual funds being subject to new rules for regulation and supervision. However, major institutional investors' sapping confidence in exchanges as encampment of high-speed traders is no less important factor in this process. According to self-regulated organization of U.S. companies, high-speed trading is exposed to severe risks for the mutual fund industry,³ because it uses confidential information about large trading orders, applies the practice of manipulating markets through front running⁴, creates unreasonable fluctuations in liquidity in the security market. Studies of efficient execution of trading orders in exchanges conducted by one of the largest U.S. asset managers T. Rowe Price and Investment Technology Group show that the HST creates substantial difficulties in the execution and appreciation of such orders in U.S. stock exchanges⁵. In 2013, the HST fell within the focus of attention of regulators in many countries considering imposing special taxes on transactions of most active traders. Mary White, a new head of the U.S. Securities and Exchange Commission (SEC, U.S.A.) stated at Senate hearings that the high-speed trading and sophisticated trading algorithms give rise to numerous questions and concerns⁶.

In our opinion, growth in large investors' distrust in stock exchanges of different countries was to a large extent provoked by their commercialization whereby many large market operators ceased to own stock exchanges while the trading arrangement activity turned into a standalone profitable business. This process resulted in erosion of large trading participants' credibility in the equity of the trading mechanism of transactions. No efforts through

¹ Strasburg J., Patterson S. High-Speed Traders Race to Fend off Regulators. WSJ, December 27, 2012.

² The data is presented in the article of Patterson S. Finra CEO Says It Is Expanding Oversight of Dark Pools. WSJ, January 8, 2013.

³ Investment Company Institute's (ICI) Letter on Concept Release on Equity Market Structure of April 10, 2010 addressed to SEC. The Letter is available on the ICI's official website: <http://www.ici.org/pdf/24266.pdf>

⁴ The unethical practice of a broker trading an equity based on information from the analyst department before his or her clients have been given the information.

⁵ Bunge J. A Suspect Emerges in Stock Hiccups: Regulation NMS. Some Say Increasing Complexity of Market Partly Due to Set of Rules. WSJ, January 27, 2014.

⁶ Strasburg J., Patterson S. Trading Clamps Spur Lobby Effort. WSJ, March 24, 2013.

conducting in-depth academic studies of pros and cons of the HST's effect on pricing of assets have so far been successful and unlikely to be so in the future. There is always arguments in favor or against. The only thing that used to maintain confidence in stock exchanges was that trading participants as owners of the exchange set the rules for themselves. This principle was undermined through commercialization of stock exchanges. This is not to say that stock exchanges have outlived their usefulness. They will continue to be centers of pricing and settlement in the financial market. However, the issue of lack of confidence of trading participants will facilitate more than expected demand for alternative trading systems including those based on the assets owned by trading participants.

Table 3

**Dynamics of the value of on-market transactions with shares of stock listed
in major stock exchanges in 2007–2013 (2007 = 100%)¹**

	2007	2008	2009	2010	2011	2012	2013
U.S.A. (NYSE and NASDAQ)	100	120.1	72.6	71.0	71.7	54.2	54.3
China (two stock exchanges)	100	63.0	128.9	132.8	106.9	81.8	124.9
Japan (Tokyo Stock Exchange and Osaka Stock Exchange)	100	87.3	61.2	63.2	66.3	57.5	103.9
Great Britain (LSE)	100	89.0	62.9	63.5	65.7	50.8	51.7
Euronext	100	84.7	42.7	44.5	47.1	34.8	36.7
Germany	100	95.5	45.1	48.4	52.3	37.9	39.7
Hong Kong	100	77.3	70.1	74.1	71.5	54.7	65.5
Canada	100	105.3	75.5	83.0	93.5	82.3	83.2
Australia	100	77.5	57.9	77.1	86.8	67.9	63.9
Russia (MICEX – market transactions)	100	89.0	77.3	75.5	95.2	55.8	44.0
Russia (MICEX – all trading modes)*	100	116.5	74.7	92.4	142.5	127.5	123.6
NASDAQ OMX Nordic Exchange	100	84.5	48.8	52.6	58.0	41.1	43.8
Total by member of the World Federation of Exchanges (WFE)	100	100.8	69.5	70.7	70.7	54.8	61.3

* Market and negotiated repo transactions, repo, classic market and Standard.

Source: the author's estimates based on the data supplied by the World Federation of Exchanges and the Moscow Exchange.

The Moscow Exchange stock market developed towards the trends prevailing in the global financial centers. The volume of on-market (anonymous) transactions in the stock exchange in 2013 accounted for only 44.0% of the level recorded in 2007. At the same time, although the value of transactions with shares of stock given all trading modes contracted in 2013 against 2012, it accounted for 123.6% of the values recorded in 2007. This is indicative of the fact that after the crisis in 2008 the stock market in Russia was growing exclusively by means of non-market repo transactions, which is attributed to the money segment rather than the capital market. In 2013, total annual volume of traded shares of stock in all modes in the Moscow Exchange amounted to Rb 47,4 trillion, far below Rb 75 trillion forecasted for the same year by the Ministry of Finance of Russia under *The Development of Financial and Insurance Markets, Creation of International Financial Center State Program* of the Russian Federation (hereinafter – the State Program).

HST transactions played an important role in the market segment of trading in shares of stock in the Moscow Exchange. The data of a financial market review of the Bank of Russia shows that in 2011 high-speed trading systems (trading robots) accounted for about a half of the trading volume in the Forts (futures & options) market and the trading volume in the MICEX. According to former Senior Managing Director of the Moscow Exchange R. Goryunov, the data on the share of transaction robots in the exchange is conservative, but

¹ Including transactions with foreign issuers' securities in respective stock exchanges.

the order of figures is correct¹. According to the data supplied by Expert journal with a reference to the Moscow Exchange, in 2012 trading robots concluded about 40% of total transactions in the stock market, and robots accounted for 97% of the total orders².

The Moscow Exchange conducts its annual Best Private Investor Contest (BPIC) contest, its most costly marketing event.

For the purpose of analyzing the distribution of HST yield, we examined in 2013 a sample of transactions conducted by the BPIC participants within a period of eight trading days in the RTS and MICEX in 2011. High-speed trading robots were the winners, which is usual for this kind of competitions. Daily summarized data on transactions and BPIC participants' yield were published on the Moscow Exchange's official website. The sample included 8350 data on December 6–9 and 12–15, 2011 on the number of daily transactions on all stock market segments which were concluded by each participant and the amount of their daily yield measured on the basis of the results of such transactions in percentage terms³. Average daily yield over the period of eight days was 1.0% on the MICEX Index and 1.3% on the RTS Index.

Table 4

Trading data on the BPIC participants in 2011

Participants	Number of observations	Daily yield, %	Standard deviation, %	Yield /Risk	Skewness ⁴	Kurtosis ⁵
100 or less daily transactions	6,887	–0.6	7.2	–0,1	–0,18	21,51
100 to 3000 daily transactions	1,388	–0.1	11.8	–0,01	–0,23	12,68
3000 and more daily transactions	76	66.9	133.2	0,5	3,57	16,55

Data source: the author's estimates based on the source data supplied by the Moscow Exchange.

Table 4 shows key characteristics of the daily yield distribution density for BPIC participants closing 100 or less daily transactions, 100 to 3000 daily transactions, and 3000 and more daily transactions. The third group was considered as high-speed traders. In all cases the yield distribution is far from normal, but it is seen from the Table that distribution for the first and third groups of traders differs largely.

Those who concluded 100 or less transactions showed near to zero and negative average yield, skewness a bit negative, which is natural for a falling market. High kurtosis implies is indicative of some abnormal values in the distribution tail area (see Fig. 7). Such a distribution suggests that winners' benefits and losers' losses are nearly equal for those trading participants who concluded 100 or less daily transactions.

High-speed traders who concluded 3000 and more daily transactions (see Fig. 8) showed quite a different nature of distribution of daily yield results, their average yield was at 66.9%, the yield-to-risk ratio was 0.5 against –0.1 for less active traders. High-speed traders' yield distribution was skewed substantially towards a positive yield, with a skewness being 3.6.

¹ Trifonov A. Vedomosti, March 26, 2012.

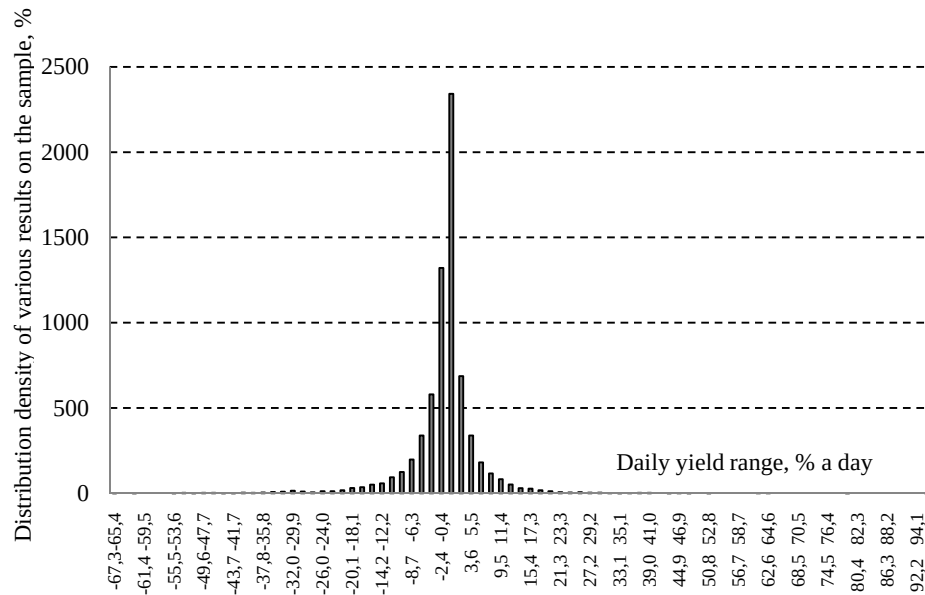
² Obukhova E. Stock Exchange beats robots. Expert, No. 37, September 17-23, 2012.

³ The sample was made based on the data on final trading days of the Best Private Investor Contest – 2011. The 8-day limit can be explained by labor consuming processing of the source data, because the Moscow Exchange presents disclosed trading data in formats which are barely compatible with the Excel format.

⁴ Skewness describes the skewness of a distribution. The skewness shows the degree of a distribution asymmetry against its average. Positive skewness refers to a distribution towards positive values, whereas negative skewness towards negative values. An above-3 value of skewness is indicative of substantial asymmetry.

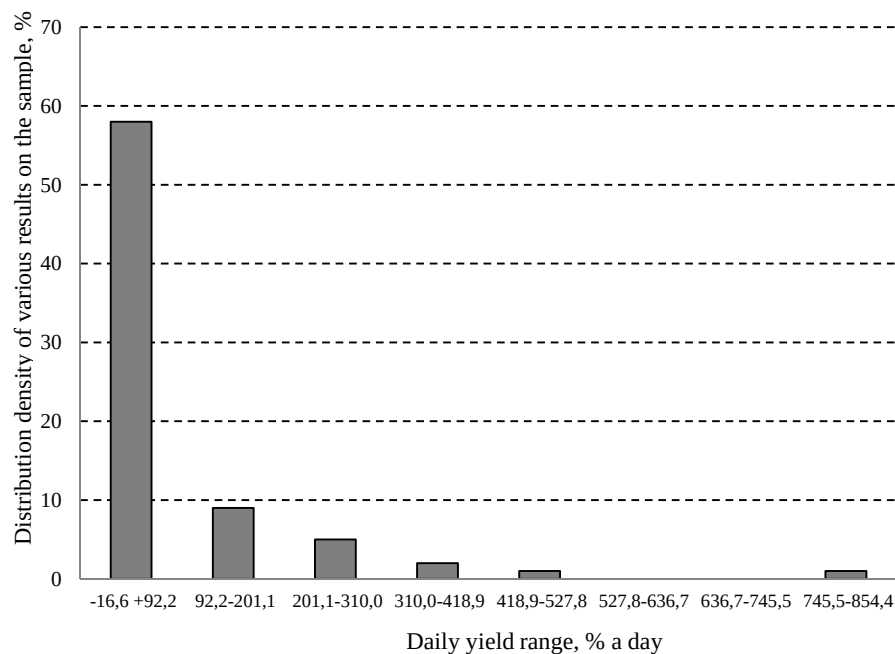
⁵ Kurtosis describes relative peakedness or flatness of a distribution against normal distribution. Leptokurtosis refers to relative cuspidal distribution; platykurtosis refers to smoothed distribution.

This suggests that high-speed traders were ahead of the other participants, leaving the latter no chance to win.



Source: the author's estimates based on the data supplied by the Moscow Exchange.

Fig. 7. Yield distribution of BPIC participants concluded less than 100 daily transactions



Source: the author's estimates based on the data supplied by the Moscow Exchange.

Fig. 8. Yield distribution of BPIC participants concluded 3000 and more daily transactions

We also know from our conversations with the BPIC participants that:

- the Moscow Exchange sells at nearly Rb 500,000 a special monthly high-speed access to the trading system used by many high-speed traders. This service offers advantages of high-speed for trading orders;
- most of HST strategies use the “openbook” data containing information on all open buy and sell orders with specified prices and the number of securities as a signal for sending orders to the trading system;
- HST strategies, such as scalping, agreed quoting, and a few others are considered, even in textbooks, as part of the unethical practice of front-running.

True, with reference to the foregoing there is no way to infer that high-speed traders are actively involved in market manipulations, but they show that distribution of their yield is considerably biased towards abnormally high profits, thereby requiring that the exchange and regulators make at least a serious analysis of the nature of such advantages¹. The nature of such advantages should be clear, because some traders generate an excess profit at the expense of extra losses of other traders. In any case, the existence of an equal distribution of the yield generated by various traders over a fairly long period of time is an important factor of keeping various types of investors confident in the exchange.

The Moscow Exchange stock market differs from global stock exchanges in its large dependence on foreign portfolio investors. According to analysts from CJSC Sberbank CIB, about 70% of free-float Russian shares of stock are being held by nonresidents. Furthermore, 14 largest investment foundations accounted for 28% of total investment by foreign portfolio investors². Such foundations, according to CJSC Sberbank CIB, include The Norwegian State Pension Fund, Vanguard Emerging Markets Stock Index Fund, Oppenheimer Developing Markets Fund, ISHARES MSCI Emerging Markets ETF BlackRock Group, Lazard Emerging Market Equity Portfolio.

3.2.2. Stock market capitalization

The Russian stock market's large dependence on foreign portfolio investors has an adverse effect on the dynamics of companies' capitalization (see *Table 5*). Unlike of a majority of global financial centers where capitalization was growing in the period of 2012 thru 2013, the value of Russian companies saw a decline against 2007 to 72.9% in 2011, 71.8% in 2012, and 69.3% in 2013.

Foreign portfolio investors fleeing BRICS's markets towards mature markets in developed economies was the reason for mixed dynamics of capitalization in Russia and mature markets. Weak performance of largest state-run companies, above all, OJSC Gazprom was another factor for lower capitalization on shares of stock in Russia. In 2013, capitalization of the largest Russian joint-stock company accounted for only 40.5% of the level recorded in 2007, having been keeping declining over the last three years. According to analysts from UBS, Gazprom is the most underestimated company among other oil and gas companies in the world³. This is an illustration of the issues of ineffectiveness and poor

¹ There were no robots among the winners of the BPIC-2013 which was held separately on foreign exchange market, Forwards market, and spot market. In 2013, 6519 persons participated in the BPIC, the trading volume (including stock market, Forwards market, and foreign exchange market) of all the BPIC participants totaled Rb 1,8 trillion within 2.5 months. The BPIC prize fund amounted to Rb 7,5m.

² Gaidarov V. Foreign free-float control. Kommersant, January 17, 2014.

³ Khodyakova E. Gazprom establishes a new antirecord. Vedomosti. February 13, 2013.

corporate governance of state-run companies becoming a serious barrier to growth in capitalization of Russian companies.

Table 5

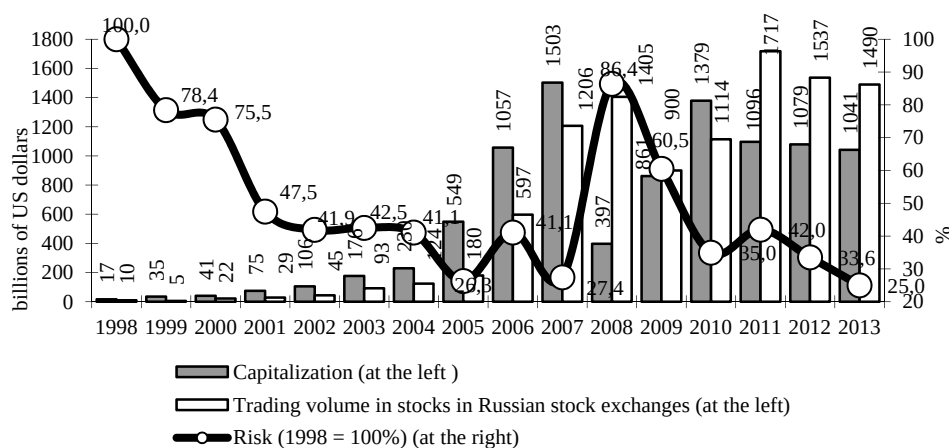
Domestic market capitalization dynamics in 2007–2013 (2007 = 100%)

	2007	2008	2009	2010	2011	2012	2013
U.S.A. (NYSE and NASDAQ)	100	58.3	76.7	87.9	79.5	94.9	122.2
China (Shanghai SE)	100	38.6	73.2	73.5	63.8	68.9	67.6
Japan (Tokyo Stock Exchange)	100	71.9	76.3	88.4	76.8	80.3	104.9
Great Britain	100	48.0	72.5	80.5	75.2	88.0	114.8
Euronext	100	49.8	68.0	69.4	57.9	67.1	84.9
Germany	100	52.8	61.4	67.9	56.3	70.6	92.0
Hong Kong	100	50.1	86.8	102.1	85.1	106.7	116.8
Canada (TMX Group)	100	47.3	76.7	99.3	87.4	94.2	96.7
Australia (Australian SE)	100	52.7	97.2	112.0	92.3	106.8	105.2
Russia*	100	26.4	57.3	91.7	72.9	71.8	69.3
including OJSC Gazprom	100	31.4	53.4	56.4	50.0	41.91	40.5
NASDAQ OMX Nordic Exchange	100	45.3	65.8	83.9	67.8	80.1	102.1

* the estimates are based on the data on 2007–2013 supplied by S&P

Source: the estimations are based on the data supplied by the World Federation of Exchanges and Finam company.

In 2013, Russian joint-stock companies' capitalization amounted to \$1,0 trillion, a bit lower the level of 2011 (see Fig. 9). Capitalization of shares of stock in 2013 accounted for 49.7% of GDP, far less than 64% forecasted for the year by the Ministry of Finance of Russia. In 2013, unlike the trend prevailing in 2011–2012, no large Russian issuers changed their jurisdiction in favor of other counties. On the contrary, a few Russian companies incorporated in other countries (e.g., RUSAL) announced that they might change their jurisdiction in favor of Russia¹ against the backdrop of executive authorities tightening countermeasures against offshore taxation schemes in 2013. Total trading volumes under all trading modes in the Moscow Exchange contracted from \$1537bn in 2012 to \$1490bn in 2013, or by 3.1%. Stock market volatility, which is measured by a standard deviation of daily changes to the RTS Index, declined in 2013 against the preceding year, accounting for 25.0% of the level recorded in 1998.



Source: the estimates are based on the data on capitalization supplied by the Moscow Exchange and S&P.

Fig. 9. Russian stock market capitalization, liquidity, and volatility

¹ Elkova O., Ermakov A., Loginov V. Business sets a course for deoffshorization. Izvestiya, December 19, 2013.

3.2.3. Competition with foreign stock exchanges

Judging by the total stock trading volume, including all trading modes, in 2013 the Moscow Exchange managed in general to maintain its position as the key authority on trading in equity instruments (shares of stock and depositary receipts) of Russian issuers (see *Fig. 10* and *Table 6*). However, the share of the Moscow Exchange in trading in the foregoing shares of stock and depositary receipts shrank from 72.2% in 2012 to 71.1% in 2013. The share of the London Stock Exchange, the German Stock Exchange, and two largest U.S. stock exchanges increased insignificantly. However, these relatively good figures for the Moscow Exchange include repo transactions with shares of stock which formerly fall into the money market category. The Moscow Exchange's share, net of repo transactions, in total volume of trading in equity instruments of Russian issuers contracted from 38.5% in 2012 to 36.2% in 2013. Therefore, the conclusion for on-market transactions is different – the share of the Russian exchange isn't prevailing, more importantly, it keeps shrinking¹.



Source: the author's estimates based on the data supplied by Russian and foreign stock exchanges.

Fig. 10. The share of stock exchanges in volumes of trading in Russian JSCs' shares of stock

The process of moving Russian companies' head offices to other countries, like it was the case with such companies as Polus Gold, Polimetall, etc., was stopped in 2013 owing to the measures which the federal government authorities were taking to counteract entrepreneurs avoiding taxation through offshore schemes and enhance the transparency of their business. In 2013, however, the process of returning under Russian jurisdiction companies previously registered abroad but conducting their core activity in Russia didn't go further than promises

¹ To measure competition with the London Stock Exchange, the Moscow Exchange uses a slightly different approach towards comparing volumes of trading in stocks. The approach is based on calculating trading volumes for the shares of only 26 issuers, ignoring volumes of repo transactions with the shares of these JSCs in the Moscow Exchange. In our opinion, the method of comparing the stock exchanges we offer is more complete, stable and objective. Furthermore, the source data of the method we use is based on the official public statistics of the stock exchanges.

of some entrepreneurs. New economy companies with Russian roots, such as TCS Group Holding, Luxoft Holding Inc., Yandex LLC, Qiwi Plc. chose foreign stock exchanges for IPO in 2013.

Table 6

The share of stock exchanges in total volumes of trading in Russian JSCs' shares of stock, %

	2000	2005	2010	2011	2012	2013	2014 –Jan.
Moscow Exchange core market	36.0	38.1	69.9	72.1	70.3	70.5	74.4
Moscow Exchange classic and conventional markets (the former RTS)	11.9	2.0	7.9	5.2	1.9	0.6	0.2
Others	0.0	8.1	0.0	0.0	0.0	0.0	0.0
Russian exchanges – total	47.9	48.2	77.8	77.3	72.2	71.1	74.6
London Stock Exchange	30.1	43.1	19.0	21.1	26.2	27.0	23.1
German stock exchanges	22.0	2.6	0.6	0.3	0.0	0.0	0.1
New York Stock Exchange and NASDAQ (U.S.A.)		6.2	2.6	1.4	1.5	1.9	2.3
Hong Kong Stock Exchange			0.0	0.0	0.0	0.0	0.0
Shares of stock and depositary receipts – total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: the author's estimates based on the data supplied by Russian and foreign stock exchanges.

In 2013, companies operating in Russia went public through IPO-SPO at \$9,0bn, a bit less than \$9,5bn in 2012. The public offerings of shares of stock of Russian issuers at a total of Rb 286bn in 2013 was found to be much less than Rb 400bn forecasted by the Ministry of Finance of Russia under the State Program. In 2013, unlike the previous year, the principal part of national issuers' public offerings of shares of stock took place in the Moscow Exchange. This was possible through an enlarged meeting of the Russian Government held on January 25, 2013, at which President Putin stated that privatization transactions as IPO must be held so as to ensure that issued shares of stock are traded in Russian stock exchanges.

In 2012, \$0,15bn of \$9,5bn public offering transactions took place in the Moscow Exchange. Sberbank of Russia (2.9%) and Megafon (2.3%) made up the two largest public offerings of Russian companies in the volume of shares of stock acquired through applications in the Moscow Exchange¹. In 2013, the Moscow Exchange, VTB, Bank Saint Petersburg, PIK Group of Companies OJSC, Zhivoj Office, ALROSA JSC, and Nomos Bank went public at Rb 194,4bn, or \$5,9bn, in the Moscow Exchange. In most cases, applications were collected in full through the Moscow Exchange. These transactions showed that major public offerings with participation of largest international investors can take place in the internal market.

However, in 2013, the Moscow Exchange failed to cope with a trend towards reduction in the number of listed shares of stock, as well as the number of issues of shares of stock traded in the regulated security market. According to FB MICEX CJSC fin, the number of stock issuers in the exchange contracted from 320 in 2011 to 275 in 2012, or by 14.1%. Based on the data supplied by the World Federation of Exchanges (WFE), the number of companies listed in the Moscow Exchange in 2013 was 262 against 293 companies in 2012, i.e. 10.6% less. According to the Bank of Russia, the number of issues of shares of stock traded in the regulated security market contracted from 467 in 2011 to 361 in 2012, and 353 in 2013.

In 2013, such issuers as PAVA OJSC, Wimm-Bill-Dann Foods OJSC, Transcreditbank OJSC, Energetic Russian Company OJSC, Permskiye Motory OJSC, Vital Development

¹ Kuznetsov I., Ladygin D. Pensions initial public offering. Presidential address to the IPO market. M. Kommersant, January 28, 2013.

Corporation OJSC, etc. left the Moscow Exchange. Despite that the number of Russian companies that left the Moscow Exchange in 2013 was much less than in 2012, the largest Russian trading floor hasn't yet resolved the key goals of its strategic development, i.e. become a market of securities issued by foreign companies. According to a report made by the World Federation of Exchanges, the Moscow Exchange listing included securities of only a single foreign issuer, which is insufficient for implementing the project of establishing an International Financial Center.

The weakness of the Russian stock market is reflected by its low scores in the global competitiveness ranking of the World Economic Forum (WEF) on such criterion as internal stock markets' ability to raise financial resources for the development of national companies (see section 3.6.3). In 2013–2014 Russia was ranked 90th of 148 countries on this criterion. Other BRICS countries – India, Brazil, China and South Africa – were ranked 18th, 48th, 38th, and 2nd respectively on the same criterion in 2013.

3.2.4. Integrating RTS and MICEX exchanges

The MICEX and RTS exchanges were integrated in 2011 through a respective deal. A general meeting of shareholders in June 2012 approved a new name OJSC Moscow Exchange MICEX-RTS or OJSC Moscow Exchange. The integration of the two Russian stock exchanges had a positive impact on the development of the Russian stock market.

The establishment of the integrated stock exchange has allowed settlement depositories of the National Depository Center (NDC) and the DKK Central Depository to be established on the base of the MICEX Settlement Chamber. Pursuant to the Order No. 12-2761/PZ-I of November 6, 2012 of the Federal Commission for Securities Market of Russia, the status was granted to the Non-Banking Credit Organization Closed Joint-Stock Company National Settlement Depository (NSD). The Federal Law of December 07, 2011, No. 414-FZ “On the Central Depository”, which has been in full force since January 1, 2013, provides for opening accounts with the central depository having a special status of registrars of joint-stock companies. The NSD opened such accounts for 1090 issuers by the end March 2013.

The emergence of the central depository has raised substantially the level of confidence of global investors and international settlement systems in the safety of holding assets invested in securities of Russian issuers and the settlements on respective transactions. In particular, the NSD was granted the official status of “eligible depository” under Rule 17f7 under the Investment Company Act of 1940, the U.S. Securities and Exchange Commission, allowing it to be used for holding assets of U.S. largest institutional investors. At present, the NSD has open inter-depository nominee accounts of largest global settlement systems Euroclear Bank S.A./N.V. (Euroclear) and Clearstream Banking S.A. (Clearstream), as well as the central depositories in Armenia, Belarus, Kazakhstan, and Ukraine. Opening in February 2013 accounts of Euroclear and Clearstream with the central depository and commencing respective operations with public securities raised lots of nonresident funds in the OFZ market (more details can be found in section 3.4.1). According to the estimates made by Euroclear Head F. Hannecart, allowing European depositories to open accounts with the NSD could have generate about \$20bn of new investment¹. Euroclear and Clearstream accounts have been open since February 2014 for nonresidents' operations with corporate and regional bonds kept in the NSD. From July 1, 2014 nonresidents' funds will be available for Russian joint-stock companies' shares through the given accounts.

¹ Financial Department. Euroclear. Kommersant, February 7, 2013.

Since February 6, 2013 the NSD has been functioning as depository registering over-the-counter transactions with various financial instruments. The establishment of such entities was envisaged by the decisions made by G-20 in Pittsburg in 2009 as a measure of coping with systemic risks. In 2013, the NSD's equity reached Rb 7,3bn. The value of the securities deposited in the NSD increased from Rb 8,1 trillion in 2011 to Rb 21,8 trillion in 2013.

The Moscow Exchange has another subsidiary CJSC JSCB National Clearing Centre (NCC). The NCC has been carrying out clearing operations in the stock market since November 2011 and in the FORTS market since December 2012. Its core function is provide guarantees to trading participants in all segments of the Moscow Exchange's financial market amid transitioning to a new mode of settlements for market transactions without preliminary depositing, i.e. to T+2. The NCC has a strategic goal of providing participants in different segments of the financial market with an integrated clearing service allowing for the use of a unified collateral and introduction of unified positions of the participants while servicing them in all stock markets of the Moscow Exchange and over-the-counter markets.

Regrettably, despite the fact that principal problems faced by settlements in the exchange market during the crisis in 2008 were associated with defaults on repo transactions, the problem related to the transition of this market segment to settlements through the central counterparty (CCP) still remains to be addressed. The problems of defaults on inter-dealer repo transactions kept occurring on a regular basis in 2013. Nonetheless, the defaults weren't significant enough to be able to bring about a systemic crisis¹.

Repo transactions with the participation of central counterparty (CCP) have been introduced in the exchange since February 2013. Based on the data supplied by the Bank of Russia, volumes of CCP repo transactions gradually increased since June 2013 and by the end of December daily turnover on the foregoing transactions reached Rb 50bn or 12% of total open positions in the inter-dealer repo market. Corporate bonds haven't been used extensively for repo CCP transactions, because discounts on these securities established by the central counterparty were slightly overpriced against the market average. In October 2013, Bank of Russia acknowledged CJSC JSCB National Clearing Centre as the sole qualified central counterparty.

The integration of the RTS and MICEX made it quite simple for market participants to close transactions in the stock market and FORTS market, thereby allowing the entire liquidity to be concentrated on trading participants' accounts which (the liquidity) is intended to carry out transactions in the government securities market and corporate securities market, as well as the FORTS market and foreign exchange market within unified settlement and trading systems. Diversification of the new stock exchange in servicing transactions with different monetary and investment assets enhanced its financial sustainability amid falling trading volumes in stock markets globally and investors fleeing investment in risk-bearing assets.

The integration of the two stock exchanges helped create a team of well-motivated managers who spearheaded a historically unprecedented development project of the Russian stock market.

The following major projects were implemented in the group of the Moscow Exchange in 2013:

- T+2 trading was introduced in the stock market in March;
- the first in Russia foreign exchange-traded investment fund FinEx Tradable Russian Corporate Bonds UCITS ETF was listed in April;

¹ Kuznetsov I., Gaidayev V. Shares steer clear of money. Kommersant, June 6, 2013.

- forts market trading system SPECTRA was upgraded to a new version in May;
- five time contracts on the shares of German companies were introduced in conjunction with Deutsche Borse in June;
- a project of marketplace trading in precious metals was launched in June;
- trading platforms were consolidated on a single technological platform in August.
- the stock market was successfully transited to T+2 in September; all shares were found to be eligible for trading in the T+2 market, namely Russian depositary receipts, investment units of unit investment funds, mortgage participation certificates, foreign exchange-traded funds;
- direct access to the stock exchange in the Moscow Exchange was made available for global banks (Citigroup, Credit Suisse Group, Merrill Lynch and Morgan Stanley) in September;
- lead German issuers' stock futures were adopted in October;
- trading in precious metals was launched in October;
- an agreement on cooperation with NASDAQ OMX was concluded in October;
- centralized clearing in the over-the-counter derivative (OTC) market was launched, a standardized derivatives market was opened in October.

According to Moscow Exchange Deputy Chairman of the Board Andrei Shemetov, it is the transition of trading to T+2 with partial preliminary depositing of assets that was the key infrastructural project 2013 for the entire the Russian stock market¹. Having decided to transit to T+2, the stock exchange made a difficult but adequate choice. Attracting foreign investment to the internal market requires creating such a procedure for settlements that is familiar for foreign investors and recognized by international regulators and reputable expert community². To attract this category of investors to the internal market, the procedure for settlements in the national stock exchanges must meet the generally accepted standards. According to the estimates made by Shemetov A., successful completion of the transition to T+2 settlements helped the market be more reliable, because the NCC acts as CCP on all transactions and guarantor for discharge of obligations; increase liquidity, because the participants are to pay less for closing their transactions; raise international investors' confidence in the domestic market which has undergone the transition to the globally accepted procedure for trading³.

At the same time, the two years after the integration didn't allayed market participants' fears of the effect this event might have on the internal financial market's competitiveness. The integration of the two stock exchanges hasn't eliminated competition between the MICEX and the RTS which has long been the key driver in the development of the stock market.

Factoring in the risk of internal competition loss, it was envisaged during the integration that this factor would be compensated by external competition of the newly established stock exchange with foreign exchanges. In pursuing these aims, the Bank of Russia Financial

¹ Shemetov A. Russian exchange infrastructure: current status and development prospects. Rynki tsennykh bumag, November 2013. Available at <http://rts.micex.ru/n4315/?nt=109>.

² More details on the requirements and evolution of settlements on transactions in global and national stock markets are available in Thomas Murray. Capital Market Infrastructure (CMI) in focus - Equities Settlement Cycles, 2 January, 2013. Published at <http://www.thomasmurray.com/>

³ Shemetov A. Russian exchange infrastructure: current status and development prospects. Rynki tsennykh bumag, November 2013. Available at <http://rts.micex.ru/n4315/?nt=109>.

Markets Service (RFMS) promised to liberalize, in establishing the central depository, the rules for Russian JSCs having access to public offerings in foreign stock exchanges. For this purposes, on August 4, 2011 the RFMS forwarded to the Ministry of Justice of Russia an order which allows a 100% or less, instead of previously allowed 25%, free float of Russian issuers' shares as receipts in foreign stock exchanges. The order was supposed to take effect on the effective date of a federal law regulating the terms and rules of procedure for the central depository, i.e. January 1, 2013. However, this rule was never adopted. Furthermore, a few critical decisions restricting Russian issuers from listing their shares in foreign marketplaces were made prior to IPO.

The key exchange projects in 2013, namely the NSD-Euroclear-Clearstream "bridge", settlements based on T+2, the use of the NCC as CCP, were focused more on creating favorable conditions for foreign market participants, as well as speculators in the domestic financial market. In order to strengthen the positions of Russian infrastructural organizations, the legislator adopted federal laws impeding generation of income on shares and bonds of Russian issuers for nonresidents who invest in shares through depository receipts and refuse to disclose final beneficiaries of shares and bonds of Russian issuers, including OFZ¹. No such projects were implemented in 2013 for domestic institutional investors, private investors who are not after short-term profit. Perhaps, projects designed to attract more domestic institutional and private investors will become major priority for the Moscow Exchange in 2014.

The establishment of the new integrated stock exchange has allowed government agencies to obtain control over the exchange² (see *Table 7*). There were two stock exchanges in the Russian market prior to the integration: OJSC RTS was fully controlled by private shareholders while the state held a 61.1% interest in CJSC MICEX. OJSC RTS ceased to exist as a result of the integration. The state has come to hold 56.1% in the integrated stock exchange. The state-held interest was reduced to 50.3% as a result of Moscow Exchange's IPO which was held in part as additional offering of shares. The state-held interest shrank also because of selling on December 21, 2012 a part of the stock of shares held by Gazprombank to an unknown buyer who, according to a few mass media, might be a strategic investor from China³. The foregoing state-held interest in the Moscow Exchange might be a bit bigger, because at the time of the IPO about 2.69% of the Stock Exchange shares was held by Saint Petersburg Bank and 0.18% by Bank of Moscow controlled by VTB. In 2013, the state control became less visible as a result of state-run banks' transactions, however, based on our estimates, the state still controls the Moscow Exchange through the stock of less than 5% of voting shares held by state-controlled entities.

¹ For example, the adoption of the Federal Law of November 2, 2013, No. 306-FZ "On Introducing Amendments to Parts 1 and 2 of the Tax Code of the Russian Federation and Certain Legal Acts of the Russian Federation" which specifies that if information on beneficiaries, for example on depository receipts, fails to be provided in time, the depository shall withhold tax at 30% (save for the cases when income on such securities is exempted from or subject to taxation at 0%).

² Bank of Russia, Sberbank of Russia, VTB, VEB, Gazprombank, and the Russian Direct Investment Fund (RDIF). A part of the integrated exchange's shares is owned by its 100% subsidiary MICEX-Finance. In our estimates of an interest held by state-run entities in the exchange's shareholding structure we don't include the shares held by the exchange into the state-controlled shares. However, it should be taken into account that given state-run entities' control interest in the exchange, the rights attached to the MICEX-Finance stock of shares are controlled by the state.

³ Rudenko P. A mysterious buyer emerges in the Moscow Exchange. *Kommersant*, December 25, 2012.

Table 7

Russian stock exchanges' shareholding structure prior to and after the integration

	Prior to the integration of the two stock exchanges		After the integration: OJSC MICEX-RTS as of 01.02.2012 ¹	After IPO: Moscow Exchange as of 15.02.2013 – evaluation ²	As of 23.12.2013 ³
	OJSC RTS	CJSC MICEX			
Bank of Russia		28.6	24.3	22.5	24.7
Sberbank of Russia		7.5	10.4	9.6	9.8
VTB		7.1	6.1	5.6	3.6 ⁴
VEB		10.5	8.7	8.0	8.0
Gazprombank		6.2	5.4		
Russian Direct Investment Fund (RDIF)		1.3	1.3	4.6	3.5 ⁵
The share of public entities	0	61.1	56.1	50.3	49.6
MICEX-Finance		2.8	2.8	5.5	6.6
Chengdong Investment Corporation				5.4	5.4
EBRD				5.8	5.8
Other investors	89.0	27.9	32.9	33.0	32.6
Total	100.0	100.0	100.0	100.0	100.0

Source: based on the data supplied by the Bank of Russia, publications in Vedomosti and Kommersant.

The Moscow Exchange's shareholding structure, which only describes certain shareholders with an interest of 5% and more, remains nontransparent for the general public. Such a situation can hardly be regarded as plausible due to its market position and quite reasonable preferences from the state in the field of legislation and through using administrative resources. The significance of the shareholding structure for ensuring state security is acknowledged by the state itself by creating a precedent, when in the summer of 2010 the RFMS Russia and the Federal Security Service of Russia (FSB) blocked an attempt to sell OJSC FB RTS's shares held by KIT Finance to foreign bank EBRD. Through the intervention of security agencies, 11% of RTS's shares were finally purchased by an entity affiliated with MICEX Group. The Bank of Russia also requires that banks disclose a full list of their beneficiaries.

The presence of state-run entities in the management of stock exchanges is negatively regarded in globally acknowledged rankings of country competitiveness. This is, for instance, the main reason why Russia has one the lowest scores on stock exchange efficient management in the global competitiveness ranking of the World Economic Forum (WEF) (see section 3.6.3). According to the stock exchange efficient management ranking in 2013–2014, Russia was ranked 102nd of the 148 countries. Brazil, India, China, and South Africa were ranked 7th, 27th, 63rd, and 1st respectively on the same criteria.

The prevalence of state-run entities in the management of the stock exchange is associated with two groups of risks. First, state-run entities expansion in the market is hard to stop given that it helps them achieve concentration of financial resources in their own hands. Second, especially in the light of creating a mega-regulator, an independent mechanism which can

¹ Mazunin A., Rudenko P., Khvostik E. Stock-exchange capital runs westward. Kommersant, March 13, 2012.

² According to the data as of 16.01.2013 supplied by the Moscow Exchange, as well as information about major shareholders in the Moscow Exchange published in Kommersant's the statistics section on February 18, 2013.

³ OJSC Moscow Exchange MICEX-RTS Quarterly Report for Q4 2013 (see <http://moex.com/a1548>).

⁴ The estimate is based on the RBK's information published on October 31, 2013. VTB bank reduces by 1.5% its interest in the Moscow Exchange Available at <http://top.rbc.ru/economics/31/10/2013/886078.shtml>.

⁵ Prime. January 15, 2014. RDIF sells its 1% interest in the Moscow Exchange. Available at <http://1prime.ru/finance/20140115/775346339.html>.

prevent overgrowth in risk-bearing operations of the Ministry of Finance of Russia and the Bank of Russia, for example in case of unfavorable financial situation in Russia or implementation of a risk-bearing industrial strategy, has been eliminated in the Russian market. The current overgrowth of the foreign exchange market and money market in the Moscow Exchange amid reducing volumes of securities transactions creates risks of self-sufficiency in the stock market and its isolation from the real economy's needs, as was the case which resulted in a financial crisis in 1998.

It therefore is very important to have a well-defined strategy aimed at the Bank of Russia withdrawing from shareholding in the Moscow Exchange and restricting its participation as co-owner in infrastructural organizations. Such a definiteness was shown in 2013. In accordance with Part 14, Article 49 of the Federal Law of 23.07.2013 No. 251-FZ "On Introducing Amendments to the Russian Legislation in Connection with the Transfer of Powers to Regulate and Oversee the Securities Markets to the Central Bank" the Bank of Russia is obliged to withdraw from shareholding in the Moscow Exchange and the St. Petersburg Currency Exchange until January 1, 2016. According to Reuters's estimates, the Moscow Exchange plans an SPO in the first half of 2014 in order to sell an interest held by the Russian Central Bank¹.

Although executive government authorities and the Bank of Russia provided their all-round support to stock market projects, the integration of the two stock exchanges hasn't yet produced a synergetic effect in the form of growing capitalization in the Moscow Exchange. OJSC RTS and CJSC MICEX had a total capitalization of \$4,6bn prior to the integration early in 2011. Early in 2012, according to the estimates of the Bank of Russia and the Board of Directors of the Exchange, Moscow Exchange's capitalization was expected to reach a total of \$6bn by the end of the year². The Moscow Exchange IPO which was held between February 4 and February 15, 2013 resulted in a capitalization of \$4,2bn in the Exchange, less than the total capitalization of the Russian stock exchanges prior to the integration. The lack of any visible progress in increasing capitalization of the Moscow Exchange is determined not only by internal factors, but also some trends prevailing in global markets. Considerable reduction in trading volumes in the major global stock exchanges (see section 3.2.1), their competition with alternative trading systems leads to decrease in the value of stock exchanges. In 2007, NYSE Euronext amounted to \$15,8bn; on November 13, 2013, NYSE Euronext was taken over by Intercontinental Exchange (ICE) at a total of only \$10,2bn. NASDAQ shares lost from \$49,49 in 2007 to \$39,80 in 2013, or 19.6% of their market value. The German Stock Exchange dropped 48.4%, whereas the London Stock Exchange advanced only 5.6% during the same period.

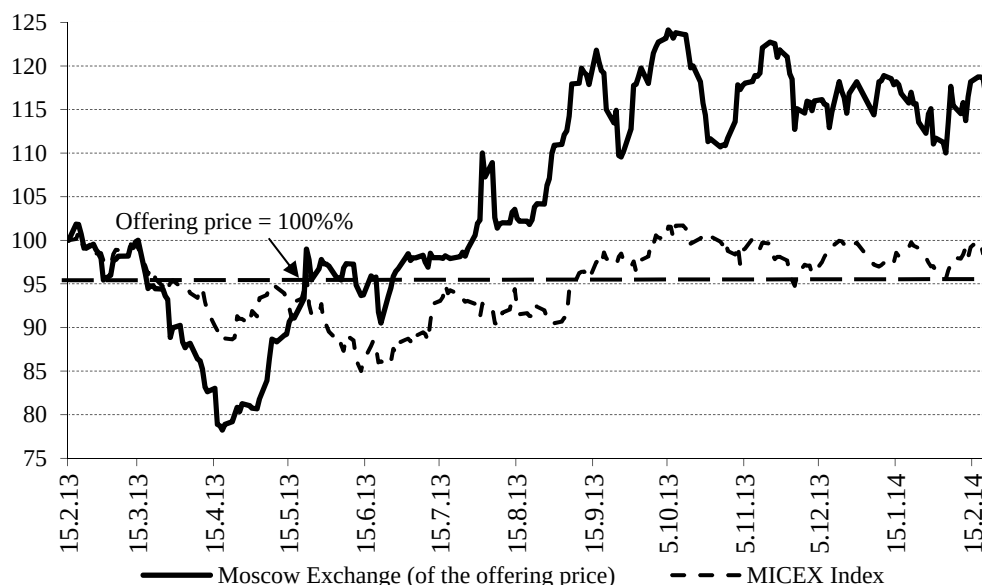
In the period of February 4 thru February 15, 2013, the Moscow Exchange held an IPO which yielded Rb 15bn, or \$500m. Although the price was announced within a range of Rb 55–63 per share, the actual price was established at the bottom of the price range, i.e. Rb 55 (see *Fig. 11*). According to mass media, state-run Chinese Investment Company (CIC), foundations such as OppenheimerFunds and BlackRock, and a lot more foreign foundations from Germany, Scandinavian countries, Great Britain, the United States, and Asian countries³ participated in the IPO.

¹ According to the information supplied by RBK on October 31, 2013.

² Interfax-AFI. Stock Exchange apprises itself prior to IPO. Kommersant, March 26, 2012.

³ Trifonov A., Papchenkova M., Kamneva G. Global guests in Moscow. Vedomosti, February 15, 2013.; Shlygin I. Chinese IPO. RBK-daily, February 15, 2013]; Gaidayev V., Kuznetsov I. Club IPO. February 15, 2013.

In the first trading day, on February 15, 2013, underrating of the stock exchange shares against the offering price was 0%. Small size of underrating of the first trading day during Russian JSC's IPO is indicative of overrating of the shares at the moment of IPO. Later it may often result in negative excess return on the shares against the base index for many years¹. However, long-term yield of the stock exchange shares outstripped steadily the yield of the MICEX Index a year after the IPO.



Source: the author's estimates based on the data supplied by the Moscow Exchange and Finam Investment Company.

Fig. 11. Dynamics of the prices of the Moscow Exchange shares and the MICEX Index in the period of February 15, 2013 thru February 22, 2014 (15.02.2013 = 100%)

Aggressive programs supporting these shares by the Exchange itself and state-run banks facilitated positive dynamics of the Moscow Exchange shares after the IPO. VTB Capital was acting as stabilization agent within the first month from the public offering and which within 30 days could repurchase shares in the market at a current price in order to sell them through option back to MICEX-Finance. According to the estimates available through mass media, VTB Capital repurchased in the market about Rb 1,5bn of Rb 6bn generated from the sell of MICEX-Finance shares in order to subsequently resell them back to the Exchange's subsidiary². Upon the completion of this period, the market value and liquidity of the shares were maintained by the Exchange itself and through a program maintaining liquidity in the stock market, as well as a repurchase program implemented by the Moscow Exchange on the basis of a resolution issued at the general shareholders meeting on November 14, 2013. According to the Exchange announcement made on February 21, 2014, the shares repurchased by MICEX-Finance LLC are planned to be repurchased, whereby an interest held by the existing shareholders and return on investment will be increased.

¹ Abramov A. E. Russian companies' problems with IPO-SPO. Economic and political situation in Russia. Gaidar Institute for Economic Policy, No. 10, 2012, pp.58-54.

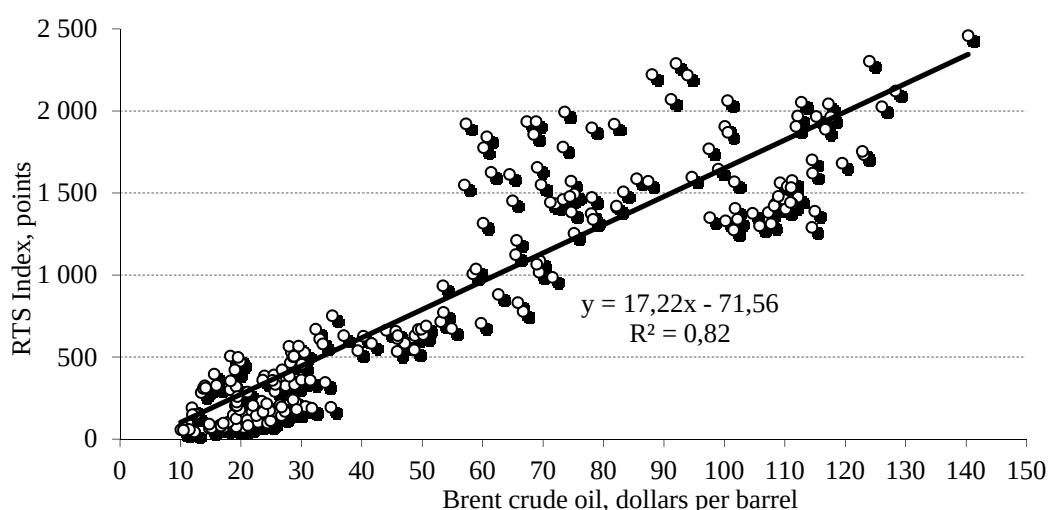
² Orlova Y. Very free floating shares. Kommersant, March 18, 2013.

The integration of IT, trading and settlement systems is a slower process against legal and administrative integration of the two exchanges. This problem manifested itself through serious technical failures that occurred in the Russian stock exchanges in the period of 2011 thru 2012¹. In 2013, the Moscow Exchange completed the process of consolidation of trading platforms in the stock market, foreign exchange market, and FORTS market into a single technological site, i.e. the M1 Data Processing Center. However, the Exchange failed to cope with all possible technical failures in 2013. Foreign exchange trading in the UTS was suspended because of a technical failure on February 21, 2013, another technical failure occurred on April 23 in the foreign exchange market. A 1-hour technical failure occurred in the FORTS market on November 13, 2013.

3.3. Russia's stock market

3.3.1. Stock market's dependence on global price movement

It is well known that the stock market of Russian shares' depends largely on crude oil prices. The determination coefficient (R^2) between absolute monthly values of the RTS Index and Brent crude oil prices in the period of September 1995 thru January 2014, as shown in Fig. 12, is 0.82, being indicative of a very close relationship between these indicators.



Source: estimated based on the data supplied by the IMF International Financial Statistics (IFS) and the Moscow Exchange.

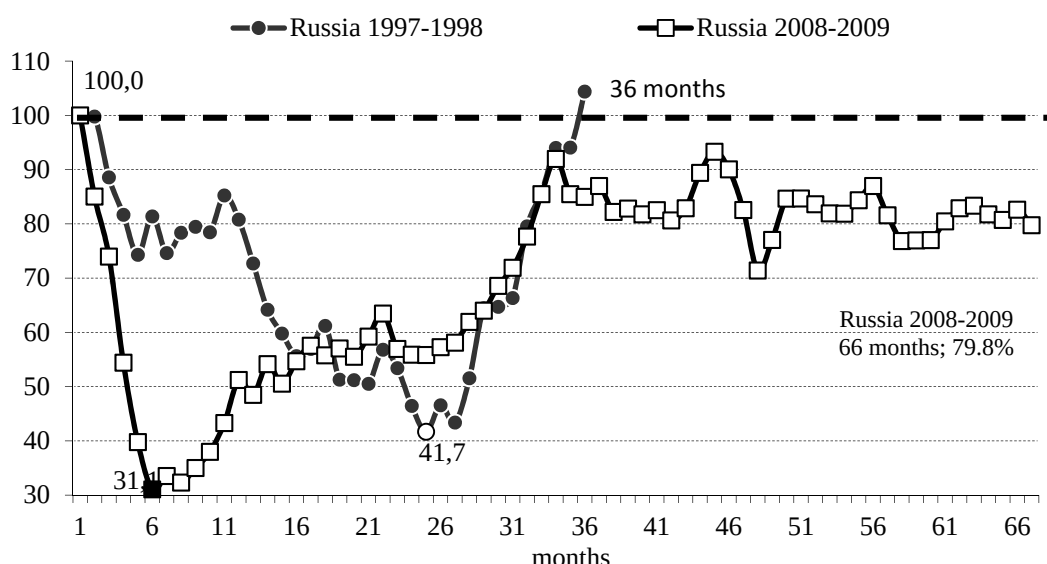
*Fig. 12. Relationship between the RTS Index and Brent crude oil prices
in the period of September 1995 thru January 2014.*

Based on the forecasts of international financial institutions and the Ministry of Economic Development of Russia, no serious growth in crude oil prices is anticipated in the short-run period. This is determined by both moderate demand for crude oil amid slowdown in the global economy and introduction of power-saving technologies, and the development of new technologies in the production of mineral resources, in particular shale oil and gas.

According to a reference scenario of economic growth in Russia in the Long-term Socio-Economic Development of the Russian Federation until 2030 (the 2030 Forecast), only in 10

¹ For more details see our bulletin *Russian economy in 2012: Trends and outlooks (Issue 34)*, M.: Gaidar Institute, 2013, pp. 140-141.

years, by 1923, crude oil prices Urals are expected to reach \$127 per barrel, i.e. the pre-recession peak which was observed in June 2008. This forecast is supported by actual data, as shown in *Fig. 13*. Unlike the crisis in 1997–1998, when crude oil prices rebounded within 36 months, prices have managed to reach only 79.84% of the pre-recession peak within 66 months. Furthermore, crude oil prices have been remaining at a relatively stable level for 22 months to date.



Source: based on the data supplied by the IMF International Financial Statistics (IFS).

Fig. 13. Fall and rebound of Brent crude oil prices during financial crises in Russia (price peak =100%) as of January 2014

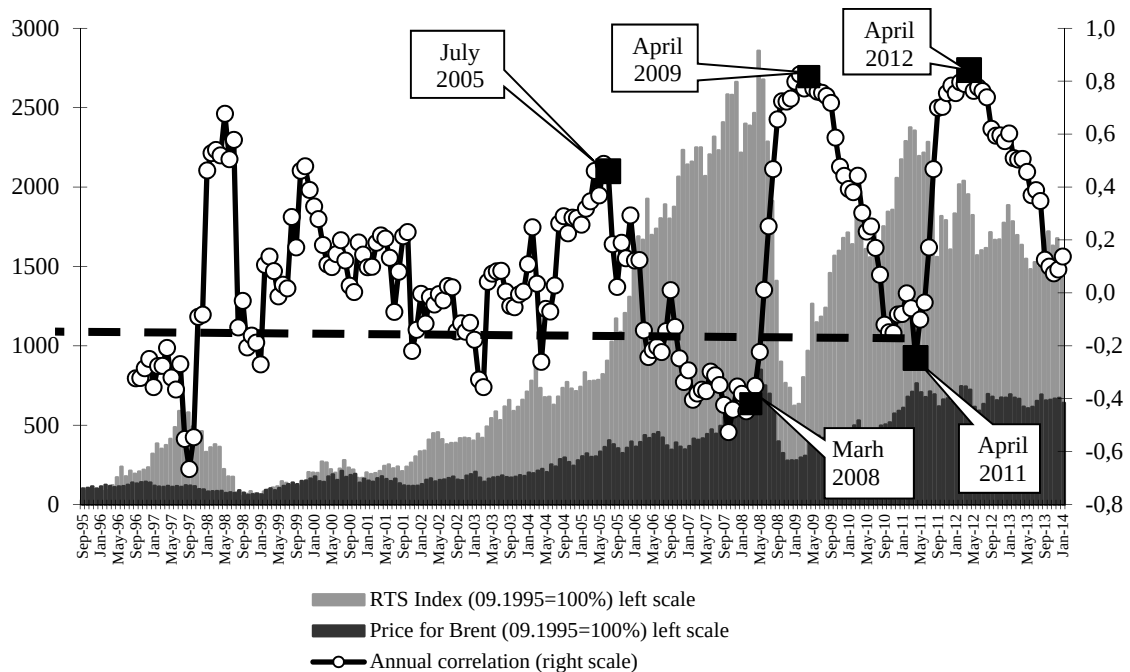
The relationship between stock indices and crude oil prices is better described by analysis of relative changes to the same. *Fig. 14* shows the results of changes to the correlation coefficient between monthly relative changes to the RTS Index and Brent crude oil prices within 12-month period. The moving correlation curve has a peculiarity which reflects strengthening or weakening of the relationship between the two indicators with a 1-year lag.

The correlation curve of changes to the RTS Index and crude oil prices is cyclic. As the index moves towards its pre-recession peak, the correlation coefficient declines and becomes negative. This means that crude oil prices and the index unexpectedly began to change in opposite directions. Positive correlation between changes to the index and crude oil prices rebounded during a meltdown in the stock market. Correlation tended again to minus unity upon the completion of recession acute phases.

The correlation curve dynamics over the recent decade has shown six periods:

- between the beginning of the 2000s and July 2005, when the correlation coefficient advanced from –0.2 to 0.5, crude oil prices and the RTS Index were growing in the same direction;
- between July 2005 and April 2008, when the correlation coefficient declined from 0.5 to –0.5, crude oil prices and the RTS Index advanced overall, however oil quotations declined in H2 2006 and H1 2007;

- between April 2008 and April 2009, when the correlation coefficient advanced from -0.5 to 0.8 , it was a period of collapsing prices of crude oil and JSC's shares;
- between April 2009 and April 2011, the correlation coefficient fell from 0.8 to -0.2 , crude oil prices increased moderately, and the RTS Index saw a drastic rally;
- between May 2011 and April 2012, when the correlation coefficient increased up to 0.8 while prices of crude oil and Russian JSC's shares went down;
- between May 2012 and January 2014, when the correlation index dropped again to 0.1 : the RTS Index mostly declined, and crude oil prices remained stable.



Source: estimated based on the data supplied by IFS IMF and MICEX-RTS.

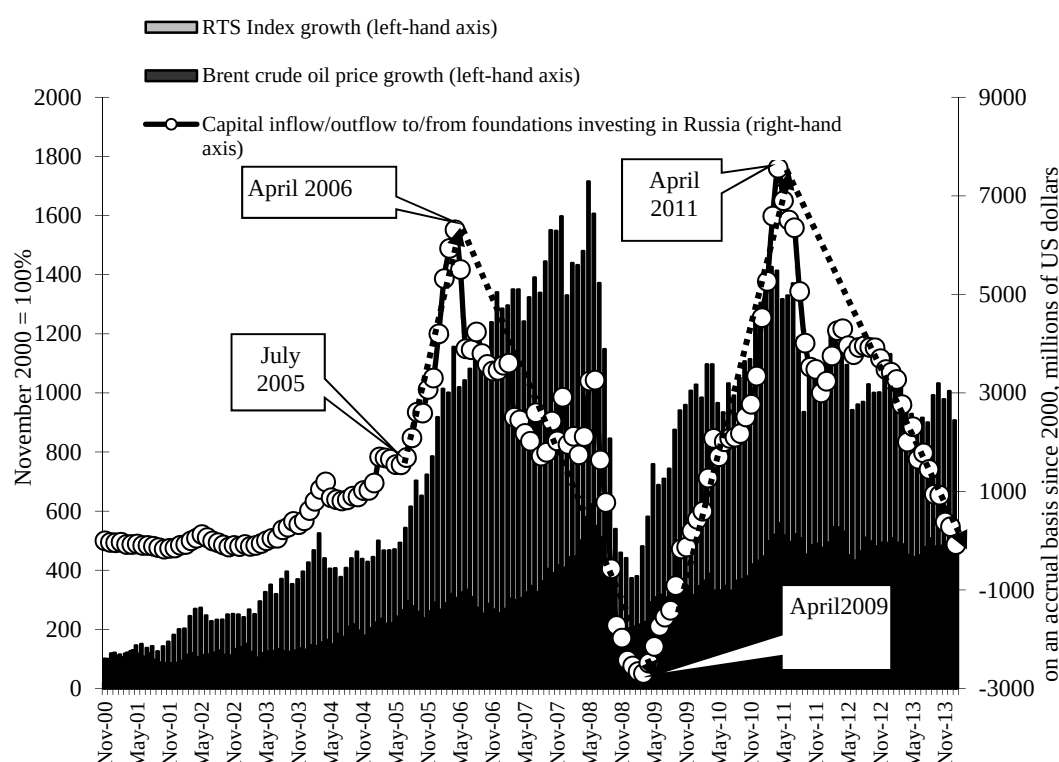
Fig. 14. Correlation between changes to the RTS Index and Brent crude oil prices in the period of September 1995 thru January 2014

3.3.2. Stock market's dependence on foreign portfolio investors

The cyclical nature of the correlation of changes to prices of crude oil and Russian companies' shares can be explained by a strong effect of outflow/inflow of foreign portfolio investments recorded by the Emerging Portfolio Fund Research (EPFR) on the dynamics of prices of stock of shares¹. This factor is highly competitive with the dynamics of crude oil

¹ The EPFR's data on inflow/outflow of money to/from foreign foundations specializing in investment in Russia can be regarded as indicator of investment behavior of major foreign portfolio investors including global and regional foundations. The portfolios of special-purpose foundations account for, according to our estimates, about 50% of the investment in Russia from regional and global investment foundations. If investors of a special investment foundation, for example, withdraw their investment from the foundation, it implies no capital outflow from Russia. Capital outflow happens when the foundation begins to sell out its investment in Russian JSCs' shares in order to discharge its obligations to the investors. Where global and regional foundations see a cash outflow, it is impossible to quantitatively evaluate the effect of such operation on the reduction of investments of such foundations in Russian companies' shares which generally account for a small part of the portfolio.

prices in terms of having impact on prices of Russian issuers' shares, as evidenced by the data presented in *Fig. 15*.



Source: estimated based on the data supplied by IFS IMF, the Moscow Exchange and EPFR.

Fig. 15. Growth in the RTS Index and Brent crude oil prices, cash inflow/outflow to/from foundations investing in Russia, as calculated on a cumulative total in the period of November 2000 thru January 2014

Getting back to the aforementioned six periods during which the nature of relationship between changes to the RTS Index and dynamics of crude oil prices, analysis of investment foreign foundations specializing in investment in Russia allows this phenomenon to be explained.

Growth in the correlation coefficient index and crude oil prices between the beginning of the 2000s and July 2005 was associated with the fact that within that period both factors effecting the dynamics of the stock market – crude oil prices and cash inflow to foreign foundations investing in Russia – moved in opposite directions. Crude oil prices increased, portfolio investment saw cash inflow, the RTS Index grew steadily. It is shown in *Table 8* that special-purpose foundations received \$1,5bn of investment funds in the period of November 2000 thru June 2005.

The correlation coefficient declined to -0.5 in the period of July 2005 thru April 2008 in response to opposite dynamics of crude oil prices and foreign portfolio investments. In the period of July 2005 thru April 2006, foundations investing in Russia received \$4,8bn of new investments despite growth in volatility of crude oil prices (see *Table 8* and *Fig. 15*). An

Nonetheless, if foundations specializing in investment in Russia see a cash outflow, it is most likely that global and regional portfolio investors reduce their investment in Russia.

upsurge of short-term investment inflow can be explained by investment rankings international agencies awarded for Russia. FITCH published its ranking on November 17, 2004 and S&P on January 31, 2005. However, a sharp turnaround in preferences of those who invested through foreign foundations was recorded in the period of April 2006 thru April 2008, when foundations investing in Russia saw an intensive cash outflow despite steady growth in crude oil prices. The RTS Index slowed down significantly in response to portfolio investment outflow against a sweeping increase in crude oil prices.

In the period of April 2008 thru April 2009, the correlation coefficient increased up to 0.8 in the period of stock market meltdown. At that time collapse in crude oil prices was accompanied by accelerated withdrawal of money from foreign foundations investing in Russia. Therefore the RTS Index dropped at the same period.

The correlation coefficient of the RTS Index and crude oil prices dropped again to –0.2 in April 2009 thru April 2011 in response to that outgrowth in the RTS Index was based mostly on active cash inflow in foreign foundations against a moderate growth in crude oil prices. Foreign foundations received \$10,2bn of new investment at the same period.

The correlation coefficient index and crude oil prices recovered in the period of May 2011 thru April 2012, because the factors of crude oil prices and foreign investment resumed to move in the same direction. Crude oil prices declined and investors withdrew their investments from investment foundations. The correlation disappeared in the period of May 2012 thru January 2014, because crude oil prices remained stable while investment foundations kept seeing cash outflow. In the period of May 2011 thru January 2014, the RTS Index itself a downtrend following the withdrawal of funds from foundations investing in Russia.

Table 8

**Inflow/ outflow of money to/from foreign foundations investing
in Russian shares, based on EPFR's data**

	Inflow (+)/ outflow (–) of money from foundations, millions of US dollars
November 2000 thru June 2005	1 538
July 2005 thru April 2006	4 769
May 2006 thru March 2009	–9 005
April 2009 thru April 2011	10 255
May 2011 thru January 2014	–7 640

Source: the estimates are based on the data supplied by EPFR.

The graph of variance in accumulated cash flows at foreign foundations specializing in investment in Russia (see *Fig. 15*) shows that principal changes to the behavior of foreign investors took place in May 2006 and in May 2011. As seen in *Table 6*, special-purpose foreign foundations saw an outflow of funds of \$9,0bn in May 2006 thru March 2009 and \$7,6bn in May 2011 thru January 2014. Even though these assessments were doubled given a possible similar behavior of asset managers at regional and global foundations which reduced their investment in Russia, it appears that shock changes to prices of shares in the Russian market can result in gradual withdrawal of sums equal to a 1–2-day stock trading volume in the Moscow Exchange.

IMF's experts explained in the IMF Financial Stability Report, September 2011, the factors which predetermine adverse changes to the behavior of global portfolio investors in emerging markets¹. The experts used the EPFR's data collected within the period of January 2005 thru

¹ IMF. Financial Stability Report. September 2011, pp. 11-18. Available at www.imf.org.

May 2011 on cash flow of special-purpose investment foundations worldwide, namely in Asia, Latin America, Europe, Middle East, and developed economies. The report shows that most influential factors with a significance of 1% on cash inflow to investment foundations were found to be:

- official forecasts of real GDP¹ growth rates (marked with a “+”);
- volatility of GDP growth rate forecasts (marked with a “–”);
- volatility of foreign exchange rates (marked with a “–”);
- stock market volatility indicator – VIX index (marked with a “–”).

Indicators of interest rates and strictness of foreign exchange regulation were found to be among less significant factors.

The foregoing factors can be regarded as forward-looking indicators of financial crises which are used by managers of portfolio investment foundations specializing in investment in specific markets. The results of the IMF's study shows that the hardest shock in terms of maximum cash outflow (\$4,4bn) from foundations investing in countries located in Europe, Middle East, and Africa, occurred exactly in June 2006. It is in this month, as shown in *Fig.15*, when investors of foundations investing in Russian JSCs' shares began to move backward. Under the circumstances, a trend towards cutting the GDP growth forecast in the second half of the year in the most significant developed and developing economies² which was recorded by the IMF World Economic Outlook (WEO), April 2006, as well as VIX index³ perturbances beginning with Q2 2005 might serve as signals for withdrawal from portfolio investment. Upsurges in volatility of forecasts of GDP growth rate and prices of shares reflected experts' and market's concern about disproportions in countries' trade balance, mounting crisis in the U.S. mortgage securities market, and other factors which eventually resulted in the recession of 2008.

These studies help understand a relatively simple model of behavior of those who invest in foreign foundations specializing in investment in the Russian stock market. By investing in Russia, they are aiming to enter the market when the price of local companies' shares is low and timely leave the market at first signs of falling crude oil prices and devaluation of the ruble. They receive signals from, for example, the Consensus Economics information system which makes consensus projections of certain key macroeconomic and financial indicators of various countries with a 24-month depth (two years) based on the forecasts of analysts at major investment banks. The GDP growth forecast is the most significant one. The moment of significant changes to the forecast for the current year or the year to come is a signal of a new trend in the behavior of investors. For example, if forecasts show a substantial decline, investors begin to withdraw their funds from foundations investing in Russia. Investors' behavior will change as soon as they receive a signal of potential increase in economic growth in Russia and the major developed countries. This creates the cyclic nature of the behavior of unit-holders of foreign foundations investing in Russia, as clearly seen in *Fig. 15*.

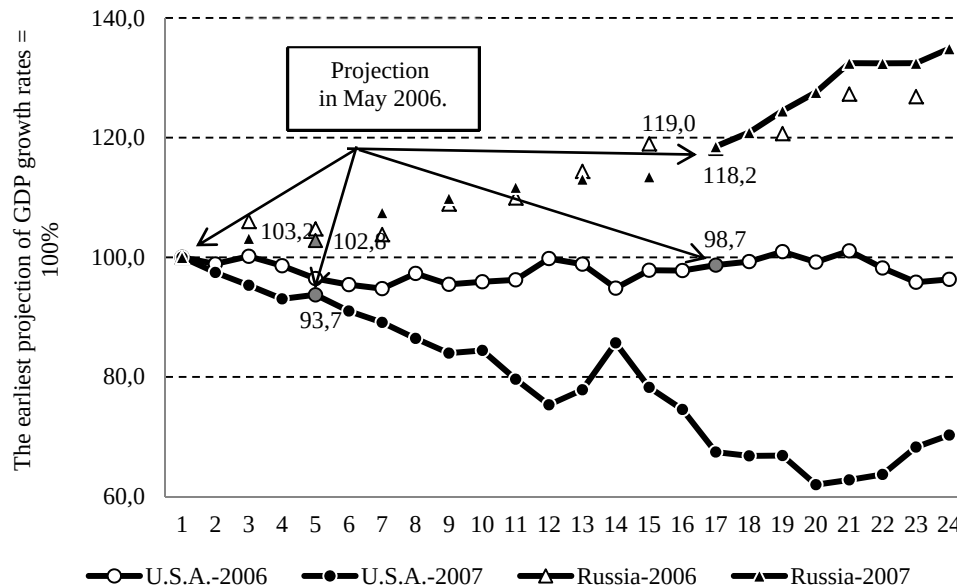
An illustration of the effect of Consensus Economics' data on foreign investors decision-making to withdraw their funds from foundations investing in Russia in May 2006 is shown

¹ GDP growth and volatility projections were calculated on the basis of the data available at the Consensus Economics database.

² World Economic Outlook (WEO), April 2006, Fig.1.8. Available at www.imf.org.

³ It is shown in R. Rajan. *Lines of Fracture* (M., Delo Publishing House, 2011, p. 272) that between Q2 2005 and Q2 2007 the two-year implied volatility of S&P500 option price – market expectations of volatility in prices of shares for two years – was 30-40% higher than short-term one-month volatility.

in Fig. 16 which presents the information on GDP growth forecasts in the United States and Russia from the foregoing analytical resource which was available for investors in May 2006. In this case, the earliest GDP growth forecast for 2006 and 2007 was taken as 100%. Each of the four curves has an arrow showing the point of the latest projection for 2006 and 2007 which was available for users in May 2006. The curve segment to the left of the point shows the values of the projection available for users in May 2006. Monthly projections issued after the date under review are shown to the right of the marked point. Furthermore, projected values on Russia were normally edited every two months within the specified periods.



Source: the estimations are based on the data supplied by Consensus Economics.

Fig. 16. Changes to analysts' consensus projections for GDP growth in 2006 and 2007

The data presented in Fig. 16 shows that it was only the curve representing U.S. economic growth projection in 2007 that worsened of the four other curves. Perhaps, it was these projections of U.S. economic growth in 2007 that injected most pessimism in those who invested in foundations investing in Russia. Slowdown in U.S. growth rates threatened the same downtrend in other regions, reduction in the demand for raw materials, fall in crude oil prices, reduction in hard currency proceeds and therefore devaluation of the ruble in Russia. By May 2006 the projection for U.S. economic growth had been worsening for four consecutive months, and this was enough to make investors withdraw their funds from foundations operating in emerging markets. Further worsening in U.S. growth forecasts for 2007 (a fragment to the right of the marked point in the "U.S.A.-2007" curve) after May 2006 made investors even more pessimistic, urging them to withdraw their funds from investment foundations.

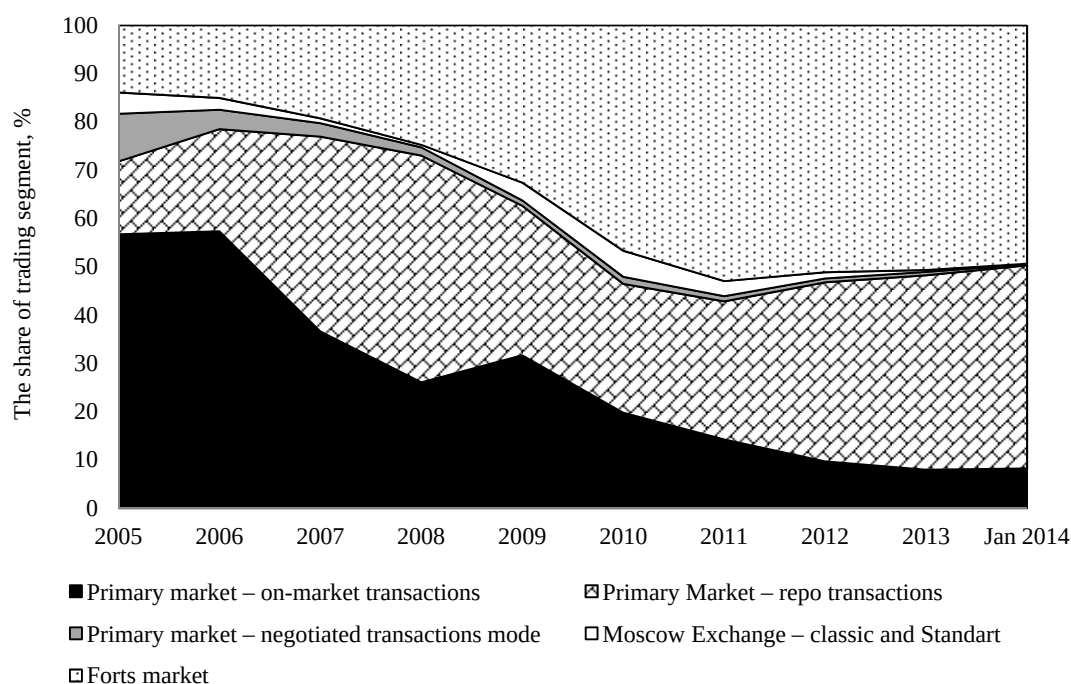
Interestingly, withdrawing their funds from foundations investing in companies of European countries including Russia, Middle East, and Africa, in June 2006 global portfolio investors demonstrated miracles of far sightedness, being far advanced of the boldest financial crisis prophets. Professor N. Roubini's famous statement on impending mortgage crisis at IMF conference wasn't made public until September 2006. At a conference in Davos (Switzerland) in February 2008 Finance Minister of Russia A. Kudrin asserted that the Russia

will remain a safe heaven amid world financial crisis. In her interview given as part of a film (*Inside Job*) directed and released by Charles Ferguson in 2010, Kristin Lagarde, incumbent Managing Director of IMF, confessed that it was not until February 2008 that she actually began to see an impending crisis when she attended as Minister of Economy and Finance Minister of France a G7 summit at which U.S. Secretary to the Treasury D. Poulsen stated that “we have everything under control”.

However, foreign investors began to fleeing Russia and other developing countries as early as May 2006. Today the reason for such a far sightedness of foreign portfolio investors vs. the most prominent stock market experts and representatives of monetary authorities seems to be more evident. What the foregoing indicators showed in 2012 will be shown in the section describing stock market risks.

3.3.3. Stock market segments in the Moscow Exchange

Fig. 17 and *Table 9* show changes to the structure of various trading modes in Russian stock exchanges, including transactions in the FORTS market. Significance of most market-oriented segments of the exchange market has been declining for two years since the integration of the two stock exchanges in December 2011, while the only market segment showing a steady growth has been repo transactions.



Source: the author's estimates based on the data supplied by Russian stock exchanges

Fig. 17. Market structure in the Moscow Exchange in the period of January 2005 thru January 2014.

The share of on-market stock transactions shank from 14.3% in 2011 to 9.7% in 2012 and 8.0% in 2013. The share of transactions in the FORTS market declined from 53.0% in 2011 to 51.1% in 2012 and 50.7% in 2013, being a seriously adverse factor, because it is on-market (anonymous) transactions that reflect the effectiveness of the stock exchange as pricing center, and serve as the basis for making fair prices of financial assets. The share of such

market segments as Classic and Standart, which advanced at a fast rate in the RTS prior to the integration, are currently close to zero, which can be explained by the establishment of a unified settlement regime for T+2 transactions in the Moscow Exchange. Only the repo market share showed a steady growth from 28.6% in 2011 to 37.1% in 2012, and 40.3% in 2013.

Table 9

**Stock market structure in the Moscow Exchange in January 2005 thru
January 2014**

	2005	2010	2011	2012	2013	2014 – Jan.
Primary market – on-market transactions	56,7	19,8	14,3	9,7	8,0	8,2
Primary market – repo transactions	15,1	26,7	28,6	37,1	40,3	42,1
Primary market – negotiated transactions mode (NDM)	9,8	1,5	1,1	0,8	0,7	0,2
Moscow Exchange – Classic and Standart	4,4	5,4	3,1	1,3	0,4	0,1
Forts market	13,9	46,7	53,0	51,1	50,7	49,4
Total	100,0	100,0	100,0	100,0	100,0	100,0

Source: the author's estimates based on the data supplied by Russian stock exchanges.

In 2013, the share of (anonymous) stock market transactions in the Moscow Exchange accounted for 13.7% (see *Fig. 18*), being almost similar to the level recorded in 2012. The share of repo transactions reached 85.5%. In the stock market brokers use repo transactions for realizing risk-bearing strategies aimed at fundraising to maintain liquidity and margin lending to their customers. According to the estimates available in mass media, it is arbitrage in the repo stock market that was a key reason for the issues faced in 2012 by Renaissance Bank, a large Russian investment bank, which led to the replacement of its control interest shareholder¹.

The principal reasons for a small share of market transactions in the Moscow Exchange in 2013 are associated with that shares of Russian issuers don't seem to look appealing to foreign portfolio investors, as well as limited internal sources of liquidity because of undeveloped institutional investors (pension and investment funds, insurance companies). These Russian stock market's weaknesses were even worsened by freezing investment of new 2013 pension accruals and "moratorium" on pension accruals in 2014. Relatively big volumes of the repo stock market were maintained, because this market serves as mechanism of redistribution at the level of smaller participants of the liquidity which large state-run banks received from the Bank of Russia through repo transactions.

A small share of market transactions leads to risks of manipulation with prices of shares which are used for calculating stock indices and other underlying assets for the Forts market. The share of stock market transactions in the Moscow Exchange in 2013 could have been less than 13.7% without such a mechanism as the liquidity maintenance program in the stock market with T+2 settlements providing for a part of the transaction fee charged on 31 issues of shares to be returned to brokers. According to experts' estimates, market makers' turnover accounts for 15% to 20% of stock transactions T+2². In 2013, the support program absorbed about one fourth of the fee initially paid by brokers to the exchange³.

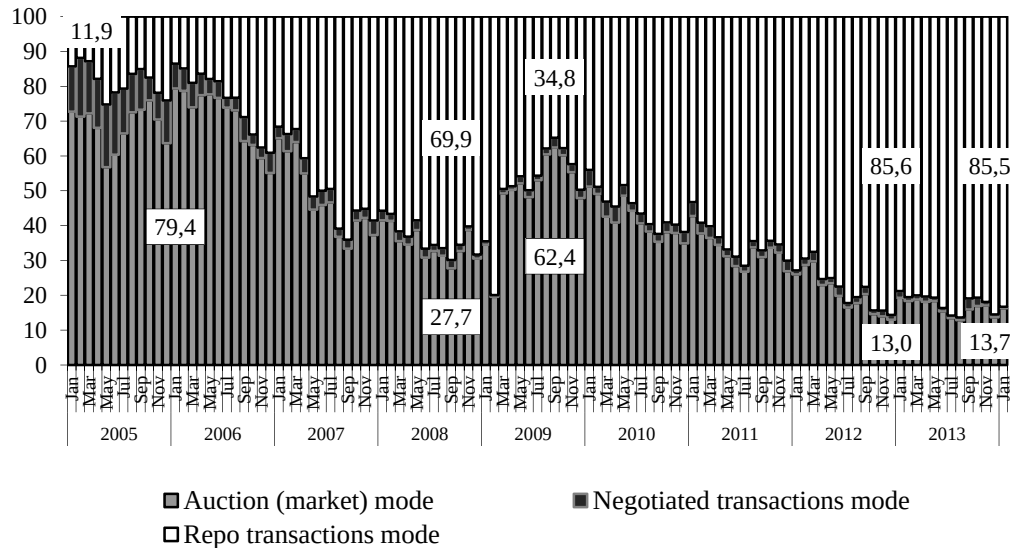
As shown in *Fig. 19*, in 2013 the number of market transactions in the Moscow Exchange and the average size of a transaction remained at the level recorded in of 2012, being

¹ Tofanyuk E. To walk in Africa. *Forbes*, No. 1 (106), 2013, pp.100-101.

² Orlova Y., Kazmin D. Moscow trags trading from London. *Vedomosti*, December 10, 2013.

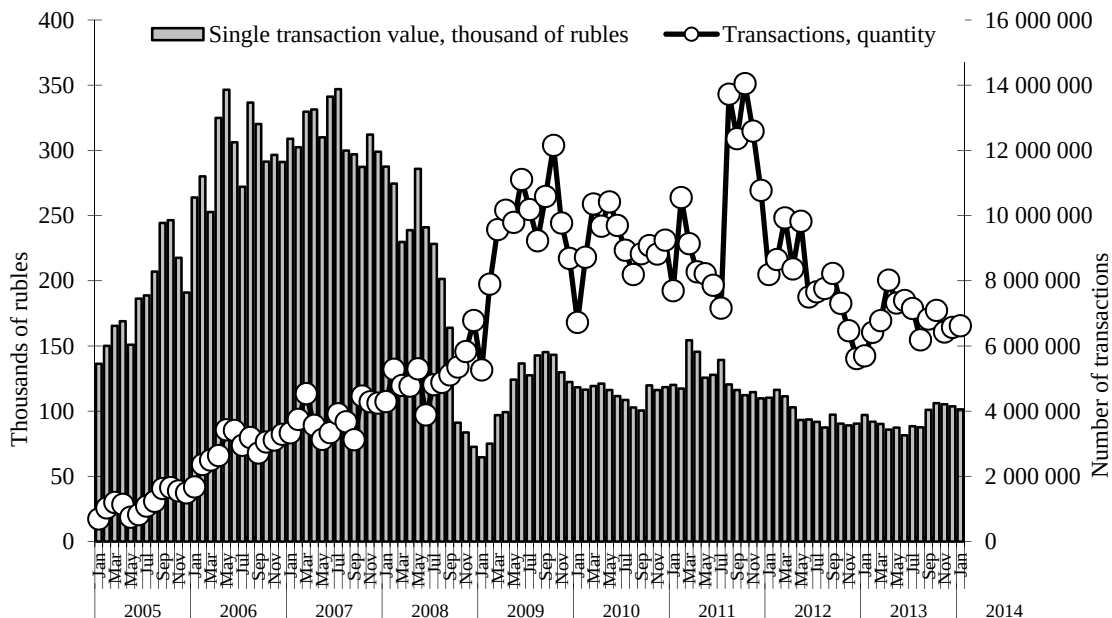
³ Kuzntsov I., Gaidayev B. A quarter-of-one fee. *Kommersant*, August 25, 2013

indicative of temporal overgrowth of high-speed trading in the Exchange, which resulted in growth in the number of transactions prior to 2012. At the same time, stable indicators of the number of transactions and the size of a single transaction is indirectly indicative of no sweeping changes in 2013 in the intensity of participation of internal and foreign institutional investors in trading, because their entering the market would, other conditions being equal, mean growth in the average volume of transactions.



Source: the author's estimates based on the data supplied by the Moscow Exchange.

Fig. 18. Structure of stock transactions in the Moscow Exchange's primary market, %



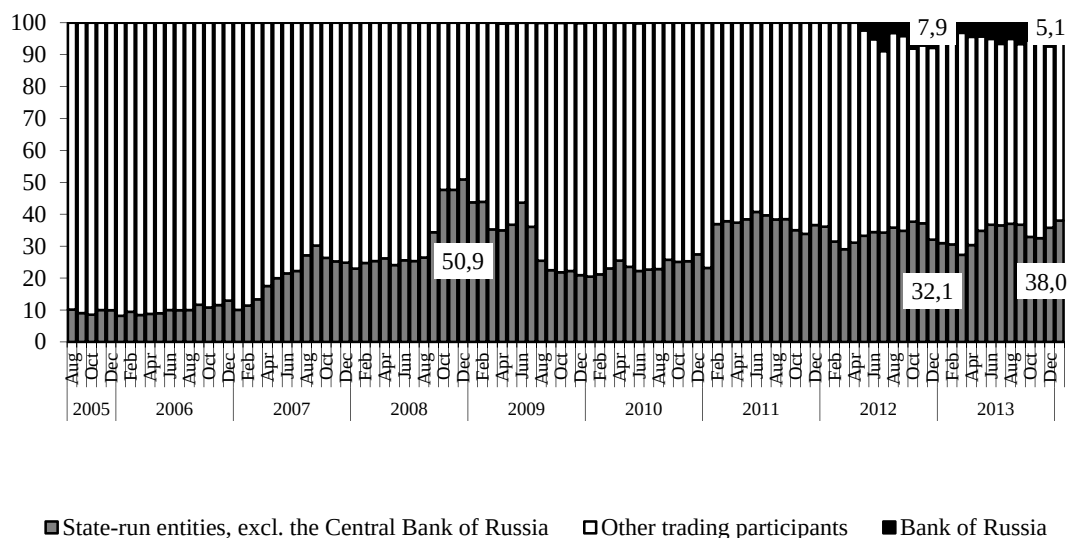
Source: the author's estimates based on the data supplied by the Moscow Exchange.

Fig. 19. Stock transactions in the Moscow Exchange's primary market

3.3.4. Competition between the internal stock market participants

In 2013, state-run entities kept strengthening their position in the stock market, being manifested by growth in the share of state-run financial organizations in stock trading volumes, increasing their role in managing the Moscow Exchange, expanding the powers vested with the Bank of Russia and the Ministry of Finance of Russia in the field of regulation and compliance monitoring.

Fig. 20 presents the results of stock transactions in the Moscow Exchange's primary market the Bank of Russia, state-run banks and related entities¹. This market segment saw a visible growth in activity of public players during the acute phase of the crisis, September 2008 thru July 2009. In December 2008, the share of state-run entities in the volume of stock market transactions increased to 50.9%, which was mostly determined by the fact that a few major participants (KIT Finance, Svyazbank) were facing financial problems and fell under control of state-run banks, as well as Vnesheconombank implemented a stock market support program financed with Rb 175bn received on a repayable basis from the National Wealth Fund. When the market was recovering, the share of state-run banks and their subsidiaries and affiliates in the volume of stock market transactions declined, but resumed growth in February 2011, reaching 36.1% in December 2011, which can be explained by Sberbank of Russia acquiring Troika Dialog (Sberbank CIB), an investment company. In 2012, the share of state-run financial organizations didn't increase, however the Bank of Russia entered the stock market in May 2012, accounting for 7.9% of the value of transactions in December 2012. In December 2013, the share of state-run financial organizations increased to 38.0%, while the share of Bank of Russia stood at 5.1%.

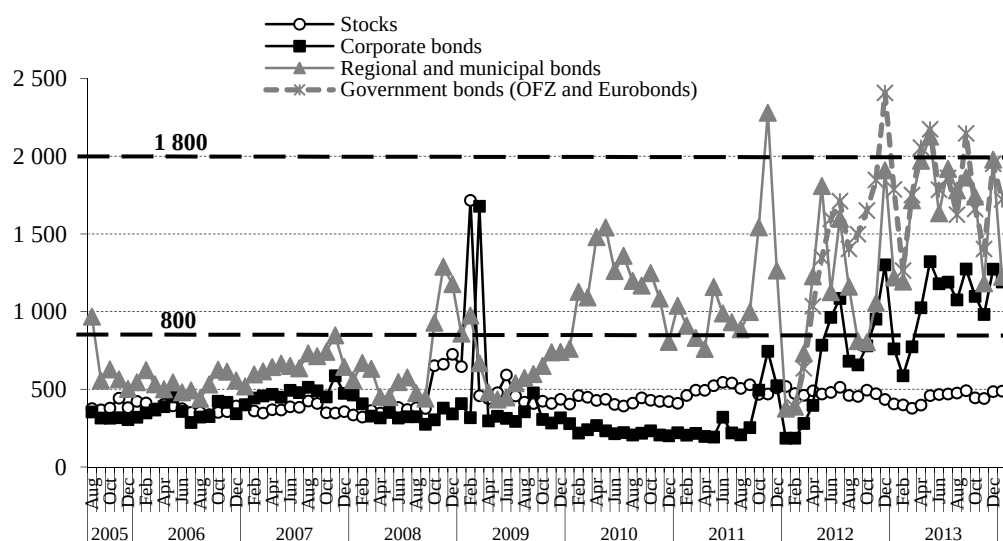


Source: the author's estimates based on the data supplied by the Moscow Exchange.

Fig. 20. The share of private and public brokers in stock trading volumes in the Moscow Exchange, %

¹ Vnesheconombank, VTB, VTB Capital, VTB24, Gazprombank, Sberbank, KIT Finance, Svyazbank, Bank of Moscow, Transcreditbank, and Sberbank CIB since 2011.

In 2013 in the Moscow Exchange saw deteriorating anti-monopoly characteristics of the corporate bond market and government securities market. The stock market concentration characteristics remained unchanged against 2012, whereas they degraded slightly for the regional bond market, as shown in the data presented in *Fig. 21*, describing the dynamics of the Herfindahl-Hirschman Index (HHI)¹ by market segment in the Moscow Exchange in the period of January 2005 thru January 2013. According to the estimates of the Federal Antimonopoly Service (FAS), the market is low concentrated if HHI being less than 800, moderately concentrated if $800 < \text{HHI} < 1800$, and highly concentrated if HHI is more than 1800². HHI on transactions in the Moscow Exchange's primary stock market was stable at about 500, i.e. this market segment was low concentrated throughout the entire 2013.



Source: the author's estimates based on the data supplied by the Moscow Exchange.

Fig. 21. Herfindahl-Hirschman Index: on the volume of secondary stock trading in the Moscow Exchange's primary market (all modes).

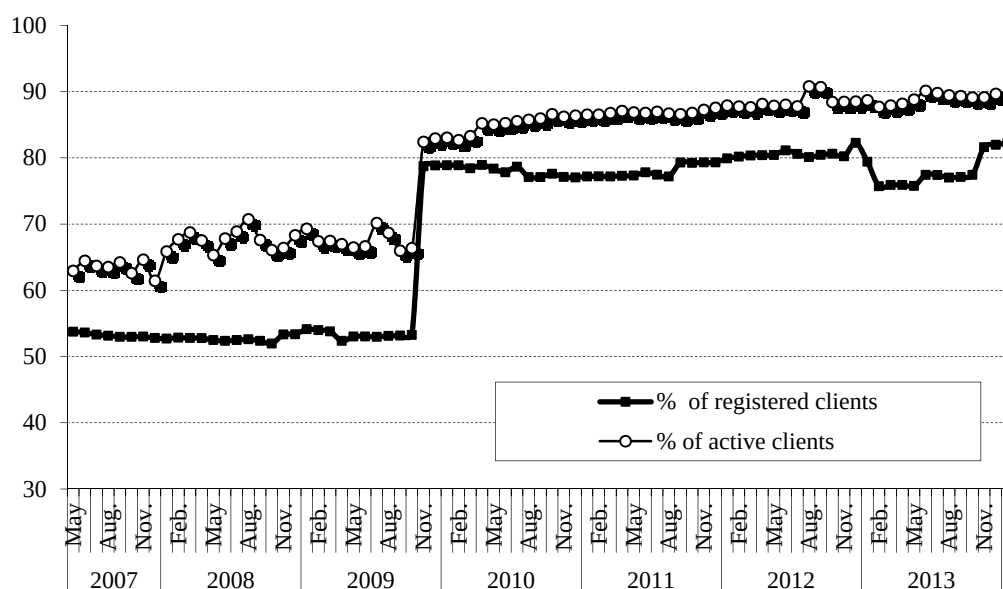
Fig. 22 presents data on the share of the seven major brokers in the total number of registered and active customers³ in the Moscow Exchange. In the period of 2010 thru 2013, the share of the given companies was growing on both indicators, reaching 89.5% on all registered customers and 82.3% on active customers of brokers as of January 2013. Growth in the level of concentration of the broker business by itself can't reveal weakening competition in the market of respective financial services. On the contrary, it may describe more effectively the manifestation of the broker business's scale effect. Brokers are facing an increasingly relevant objective to switch to attracting more conservative investors interested

¹ The Herfindahl-Hirschman Index (HHI) is a commonly accepted measure of market concentration. The HHI is calculated by squaring the interest rate in terms of trading volume of each participant and totaling the obtained results: $\text{HHI} = (D_1)^2 + (D_2)^2 + \dots + (D_m)^2$, where D_i is i -participant's market share expressed in percents; $i = 1, 2, \dots, m$.

² See section 2.6.4. The guidelines on the procedure for analyzing and evaluating the competitive environment in the financial service market approved by the Order of 31.03.2003, No 86 of the Russian Federation Ministry for Antimonopoly Policy and Support of Entrepreneurship.

³ Under the the Moscow Exchange's rules customer which closes at least a single transaction a month in the Exchange.

in long-term savings, rather than strengthen their own position while providing services to reducing number of active customers (see section 3.6.2). However, to prevent growth in broker business concentration from breaching the free competition principles, conditions should be created so that new market participants providing an adequate level of competitive pressure on the “veterans” in the industry may easily enter and exit this market segment.



Source: the author's estimates based on the data supplied by the Moscow Exchange.

Fig. 22. The share of seven major brokers in total number of registered and active customers of Russian brokers, %

Contraction of private investors' trading activity and increased role of state-run entities in the financial market enjoying privileges in borrowing from monetary authorities has raised a question of staying in business for many private companies, i.e. brokers and asset managers. In this respect, a Bank of Russia Financial Markets Service's (FMS) initiative on relaxing the capital adequacy requirements from the current Rb 35m to Rb 1m, which was mentioned early in 2014, has an important positive effect on the development of the industry.¹

However, it appears that it is not sufficient to just eliminate redundant administrative pressure on nonbank financial institutions. The number of professional securities market participants has been contracting for four consecutive years since 2009 (see Table 10). In 2013, the number of brokers dropped from 983 to 885, or by 10.0%, the number of dealers fell from 994 to 888, or by 10.7% on an annualized basis.

Table 10

The number of stock market professional participants

	2007	2008	2009	2010	2011	2012	2013
Number of organizations holding the license for:							
1. Broker activity	1445	1475	1335	1213	1090	983	885
Changes as % year on year	0.8	2.1	-9.5	-9.1	-10.1	-9.8	-10.0
2. Dealer activity	1422	1470	1337	1198	1088	994	888
Changes as % year on year	2.0	3.4	-9.0	-10.4	-9.2	-8.6	-10.7

Source: based on the data supplied by the RFMS Russia and the Bank of Russia.

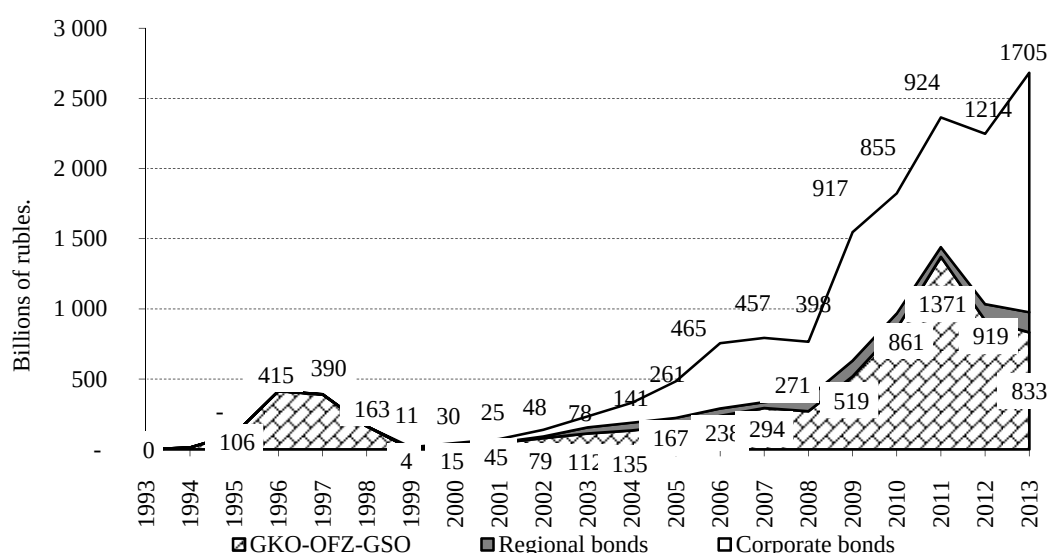
¹ Yakovenko D. Making brokers' life easier. Expert, No. 5, January 27, 2014 – February 2, 014, p. 51.

3.4. Ruble-denominated bond market

3.4.1. Government securities market

In 2013, the ruble-denominated federal bond market kept developing successfully in response to previous efforts aimed at unifying the trading rules, settlements in the internal market, as well as liberalizing since February 2013 access for nonresidents to the OFZ market, above all, through Euroclear and Clearstream settlements in the NSD.

At the same time, in 2013, OFZs achieved no new records in terms of volumes of new bond issues. Furthermore, federal bond issues have been tending to decline for two consecutive years (see *Fig. 23*). The volume of issued OFZs amounted to Rb 1371bn in 2011, whereas it shrank to Rb 919bn in 2012 and Rb 833bn in 2013. In this case, a more moderate issuing activity in the OFZ market can mostly be explained by Ministry of Finance of Russia's moderate needs for borrowing from the market rather than market capacity.



Source: based on the data supplied by the Moscow Exchange and cBonds.

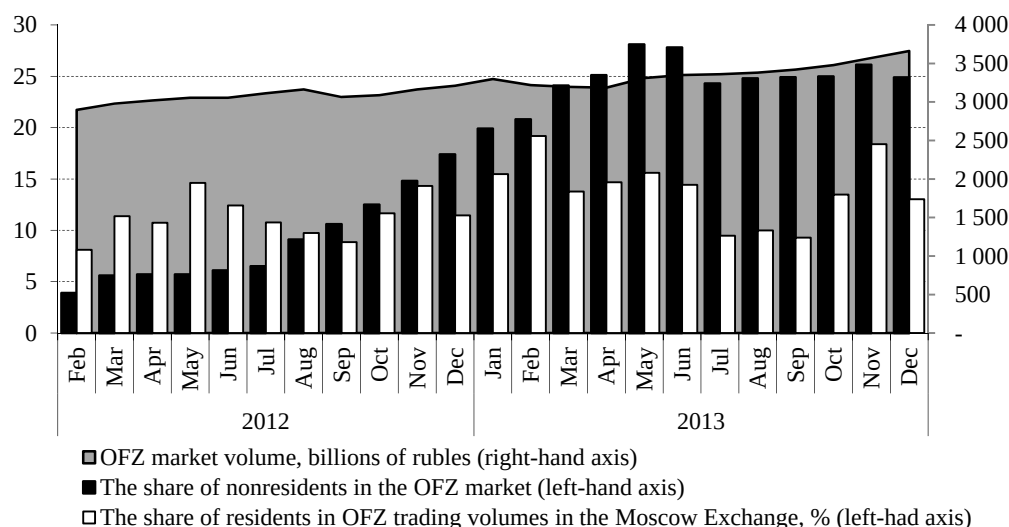
Fig. 23. Placement volumes of ruble-denominated bonds in 1993–2012.

According to the Bank of Russia, opening of the Russian central depository of nominee accounts for foreign clearance and settlement organizations at the beginning of 2013 attracted a significant inflow of foreign investment to the state debt internal market. The foreign investment base is quite diversified and includes participants adhering to quite different investment strategies¹. However, the data presented in *Fig. 24* show that the share of nonresidents in the OFZ bondholding structure increased slightly before the official announcement of the commencement of operations on Euroclear and Clearstream accounts in the NSD in February 2013. The share of nonresidents in the structure of OFZ bondholders increased from 3.9% in February 2012 to 19.9% in January 2013, reaching 24.9% by the end of 2013. Perhaps, foreign investors decided to purchase the principal part of OFZs during the negotiations and testing a new technology of providing services to them in the NSD. Rapid growth in the share of nonresidents in the OFZ market came as a surprise to the Ministry of Finance of Russia. According to the Guidelines of the Public Debt Management Policy in the

¹ The Central Bank of the Russian Federation. Money Market Review, Quarter 4, 2014, p.22.

Russian Federation for 2013–2015¹ (p.25), the foregoing indicator was anticipated to increase to 10% in the medium-term perspective, and to 25% in the long-term period.

The introduction of the new system of providing services for nonresidents through a bridge between the NSD and international clearing organizations hasn't yet resulted in any serious growth in transaction volumes of the dealers providing services to nonresidents in the secondary government bond market. In December 2013, the share of dealers (banks) oriented to providing services to nonresidents² accounted for 13.0% of the total government bonds trading volume in the Moscow Exchange as compared to 11.4% in December 2012.



Source: the author's estimates based on the data supplied by the Moscow Exchange and the Bank of Russia.

Fig. 24. Nonresidents' share in the OFZ market

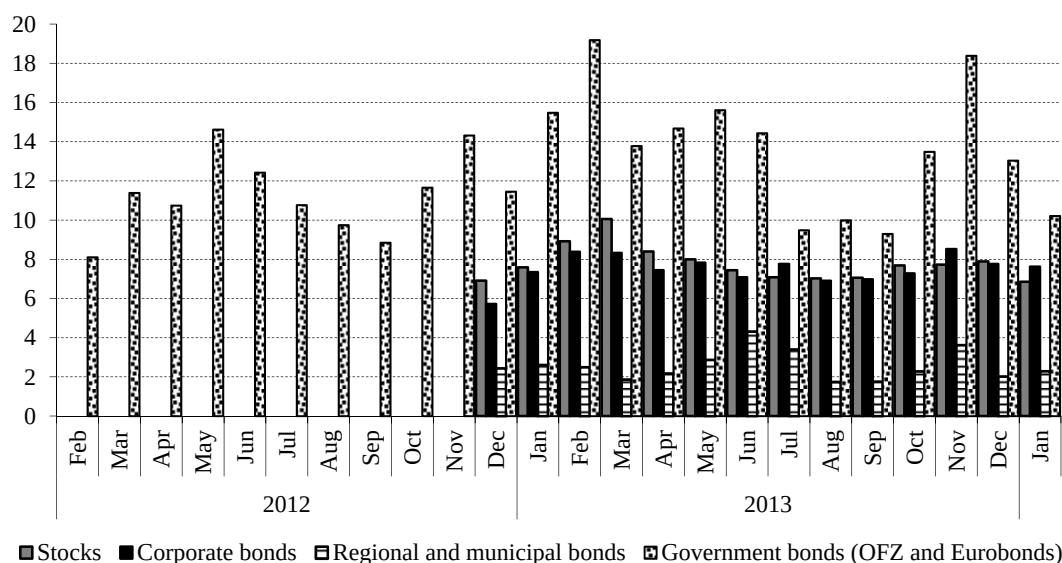
In 2013, the indicator for the same 12 nonresident banks' contribution in the trading volume in the secondary government bond market was visibly much higher than that estimated for the same financial institutions in the secondary stock market, secondary corporate and regional bond market in the Moscow Exchange (see Fig. 25). This is indicative of that many nonresidents still prefer the government bond market segment to other securities.

It was anticipated, according to the Guidelines of the Public Debt Management Policy in the Russian Federation for 2013–2015 (p.25), that increase in the share of foreign investors in OFZs would inevitably reduce their yield by one percentage point, like it happened in 2012, when nonresidents' share in the OFZ market increased most. In 2012, inflation increased to 6.6% against 6.1% in 2011, while the OFZ average monthly long-term interest rate dropped to 7.10% p.a. in December 2012 against 8.10% in the preceding year (see Fig. 26). However, the trend was different in 2013. Inflation lowered to 6.5%, the OFZ long-term interest rate

¹ Available at: http://www.minfin.ru/common/img/uploaded/library/2012/12/DOLGOVAYA_POLITIKA_ROSSIYSKOY_FEDERATSII_NA_2013-1015.pdf

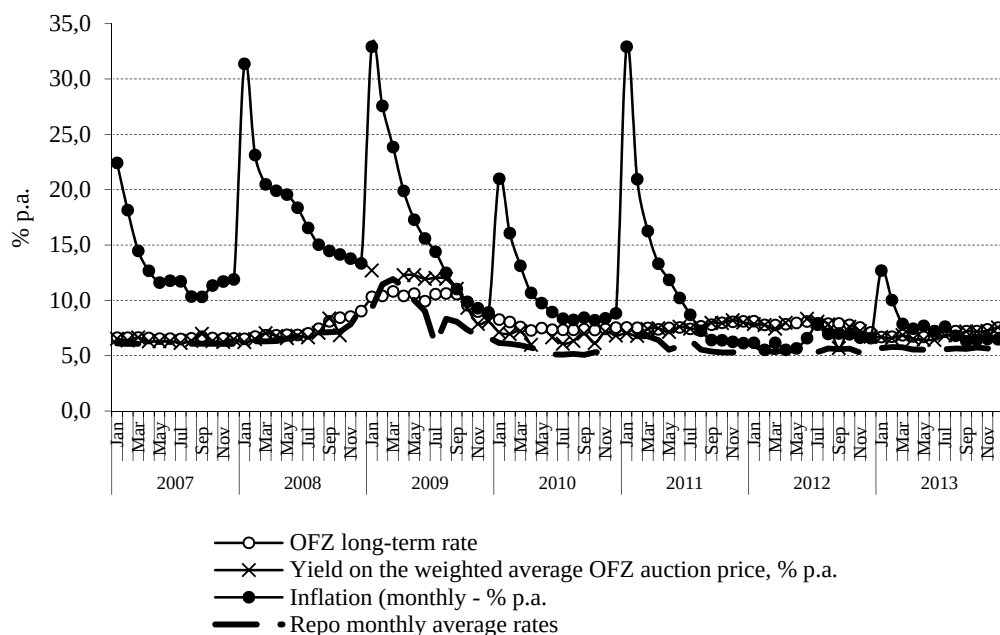
² Estimated by the author on the basis of official data supplied by the Moscow Exchange on 12 nonresid banks: Goldman Sachs Group, Deutsche Bank, ING BANK (EURASIA) ZAO, CJSC "Bank Credit Suisse (Moscow), CJSC Raiffeisen Bank, ZAO Citybank, ZAO Unicredit, JP Morgan Bank International (LLC), OJSC Rosbank, Barclays Capital LLC, OOO Morgan Stanley Bank (LLC), HSBC Bank plc. This indicator helps evaluate real increase in nonresidents' trading activity in the Moscow Exchange's secondary market.

increased from 7.10% p.a. in December 2012 to 7.53% p.a. in December 2013 despite continuous but slowed down growth in nonresidents' share in the OFZ market.



Source: the author's estimates based on the data supplied by the Moscow Exchange.

Fig. 25. The share of nonresidents in securities trading volumes in the Moscow Exchange, %



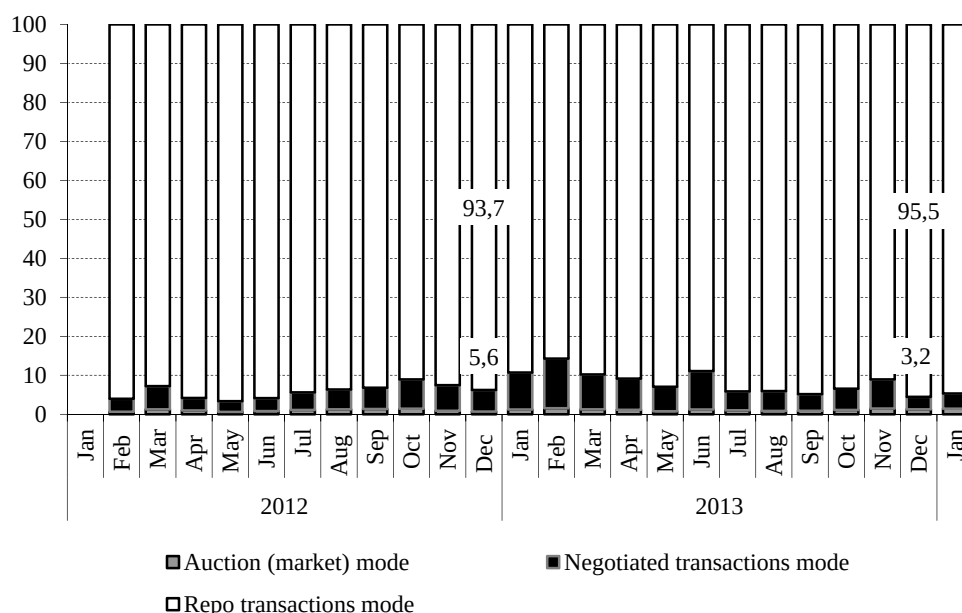
Source: the author's estimates based on the data supplied by the Bank of Russia and the Federal State Statistics Service (Rosstat).

Fig. 26. Average monthly interest rates in the OFZ market and inflation, % p.a.

Overgrowth in OFZ interest rates over inflation for the last two years has made them more appealing to investors. However, the Russian economy is facing a substantial risk of OFZ interest rates substantially overtaking the key interest rate at which the Bank of Russia

actively refinances the banking system. In December 2012, the average monthly key interest rate on repo operations was 5.6% at a OFZ long-term interest being 7.1% p.a.. In December 2013, the corresponding interest rates stood at 5.6% and 7.53% respectively¹. Under the circumstances, it would be more advantageous for banks to generate profits from almost risk-free arbitrage strategy based on the difference between interest rates, rather than keep lending to borrowers in the real sector of economy. This may have an adverse effect on the economic growth potential.

The data on different transactions volumes in the in the corporate bond market became publicly available in 2012–2013 owing to the statistics supplied by the Moscow Exchange. Previously, in its financial market reviews the Bank of Russia used to only disclose information on volumes of market (auction) transactions and operations on OFZ negotiated transactions. It is seen from the data presented in *Fig. 27* that in 2013 the share of repo transactions in the corporate bond market stood at 95.5%. Market transactions accounted for only 1.3% of the trading volume. Under the circumstances, it isn't quite clear what kind of function is performed by market transactions, how useful they can be in obtaining objective information on the parameters for the OFZ market and Eurobonds market.

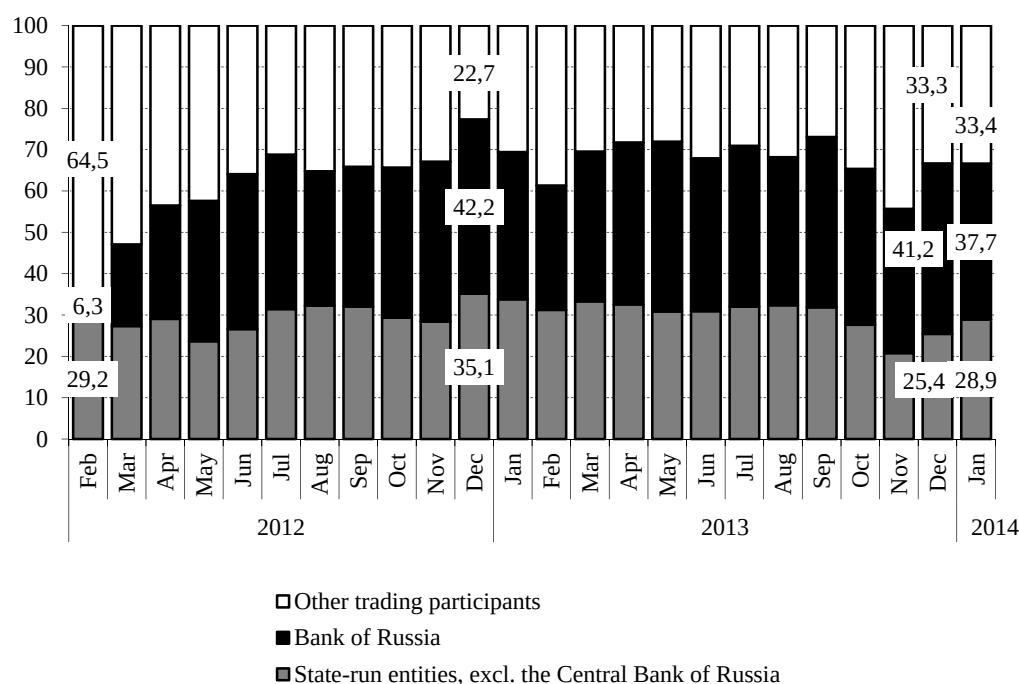


Source: the author's estimates based on the data supplied by the Moscow Exchange.

Fig. 27. The structure of federal bond transactions in the Moscow Exchange since February 2012, %.

Fig. 28 presents data on the share of state-run entities and the Bank of Russia in the federal bond market, which the Moscow Exchange began to disclose since February 2012. It shows that state-run entities and the Bank of Russia accounted for 33.8% and 35.6% respectively of the government securities transactions given all trading modes.

¹ In December 2012 and 2013, the average monthly yield on weighted average OFZ auction price corresponded approximately to the foregoing long-term yields on OFZs.



Source: the author's estimates based on the data supplied by the Moscow Exchange.

Fig. 28. The share of private and public brokers in volumes of trading in federal bonds (OFZs) and Russia's Eurobunds in the Moscow Exchange, %

According to the Herfindahl-Hirschman Index (HHI) in 2013, the government bond secondary market remained one of the mostly high-concentrated segments in the Moscow Exchange market (see Fig. 21). The HHI shows that the market remained mostly within a high-concentration range, showing some rare signs of a moderately concentrated market. This implies that the government securities market has less participants than in the stock market and corporate bond market. Limited competition may manifest itself in higher transaction costs and less beneficial transaction parameters for investors.

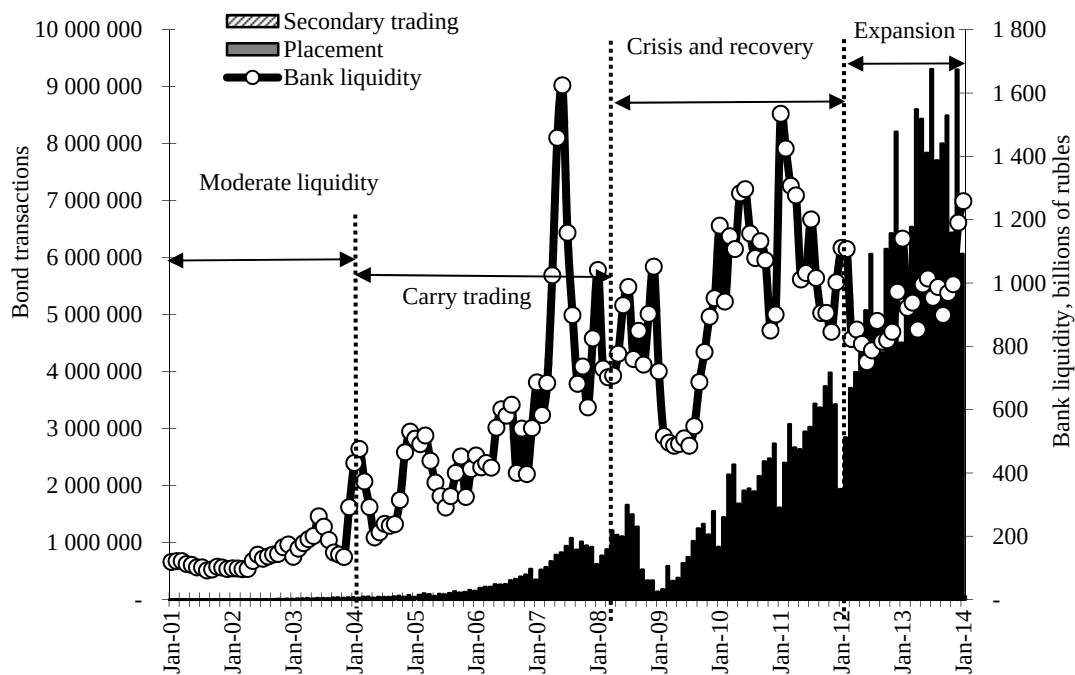
3.4.2. Corporate bond market

Fig. 29 presents monthly data on volumes of issues and turnover in the secondary ruble-denominated corporate bond market in the Moscow Exchange in the period of 2001 thru January 2014. Furthermore, there is data on bank liquidity represented by banks' average monthly balances on accounts and deposits with the Bank of Russia. In 2013, trading volumes in the secondary corporate bond market increased to Rb 90,3 trillion against Rb 58,0 trillion in 2012. Since 2012 corporate bond trading volumes have been overtaking trading volumes in the stock market which amounted to Rb 47,4 trillion in 2013 and Rb 47,7 trillion in 2012.

Since liquidity in the corporate bond market depends largely on liquidity in the banking system, different stages can be distinguished in stock trading dynamics in these instruments, namely carry trading, recession and recovery, state expansion. In the pre-recession years, growth in trading volumes in the corporate bond market relied mostly upon the carry trading strategy, whereas during the crisis and recovery period it relied upon Bank of Russia's resources received as unsecured loans and other forms of loans. Since April 2012 liquidity in the corporate bond market has been maintained mostly through repos with the Bank of Russia. Repo loans have turned from an instrument of temporal support of bank liquidity into

the principal instrument of financing the banking system, the scope of such operations has become unprecedented (see section 3.3.2 for more details).

Another distinctive feature of the corporate bond market was that the secondary market has becoming more significant vs. the bond placement process. The difference between volumes of issues and secondary market trading in corporate bonds reduced from 3.7% in 2010 to 1.9% in 2013. On the one hand, outstripping growth in liquidity in the secondary corporate bond market has a positive impact on interest rates and credit terms. On the other hand, funding long-term loans with short-term resources increases risks this market is exposed to, including a possibility for issuers to refinance loans in the future.



Source: the author's estimates based on the data supplied by the Bank of Russia and the Moscow Exchange.

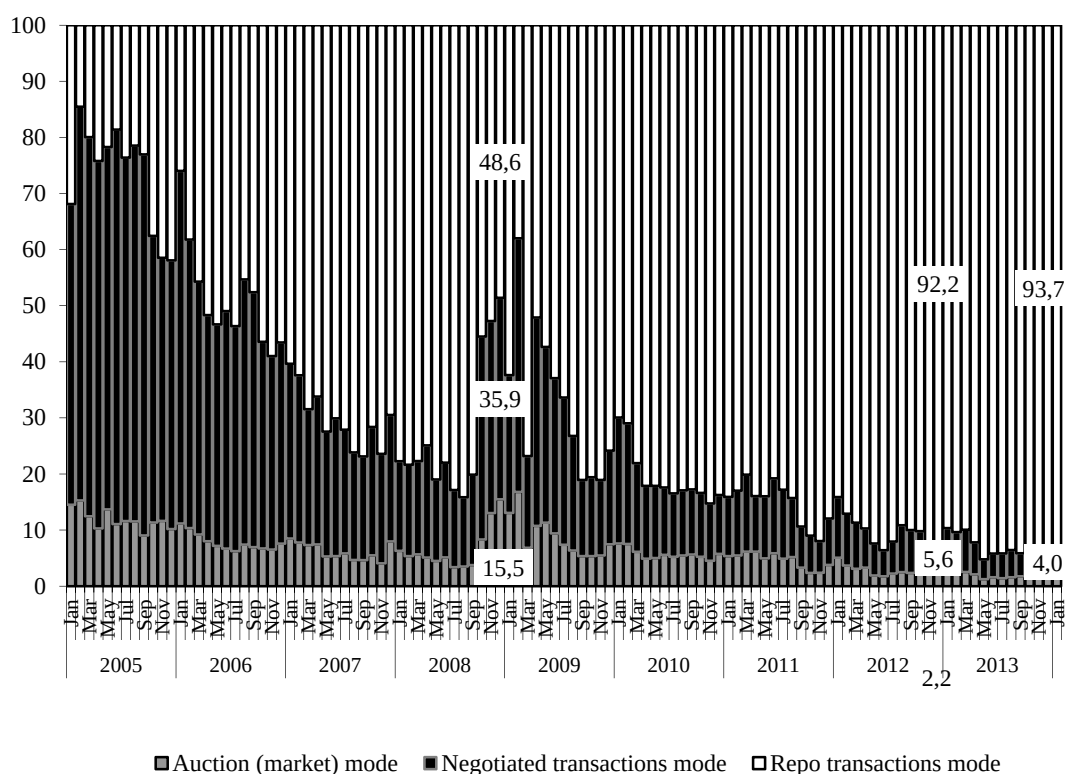
Fig. 29. Operations with corporate bonds and bank liquidity in the period of January 2001 thru January 2014

The ruble-denominated bond market is still facing the issue of attracting internal investors. Banks are still dominating as money source in the market. The share of banks in the structure of corporate bondholders shrank from 40.9% in 2011 to 30.9% in 2012, and 27.5% in 2013. The share of pension accruals managed by asset managers including Vnesheconombank in the value of bonds increased from 4.9% in 2011 to 7.6% in 2012 and 12.0% at the end of the 9-months period in 2013. The share of unit (bond) investment funds in the structure of corporate bondholders was merely 0.6% in 2011, 0.7% in 2012, and 1.5% in 2013. A certain weakening of the role of banks in the corporate bond market in 2013 was compensated with growth in investment from internal institutional investors and nonresidents.

Since February 2014 nonresidents has had access to ruble-denominated corporate bonds through Euroclear and Cleanstream accounts with the NSD. At present, the share of operations of banks providing services to nonresidents in the secondary corporate bond market in the Moscow Exchange is 8% or less (see *Fig. 25* in section 3.4.1). In our opinion, amid currently prevailing expectations of devaluation of the ruble, opening a technological

gateway for nonresidents' operations with internal corporate bonds in 2014 wouldn't lead to any significant increase in their share in this stock market segment.

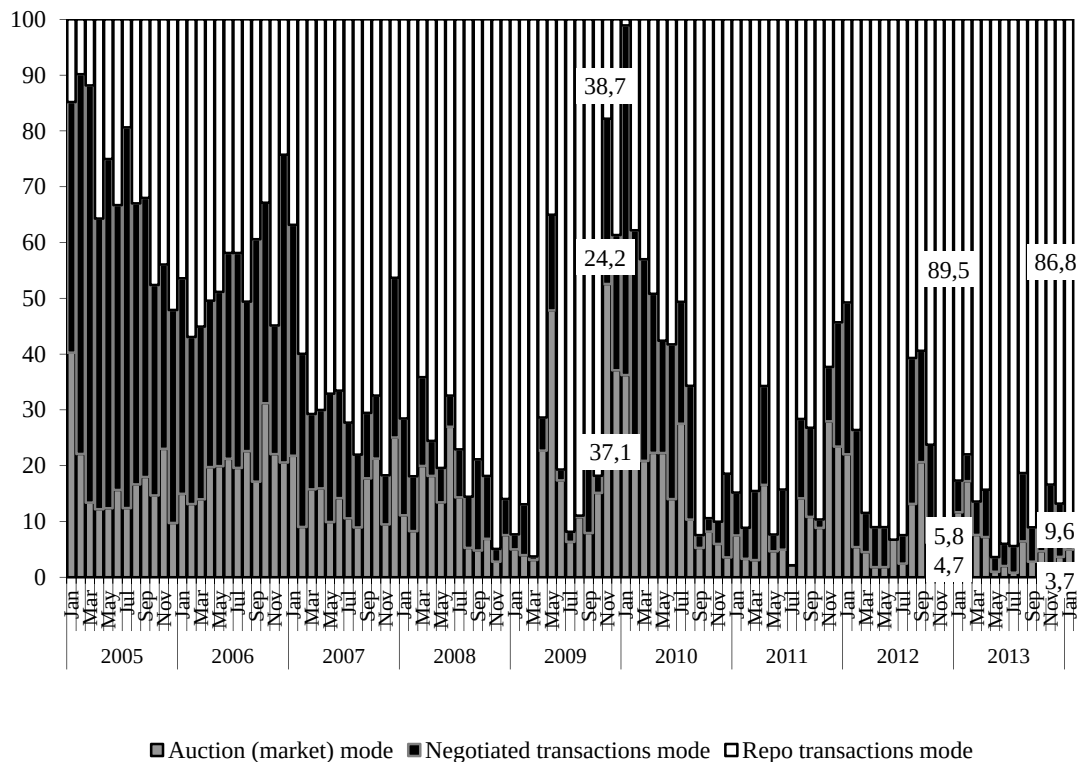
The fact that the corporate bond market has been turning into a money market instrument as opposed to the long-term nature of corporate bonds themselves shows that the structure of corporate bond transactions in the Moscow Exchange (see *Fig. 30*). In December 2013, the share of repo transactions in the value of on-market corporate bond transactions achieved an absolute record of 93.7%, overtaking the values recorded in 2012. At the same time, only 2.3% of corporate bond transactions are on-market ones. Such a drastic decline in the share of on-market transactions raises risks of credible pricing of corporate bonds during transactions in the Moscow Exchange. Our studies of the factors influencing yield spreads of ruble-denominated corporate bonds which were carried out in 2013 for The National Securities Market Association (NSMA) show that fundamental factors such as issuer's credibility, indicators of issuer's financial performance and liquidity of bond issues have no significant effect on the size of spreads on corporate bonds.



Source: the author's estimates based on the data supplied by the Moscow Exchange.

Fig. 30. Corporate bond transactions structure in the Moscow Exchange, %

The exchange regional bond market is facing similar problems related to the reduction of the share of on-market transactions, (see *Fig. 31*). In December 2013, the share of on-market transactions decreased here to 3.6%, whereas the share of repo transactions reached 86.8%.



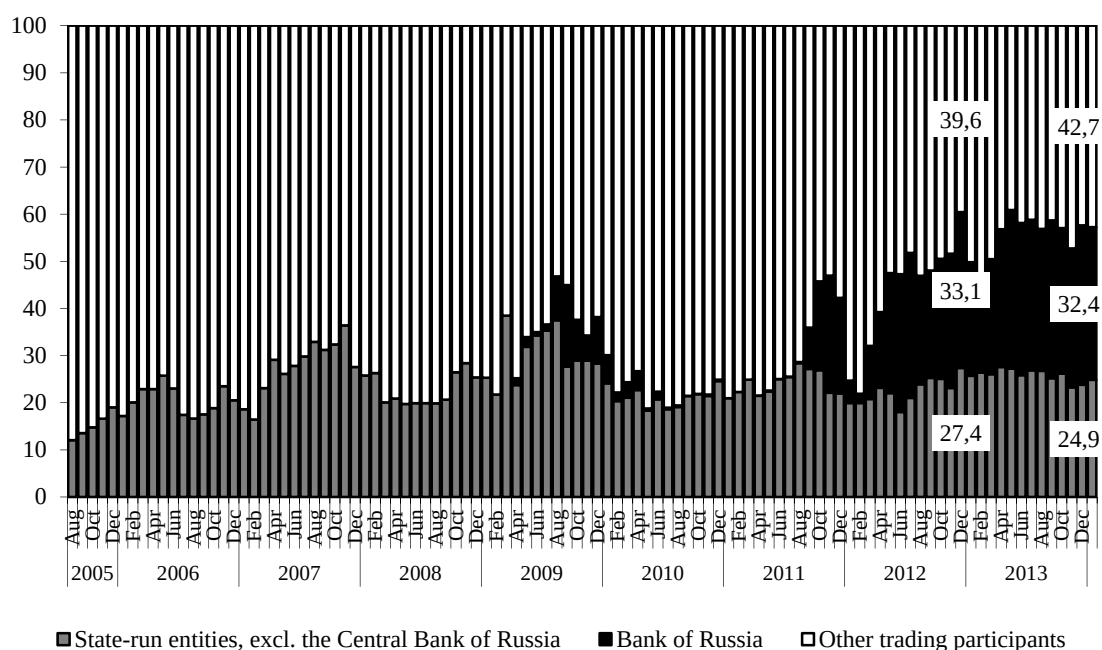
Source: the author's estimates based on the data supplied by the Moscow Exchange.

Fig. 31. Structure of regional bond transactions
in the Moscow Exchange, %

3.4.3. Competition in the corporate and regional bond markets

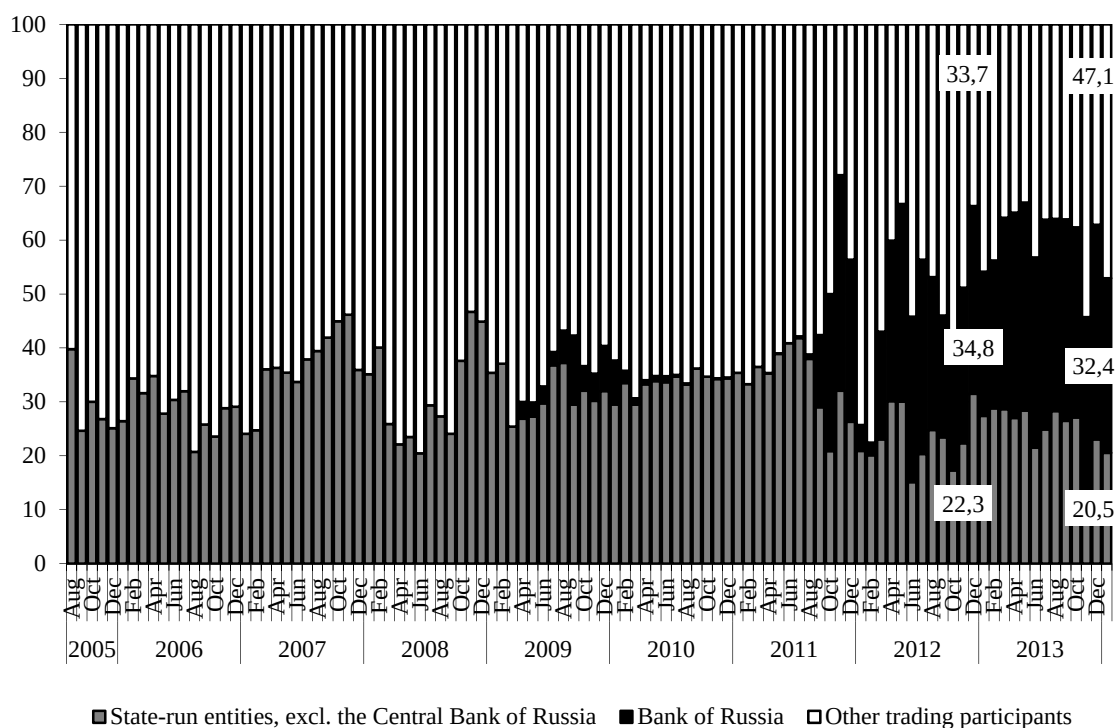
Fig. 32 provides analysis of various groups of traders' (private and state-run financial institutions (Vnesheconombank, VTB, VTB Capital, VTB24, Gazprombank, Sberbank, KIT Finance, Svyazbank, Bank of Moscow, Transcreditbank, a c 2011 Sberbank CIB), the Bank of Russia) contribution in corporate bonds trading volumes in the Moscow Exchange in all modes including market, negotiated deals, and repo transactions. In December 2013, the share of state-run entities and the Bank of Russia in volumes of corporate bond transactions in the Moscow Exchange was 24.9% and 32.4% respectively. The scope of the Bank involvement in transactions in the corporate bond market exceeded largely its activity volumes during the crisis of 2008–2009.

Fig. 33 reflects the share of state-run financial institutions and the Bank of Russia in exchange trading volumes of regional bonds. In 2012, it was even bigger than in the exchange corporate bond market. In December 2013, the share of state-run entities and the Bank of Russia in regional bond transactions reached 20.5% and 32.4% respectively. These figures inched down against 2012 when they measured 22.3% and 34.8% respectively.



Source: the author's estimates based on the data supplied by the Moscow Exchange.

Fig. 32. The share of private and public brokers in corporate bond trading volumes in the Moscow Exchange, %

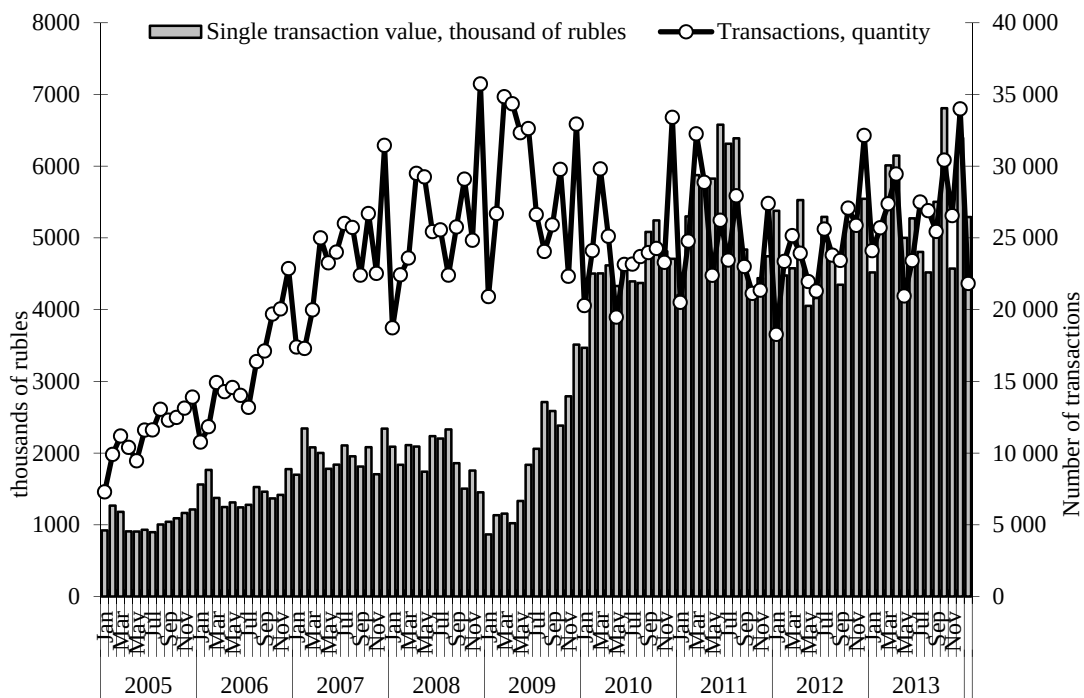


Source: the author's estimates based on the data supplied by the Moscow Exchange.

Fig. 33. The share of private and public brokers in regional bond trading volumes in the Moscow Exchange, %

Concentration characteristics of the secondary corporate bond market in the Moscow Exchange saw considerable deterioration in the period of 2012 thru 2013 (see *Fig. 21* in section 3.3.4). The Herfindahl-Hirschman Index (HHI) on transactions in the secondary corporate bond market exceeded 800 points since May 2012. The HHI on corporate bonds has since then been ranging within 800 and 1800 points, which means that this market segment shifted from low concentration to moderate concentration. To compare with the corporate bonds, the regional bond market in the Moscow Exchange is more concentrated. In 2012, it was within a range of moderate concentration, according to the HHI criteria, the regional bond market was highly concentrated most of the time in 2013, with HHI showing over 1800 points. On our opinion, any further following the course towards outstripping growth in repo transactions in the Exchange should be accompanied by anti-monopoly measures aimed at enhancing supervision over various exchange market segments.

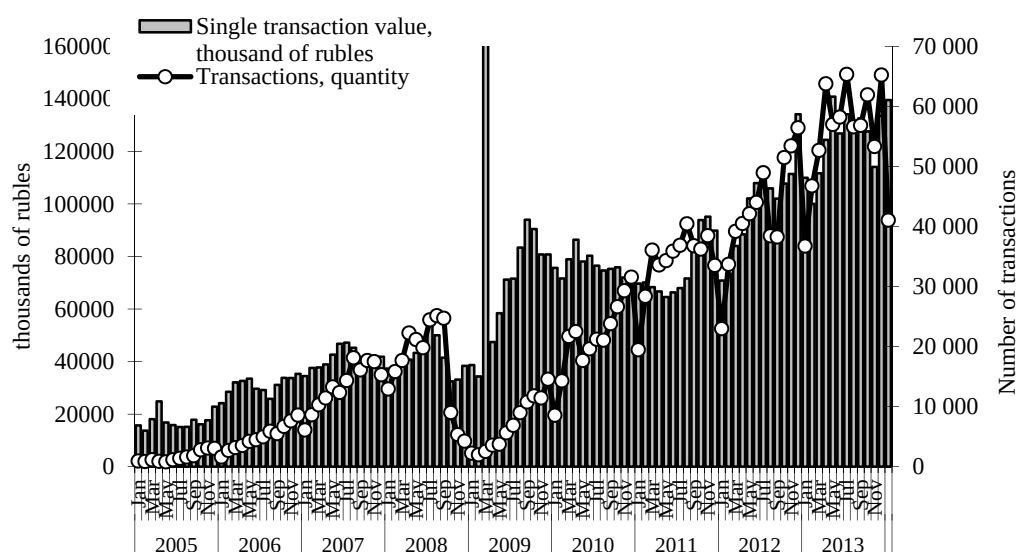
Fig. 34 presents data on the number of transactions and the value of a corporate bond transaction in autonomous trading in the Moscow Exchange. Similar to the market segment of trading in shares (see *Fig. 19* in section 3.3.3), 2013 saw a trend towards stabilizing the number of on-market corporate bond transactions and the average volume of a transactions.



Source: the author's estimates based on the data supplied by the Moscow Exchange.

Fig. 34. On-market corporate bond transactions in the Moscow Exchange

Fig. 35 presents analysis of the repo corporate bond transaction segment in the Moscow Exchange. Unlike the market mode of transactions in the repo segment, steady growth in the number of transactions and the average volume of a transaction was observed in 2013. The size of an average repo transaction also twice as much as the value of on-market corporate bond transactions, which is not surprising, because volumes of bank loans for financial companies cannot be small.



Source: the author's estimates based on the data supplied by the Moscow Exchange.

Fig. 35. Repo corporate bond transactions in the Moscow Exchange

Major state-run companies began to play the leading role in the primary corporate bond market in the post-recession period. In 2013, 24 issuers with major corporate bond issuance volumes accounted for 59.4% of the total issuance of the given bonds, while state-run companies of these issuers accounted for 47.7% of the total corporate bond issues (see *Table 11*). According to various indicators of concentration of corporate bond issues, as referred to in *Table 11*, two trends were observed in 2013 against 2012: higher concentration of major bond issuers including state-run companies' bond issues. For example, the share of 10 issuers with the largest corporate bond issues was 40.5% in 2013 as compared to 35.7% in 2012, of which the share of state-run companies in total corporate bond issuance volumes increased from 27.9% in 2012 to 36.8% in 2013.

Table 11

Concentration of ruble-denominated corporate bond issuers in 2009–2013

	First 5 bond issuers		First 10 bond issuers		First 24 issuers		Total market
	Total	including government bonds	Total	including government bonds	Total	including government bonds	
2009							
Billions of rubles	440	390	610	441	803	513	917
Share, %	48.1	42.5	66.8	48.1	87.8	55.9	100.0
2010							
Billions of rubles	177	147	304	200	513	317	855
Share, %	20.6	17.2	35.4	23.4	59.9	37.1	100.0
2011							
Billions of rubles	241	191	389	309	642	405	1089
Share, %	22.0	17.5	35.7	28.4	58.9	37.2	100.0
2012							
Billions of rubles	265	265	429	334	690	443	1199
Share, %	22.1	22.1	35.7	27.9	57.8	36.9	100.0
2013							
Billions of rubles	550	550	705	640	1035	830	1741
Share, %	31.6	31.6	40.5	36.8	59.4	47.7	100.0

Source: the author's estimates based on the data available at www.cBonds.ru, www.rusbonds.ru and supplied by the Moscow Exchange.

Year by year the corporate bond market has increasingly been servicing cash flows between state-run entities. State-run companies borrow from state-run entities. The secondary market is also maintained by mostly state-run banks in conjunction with the Bank of Russia. Furthermore, state-run investment banks have been mostly acting as underwriters and investment advisors in placing corporate bonds (see *Table 12*). In 2007, state-run banks acted as underwriters for 36.3% of corporate bond issues (in terms of value). In 2013, their share increased to 60.1%. A similar situation was observed with investment and banking services in the regional bond market. In 2007, the share of public lead managers of regional bond issues was 14.2% in terms of value. It increased to 51.9% in 2013.

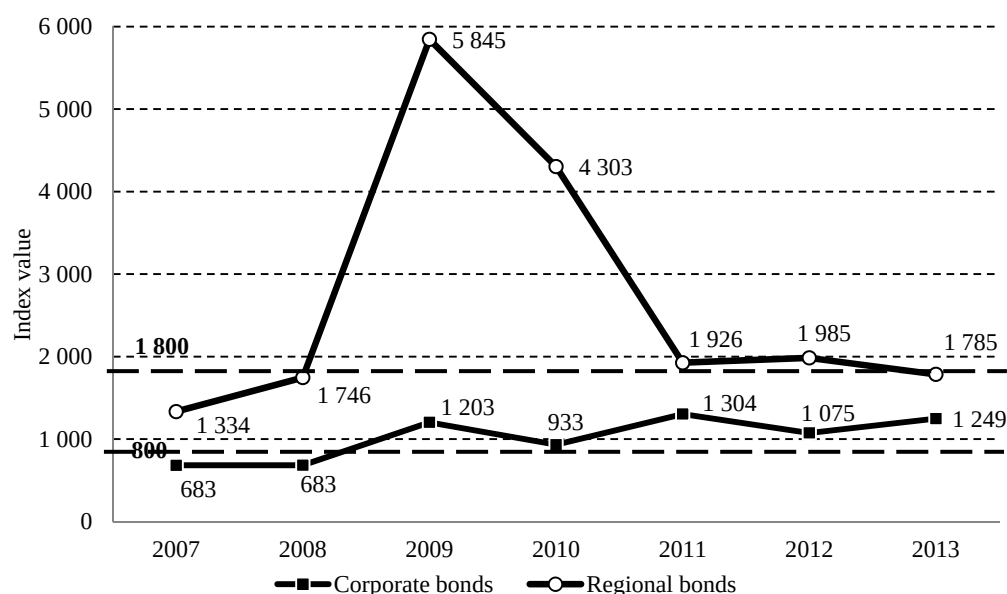
Table 12

**The share of public and private financial organizations in the market
of internal bond issue organizers in Russia**

	Bond issue organizers:					
	corporate bonds			regional bonds		
	Public financial organizations	Private financial organizations	Total	Public financial organizations	Private financial organizations	Total
2007						
Millions of rubles	169 668	298 302	467 970	7 551	45 481	53 032
Share, %	36.3	63.7	100	14.2	85.8	100
2008						
Millions of rubles	219 892	249 900	469 792	42 227	29 716	71 943
Share, %	46.8	53.2	100	58.7	41.3	100
2009						
Millions of rubles	620 044	373 978	994 022	133 325	22 511	155 836
Share, %	62.4	37.6	100	85.6	14.4	100
2010						
Millions of rubles	393 743	461 292	855 035	86 613	28 288	114 901
Share, %	46	54	100	75.4	24.6	100
2011						
Millions of rubles	620 698	374 146	994 844	7 767	46 177	53 944
Share, %	62.4	37.6	100	14.4	85.6	100
2012						
Millions of rubles	734 697	502 831	1 237 528	61 925	57 637	119 562
Share, %	59.4	40.6	100	51.8	48.2	100
2013						
Millions of rubles	1 033 849	686 894	1 720 743	79 980	74 259	154 239
Share, %	60.1	39.9	100	51.9	48.1	100

Source: based on the rankings bond issue organizers www.cBonds.ru for 2007–2013.

The Herfindahl-Hirschman Index (see *Fig. 36*) measures is indicative of inadequate level of competition in the markets of underwriting and advisory services in terms of placing corporate and regional bonds. Since 2009 the market of investment and banking services within the corporate bond market has turned from a highly concentrated into a moderately concentrated, when monthly HHI measures fall within a range of 800 to 1800. Prior to 2013 the market of regional bond services was steadily highly concentrated, with the HHI being above 1800. It was not until 2013 when it fell into the category of moderately concentrated market, with the HHI measuring 1785. All this raise the question of having to enhance the role of anti-monopoly regulation in the securities market.



Source: based on the rankings for bond issue organizers www.cBonds.ru за 2007–2013

Fig. 36. Herfindahl-Hirschman Index: bond issue organization services for ruble-denominated corporate and regional bond issuance.

3.5. Financial system' and mediators' contribution to economic growth

3.5.1. Financial system's influence on economic growth

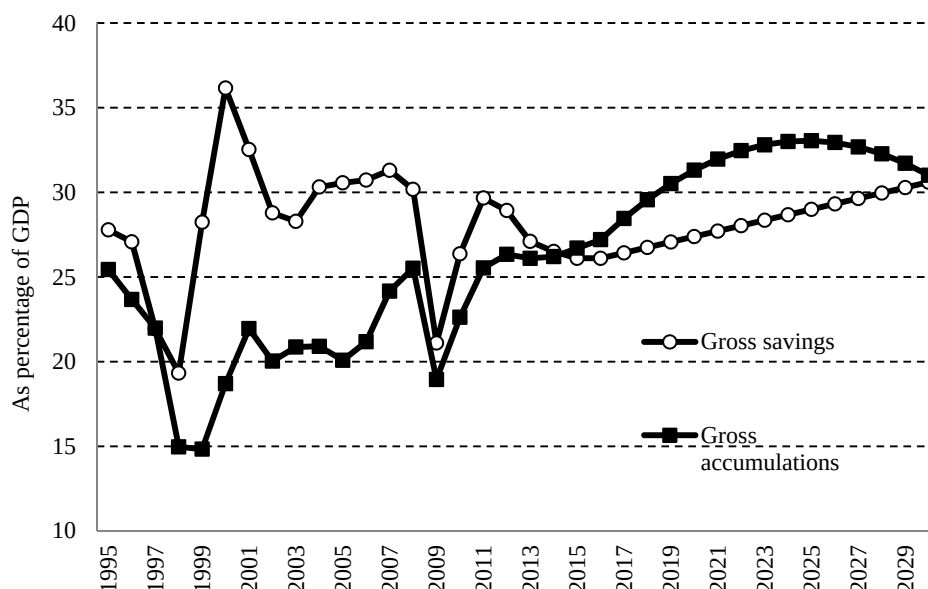
Hardening the requirements to the financial system in terms of its potential in accelerating GDP growth cannot be avoided against the backdrop of slowing down economic growth which manifested itself in 2013. Inconsistency of result-oriented documents on economic growth and financial market development which are adopted at the departmental level is one of the factors preventing the financial system from realizing such a potential. The key parameters of the financial market development are specified in the State Program of the Russian Federation *The Development of Financial and Insurance Markets, the Creation of an International Financial Center* (the State Program) designed by the Ministry of Finance of Russia, and the key performance indicators (so called KPIs) which the Bank of Russia develops for its entities and offers for adoption by the Moscow Exchange¹. The economic growth key instruments are specified in *The Forecast of Long-Term Socio-Economic Development of the Russian Federation until 2030* developed by the Ministry of Economic Development of the Russian Federation (Forecast-2030). The problem is that none of the instruments provided for by the State Program and discussed KPIs is engaged as driver of economic growth in the current version of Forecast-2030 adopted in March 2013. Furthermore, there is no quantitative evaluation whatsoever of the effect the stock market may have on economic growth acceleration now and in the future.

With respect to the financial system, it is narrowing the gap between savings rates and accumulation and growth in domestic consumption supported through accelerated retail

¹ Policy guidelines in financial market regulation with the assistance of the FMS were considered at the October 17, 2013 meeting of the working group on the establishment of an International Financial Center. More information is available at <http://mfc-moscow.com/index.php?id=119>.

lending that was specified as the key incentives of economic growth in the Forecast-2030 in March 2013. In doing so, the transition to outstripping growth in retail credit portfolio against retail deposits under the forecast of the Ministry of Economic Development of Russia should have resulted in long-term decline in household saving rates and therefore the demand for investment and financial instruments.

To accelerate economic growth under the accelerated development version of the Forecast-2030, the accumulation ratio was expected to increase from 26.0% in 2012 to 33.0% in 2025, the highest ever in the modern economic history of Russia, with further decline to 31% in 2030 (see Fig. 37). The accumulation ratio was supposed to be higher than the saving rate through making the former grow in 2015. This means that in the long run Russia will transit from the economy exporting “excessive” savings in global capital markets to a country where foreign capital inflow is stronger than outflow. In other words, this way of stimulating growth implies using idle excessive gold and foreign currency reserves for the purpose of internal investment, because the currently existing difference between internal savings and accumulations is what centralized public funds gain. The key agents in investing such resources are development institutes and major state-run companies and banks.



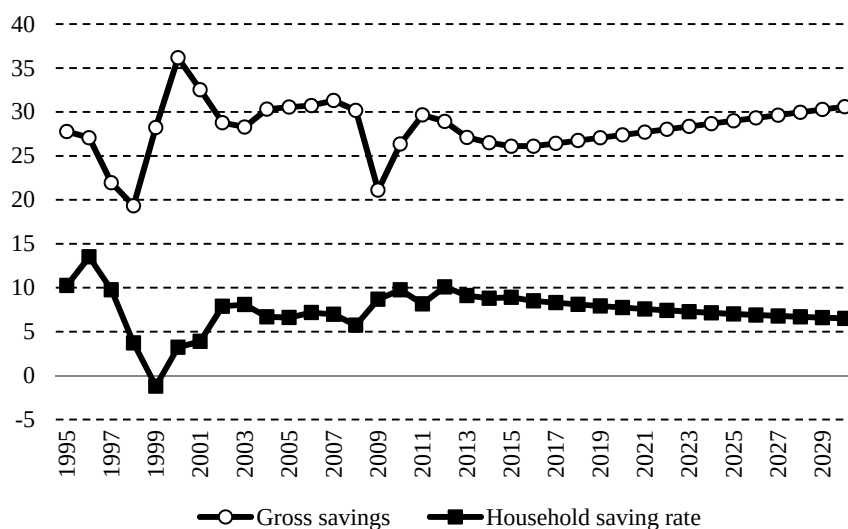
Source: the author's estimates based on the data for the period of 1995-2012 supplied by Rosstat and the Forecast-2030 data.

Fig. 37. Gross savings and accumulations in Russia

Another source of economic growth, according to the Forecast-2030, should be outstripping growth in household consumption through a marked decline in the saving rate of this economic sector. Our estimates of the figures specified in the foregoing forecasts show that household savings rate should have dropped from 10.3% of GDP in 2012 to 7.7% of GDP in 2020, and 6.5% in 2030 (see Fig. 38).

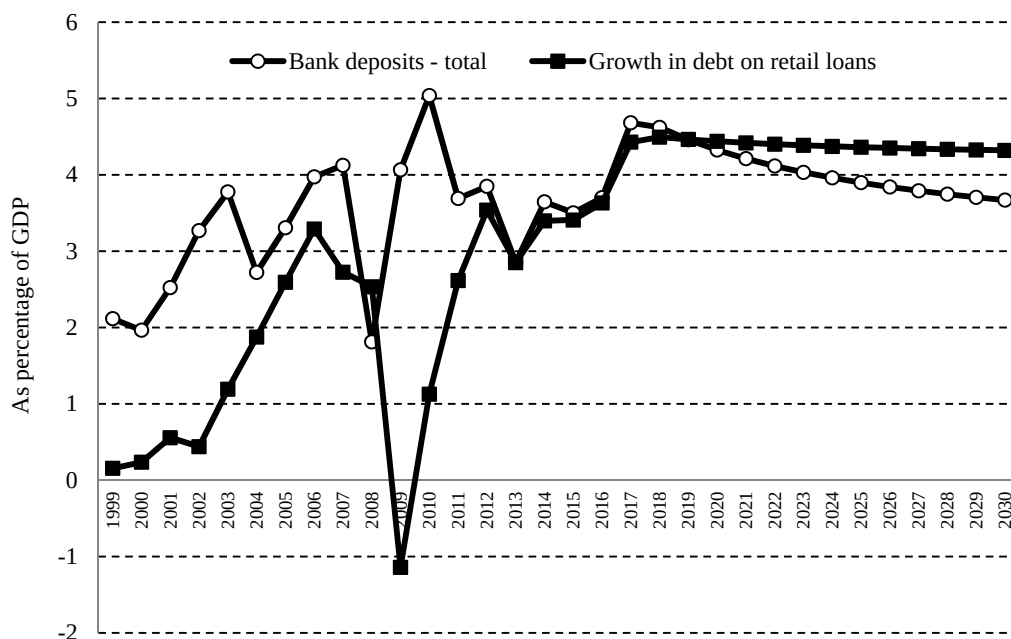
Growth in retail loans should be governed not only through increasing the deposit base, but also state refinancing of banks. As a result, by 2020 the value of household loans would grow by 4.4% of GDP, while total growth in bank deposits grow only 4.3% (see Fig. 39). By 2030

the gap between annual growth in credit portfolio and household deposits could reach 0.6% of GDP.



Source: the author's estimates based on the data for the period of 1995-2012 supplied by Rosstat and the Forecast-2030 data.

Fig. 38. Gross saving rate and household saving rate in 1995–2030.



Source: the author's estimates based on the data for the period of 1995-2012 supplied by Rosstat and the Forecast-2030 data.

Fig. 39. Growth in bank deposits and household's outstanding debt in Russia

The 2013 results show that focusing on the promotion of consumer demand and growth in retail credit portfolio amid slowdown in household incomes just increased risks of financial

system stability. The aggressive credit policy provoked growth in bad household debts owed to banks. Based on the data supplied by the Bank of Russia, in January-October 2013 the share of overdue debts on consumer loans increased from 5.9% to 7.7%, and the quality of credit portfolio is expected to keep deteriorating until the middle of 2014¹, as forecasted by representatives of the Bank. According to Bank of America Merrill Lynch (BAML) report, *Unsecured retail loans in Russia: a new era*, 40% of the population have to pay 20% on average of their salary on loans issued for purchasing goods at retail stores, with an even bigger share of 50% and more for those who have a credit card loan². Households' bad debts and financial status worsening normally result in a long-term stagnation of their consumer demand.

In our opinion, the currently applicable mechanisms of facilitating economic growth could be complemented with the promotion of internal investment through creating long money for institutional investors (see section 3.6.1 for more details) and accelerating growth in household savings (see section 3.6.2)³. In accordance with the G20/OECD principles on long-term investment financing which were developed in September 2013⁴, governments are recommended to create favorable conditions for financing long-term investment. According to the developers of the document, long-term investment helps reach financial stability, debt sustainability, new jobs, economic growth, higher standards of living, competitiveness, sustainable economic development and green economy development. Institutional investors who should be adequately regulated and subject to supervision factoring in their specific features and risks they may encounter may play a special role in addressing this issues.

Approximation of growth rates in debts on bank loans issued to households and non-financial organizations may further help promote economic growth. It is shown in *Fig. 40* that the sweeping growth since the second half of 2011 in the Bank of Russia's support to the banking system through repo transactions has resulted, above all, in outstripping growth in retail loans rather than loans to companies operating in the real sector of economy. This priority was chosen for some reasons which can be explained: retail lending is a more marginal operation against financing of business. Additionally, funding of such operations with Bank of Russia's short-term financing also tends to choose in favor of retail loans which are more short-term in nature.

However, the choice in favor of retail lending has failed to boost economic growth for the past 2.5 years. Since the end of 2013 the Central Bank of Russia has been taking measures aimed at extending terms of refinancing of banks and widening the list of assets that may serve as security on loans. Since 2014, the terms of loans on repo transactions have been set for seven days, a new mechanism of lending to banks against non-market assets which are first of all associated with business loans has been introduced. The Bank of Russia plans to work on mechanisms of refinancing project bonds, securitized assets, pools of loans for small businesses⁵. These measures, in our opinion, should be continued so that the bank refinancing mechanism can be more seriously reoriented towards supporting loans issued to companies engaged in the real sector of economy.

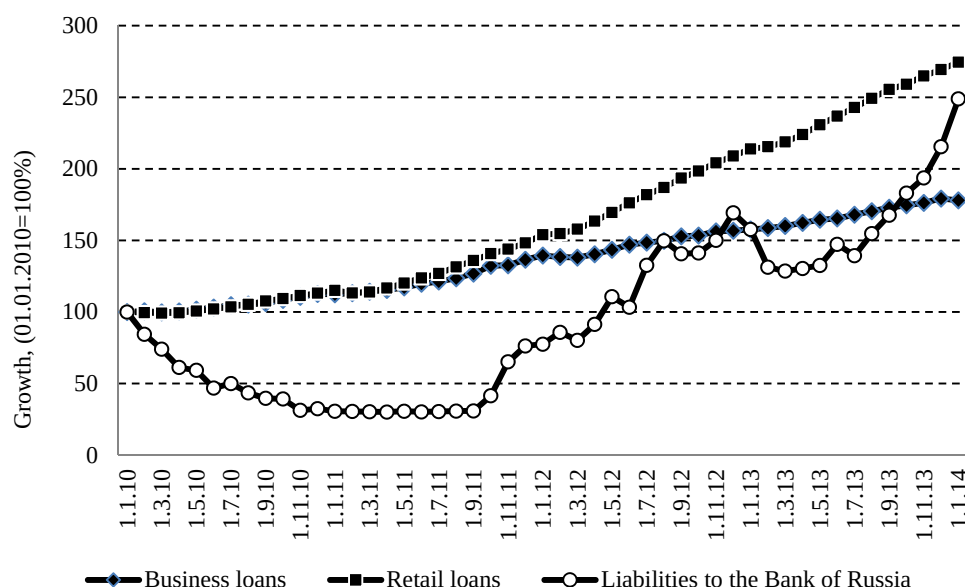
¹ Biyanova N. Et al. "Abnormal" loans. *Vedomosti*, November 1, 2013.

² Cited from Shestopal O. Recreational poverty. *Kommersant*, October 18, 2013.

³ This measure is also a way to narrow the gap between internal savings and accumulation rates through reducing household capital outflow.

⁴ G20/OECD High-Level Principles on Long-Term Investment Financing by Institutional Investors. OECD, September 2013.

⁵ Youdayeva K. Economic reversal may come as a surprise. *Vedomosti*, February 24, 2014.



Source: the author's estimates based on the data supplied by the Bank of Russia.

Fig. 40. Credit portfolio growth and increase in Bank of Russia's support to banks in the period of January 2010 thru December 2013.

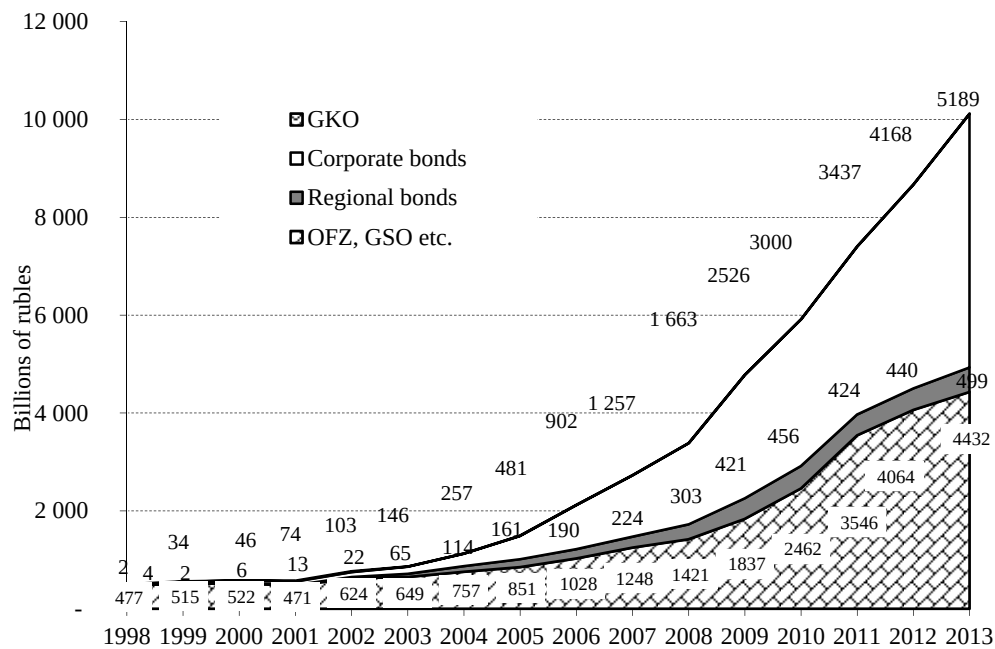
3.5.2. Corporate bonds and economic growth

Supporting banks' investment in corporate bonds through repo transactions is one of Bank of Russia's core measures aimed at promoting economic growth. This mechanism helps the Bank of Russia provide banks with cheap short-term monetary resources at a basic rate of 5.5% p.a. effective in 2013 to against corporate bonds. This mechanism allowed banks to receive resources for purchasing corporate bonds, "plus" extra return on investment in bonds through their remortgaging in the Bank of Russia.

In the period of state expansion the repo mechanism turned from a tool of coping with temporal gaps in banks' liquidity into a permanent method, whereby steady growth in the corporate bond market was maintained (see Fig. 41). The possibility to use bonds for refinancing in the Bank of Russia gives rise to extra demand for bonds and facilitates issuance activity in the securities market¹. Capitalization the ruble-denominated bond market increased from Rb 0,6 trillion in 2000 to Rb 10,1 trillion in 2013, or by 16.8 times. The corporate bond market saw the fastest growth against other ruble-denominated bonds, their total capitalization increased from Rb 46bn in 2000 to Rb 5,2 trillion in 2013, or by 113.0 times.

It is, however, not obvious that the repo mechanism has the same positive effect on economic growth like growth in the corporate bond market does. This in particular is evident by the Federal State Statistics Service (Rosstat) official data on the role of companies' fundraising through issuing corporate bonds as investment source. Table 13 reflects the parameters of the ruble-denominated corporate bond market in 2000–2013, expressed in US dollars. The amount of corporate bond proceeds contributed to equity still remain low despite rapid growth in corporate bond issuances from \$1,1bn in 2000 to \$54bn in 2012.

¹ The Central Bank of the Russian Federation. Money Market Review, Quarter 4, 2013, p.19.



Source: based on the data supplied by the Ministry of Finance of Russia and Cbonds.ru.

Fig. 41. Outstanding ruble-denominated bonds,
billions of rubles

In 2012, only Rb 4,2bn, or 35% of companies' bond issue proceeds, of a total of Rb 1214,2bn corporate bond issuance were allocated to fixed capital investment, according to Rosstat's official data. In 2013, only Rb 5,0bn, or 0.29%, of companies' annual bond issue proceeds of a total of Rb 1705,2bn annual corporate bond issuance were allocated to fixed capital investment within nine months of the year. According to the foregoing statistics, one may infer that Bank of Russia's artificial support to the corporate bond market through repo transactions has no positive effect whatsoever either on fixed capital investment, or economic growth. Perhaps, corporate bonds, which are supported through funding from the money market, are *de facto* too short-term sources of financing for companies engaged in the real sector of economy, this is why the latter use them for working capital financing and old debt financing. All this raises the question of seeking alternative forms of financing the banking system by the Bank of Russia to make this mechanism appealing for banks in financing long-term projects of companies engaged in the real sector of economy, having a positive effect on economic growth.

Another issue of the financial market's effect on economic growth is the effect of the interest rate policy on bank's interest in lending to companies engaged in the real sector of economy. Accelerated growth in bank financing volumes through repo transactions in 2012–2013 took place at the backdrop of an increase by 1–2 percentage points in returns on investment in government securities (OFZ) over interest rates in the repo market (see Fig. 42). In other words, major state-run banks as principal beneficiaries in the repo market could generate profit without any serious risk simply by investing funds received from the Bank of Russia, as government securities, instead of lending to organizations engaged in the real sector of economy.

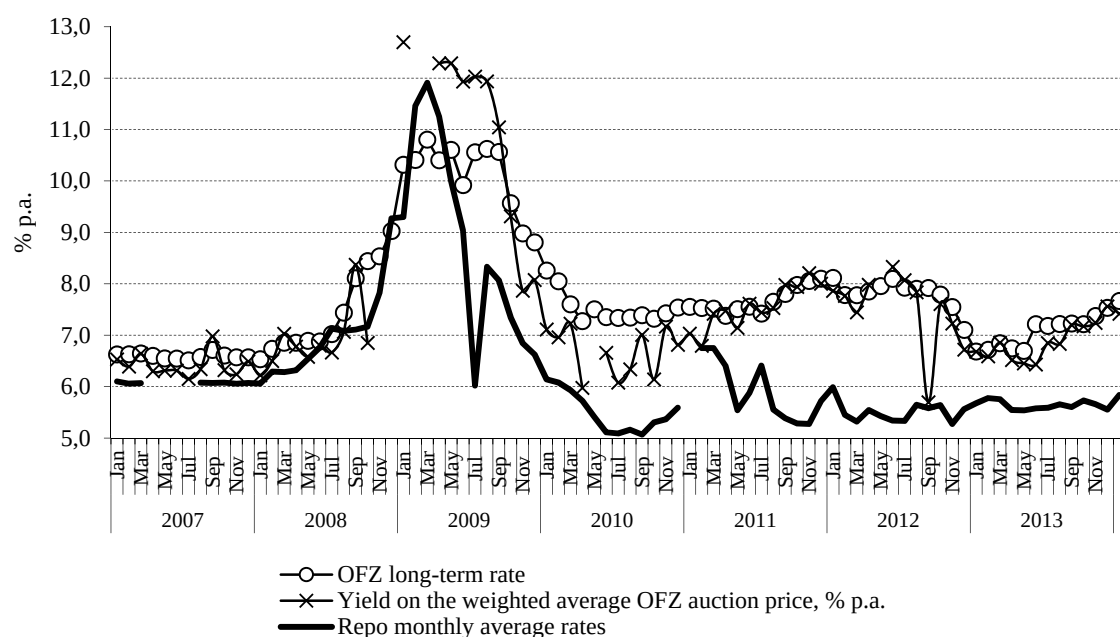
Table 13

**Parameters of the ruble-denominated corporate bond market
(billions of US dollars)**

	Capitalization	Secondary market including repo	Bond placement	Bond issue proceeds to the equity		
				billions of US dollars.	the same as % of capitalization	the same as % of bond placement volume
2000	2	0,2	1,1			
2001	3	1	0,8			
2002	3	2	2	0,1	3.0	6.7
2003	5	8	3	0,1	2.1	3.8
2004	9	15	5	0,1	1.1	2.0
2005	17	44	9	0,3	1.8	3.3
2006	33	135	17	0,1	0.3	0.6
2007	49	371	18	0,2	0.4	1.1
2008	67	457	16	0,2	0.3	1.2
2009	80	293	29	0,1	0.1	0.3
2010	99	757	28	0,03	0.03	0.1
2011	117	1237	31	0,014	0.01	0.05
2012	134	1866	39	0,14	0.1	0.4
2013	163	2839	54	0,16*	0.1	0.3

* in the period of January thru September 2013.

Source: the author's estimates based on the data supplied by the Moscow Exchange, cBonds, the Bank of Russia, and Rosstat.



Source: the author's estimates based on the data supplied by the Bank of Russia.

Fig. 42. Average monthly rates in the OFZ market and repo market

3.5.3. IPO of shares' effect on the economy

IPO and SPO of shares is more efficient tool of fundraising than corporate bonds for fixed capital investment. This is determined by the fact that IPO proceeds are of more long-term nature. Table 14 presents parameters of the Russian stock market. The parameters show that most active IPOs of shares took place in 2006 and 2007 when companies borrowed \$17,0bn and \$33,0bn respectively. In 2006, companies allocated 18.8% of IPO-SPO proceeds to

purchase fixed assets, whereas in 2007 this indicator declined to 10.9%. There were years, for example 2008 and 2009, when 110.5% and 117.6% respectively of IPO proceeds was fixed capital investment, which is associated with that companies received a part of fixed capital investment through closed subscription rather than IPO-SPO.

In 2013, \$1,6bn, or 17.8%, of a total \$9,0bn of public offerings were allocated to fixed capital investment within nine months of the year. In 2012, \$3,1bn, or 32.6%, of a total \$9,5bn of initial public offerings were allocated to fixed capital investment. A part of the resources borrowed in the stock market was allocated to repurchase a business from the previous owners, debt refinancing, and servicing A&M transactions including purchase of major stocks of shares. IPOs and investment in real capital through issuing shares have so far been much less in volume than A&M transactions. In the period of 2000 through 2013, Russian companies' IPO-SPO volume totaled \$100,5bn, whereas A&M transactions volume totaled \$941,8bn, or by 9.4 times and beyond.

Table 14

**Parameters of the market of Russian companies' stocks
(billions of US dollars)**

	Capitalization	Secondary market including foreign exchanges	IPO of shares	IPO contributions to equity			A&M transactions volume
				billions of US dollars.	the same as % of capitalization	The same as % of IPO volume	
2000	41	47	0,5	0,2	0,5	40,0	5
2001	75	49	0,2	0,1	0,1	50,0	12
2002	106	87	1,3	0,2	0,2	15,4	18
2003	176	188	0,6	0,2	0,1	33,3	32
2004	230	541	3	0,1	0,0	3,3	27
2005	549	374	5,2	3,2	0,6	61,5	60
2006	1057	914	17	3,2	0,3	18,8	62
2007	1503	1687	33	3,6	0,2	10,9	126
2008	397	1983	1,9	2,1	0,5	110,5*	110
2009	861	1156	1,7	2,0	0,2	117,6*	56
2010	1379	1431	6,3	2,4	0,2	37,9	56
2011	1096	2222	11,3	2,6	0,2	23,1	79
2012	1079	2128	9,5	3,1	0,3	32,6	135
2013	1041	2095	9,0	1,6**	0,2	17,8	163

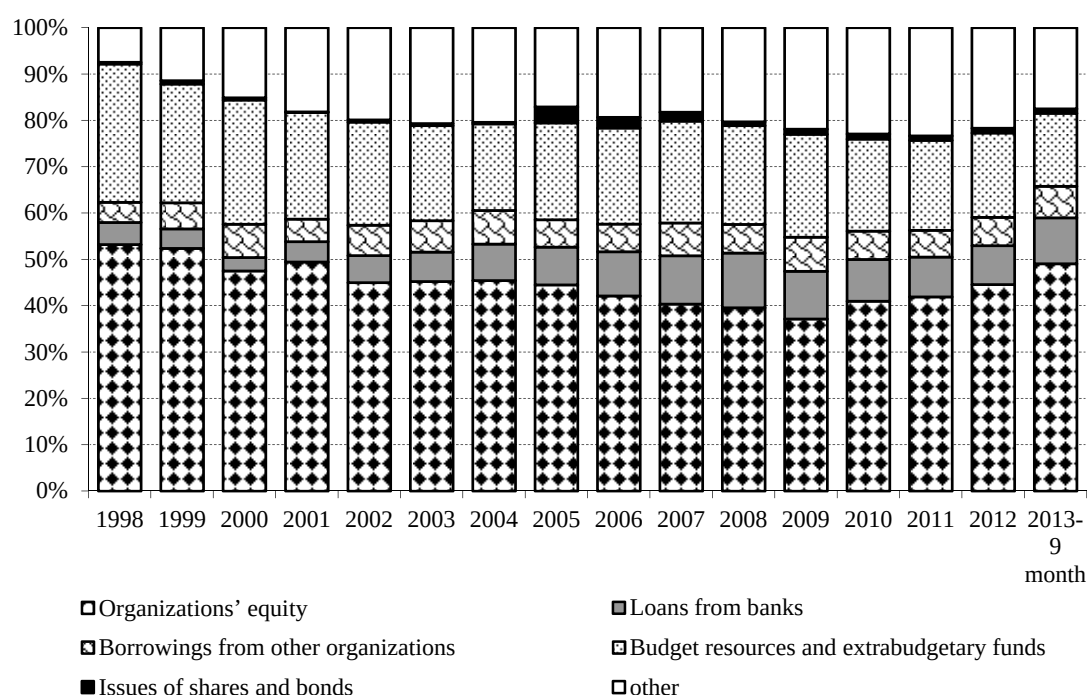
* the value is more than 100%, because a part of fixed capital investment might be through private subscription of shares;

** in the period of January thru September 2013

Source: the author's estimates based on the data supplied by the Moscow Exchange, cBonds, the Bank of Russia, and Rosstat.

The amount of funds which companies raise through issuing stocks and corporate bonds and then allocate them to purchase fixed assets accounts for a small part of sources of fixed asset financing. This is supported by the data on sources of financing investment in fixed assets (*Fig. 43*).

In the period of 2000 thru 2012, the share of funds raised through issuing bonds and stocks in sources of fixed capital financing varied within a range of 0.1% in 2001 to 3.4% in 2005. The same indicator was recorded 1.0% in 2012 and within nine months in 2013.



Source: the estimations are based on the data supplied by Rosstat.

Fig. 43. Structure of sources of investment in fixed assets

3.6. Investors in the Russian stock market

3.6.1. Internal institutional investors

Stable institutional investors are required to increase the rate of household savings and fundraising of long-term resources, as is the case with public reserves. Their low relative level of development in Russia (see *Table 15*) constitutes the key problem for the Russian financial market. The initial stage of pension reform slowed down growth in pension accruals through allowing policy holders to choose between a zero rate and 6% contributions to the funded component of retirement pension, as well as temporal waiver to accumulate pension accruals in 2014. Nevertheless, pension accruals are most likely to resume growth when a system of pension accruals safety guarantees is introduced in 2015 and comprehensive revision of financial stability of non-government pension funds is completed.

All three types of institutional investors (pension and mutual funds, insurance organizations) are poorly developed in Russia as compared to other countries including major emerging economies. The Russian banking system has been ranked with a mean score in terms of value of commercial banks' assets as percentage of GDP (see *Table 15*). Russia has been ranked 64th of the 67 countries covered by the statistics on mutual funds' assets; 53rd of the 67 countries in terms of autonomous pension funds' assets; 47th of the 50 countries in insurance companies' assets. In 2012, the value of open-end and interval unit investment funds in Russia accounted for 0.2% of GDP; pension accruals and reserves for 5.0% of GDP; insurance organizations' assets for about 1.7% of GDP. Additionally, Russia has been ranked 100th of the 168 countries on which the World Bank discloses data on the share of commercial banks' assets as percentage of GDP.

Table 15

Institutional investors and banks in Russia (based on average values in 2001–2012)

	Number of countries in samples ICI ¹ , OECD and World Bank	Russia's place in samples	As percentage of GDP	
			Average in 2001–2011 .	2012
Open-end investment funds' assets*	67	64	0.3	0.2
Autonomous pension funds' accruals and reserves **	67	53	2.1	5.0
Insurance companies' assets ***	50	47	1.4	1.7****
Commercial banks' assets*****	168	100	33.0	45.6*****

* Russia – open-end and interval unit investment funds (UIFs);

** Russia – pension accruals and reserves – total (in non-state pension funds and asset managers);

*** Russia – insurance reserves;

**** 2011;

***** Net of development banks. The average is 55.0% in 2001–2011; 76.9% in 2012 for all commercial banks of Russia

Source: the author's estimates based on the data supplied by Investment Company Institute, resources www.stat.org OECD, www.econ.worldbank.org, World Bank and IFS IMF.

Russia should cope with the lag in the development of institutional investors in order to maintain investment activity in the country. This means that the banking sector should focus on making sure that the banking system is reliable and strong. With the regard to pension funds, insurance companies, open-end and interval unit investment funds (UIFs), most importantly, a development policy aimed at creating efficient companies which enjoy confidence of individuals should be implemented. This requires support of competition in the financial services market and protection of investors' rights, i.e. what is referred to the regulating rather than supervising function of the state.

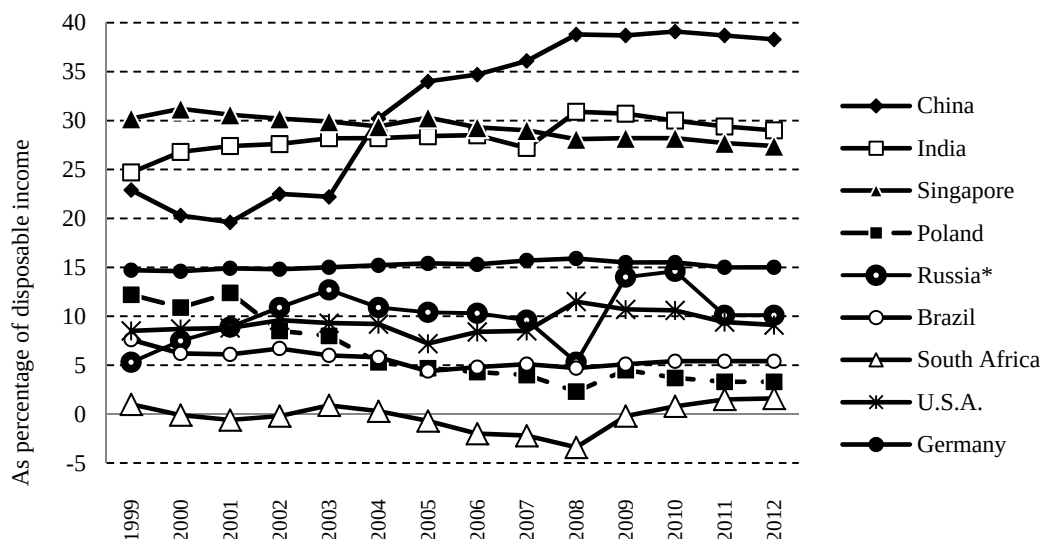
3.6.2. Individual domestic investors

Russia should maintain high rates of domestic savings to be able to maintain its economic and modernization growth rates. Increasing the household saving rate serves as reserve for savings growth. Rosstat's official statistics shows that Russian households save about 10% of their income (see *Fig. 44*). Household saving rate is much higher than that of disposable income in those countries which are leading in economic growth and modernization, namely China, India, Singapore, Hong Kong. Indeed, social and demographic situation in these countries differs from that in Russia, however it should be admitted that any large-scale modernization tends to rely on internal finances. Furthermore, under the current circumstances high consumption rate in Russia means promotion of foreign manufacturers through internal demand.

Fig. 45 presents data on the number of individual investor accounts opened with brokers and the number of personal accounts in the register of unitholders of unit investment funds (UIFs). The period of 2010–2013 was distinguished by an emerging trend towards slower growth in the number of brokers' customers registered in the MICEX trading system. Annual growth in the number of registered customers was 112,200 persons in 2009, only 42,800 persons in 2010, 66,500 persons in 2011, 24,800 persons in 2012, 38,800 persons in 2013. The number of brokers' active customers dropped from 114,100 persons in 2009 to 54,600 persons in January 2014. This might mean that the existing model of attracting customers to the Russian stock market has begun to run its course. Every country has a limited number of

¹ Investment Company Institute.

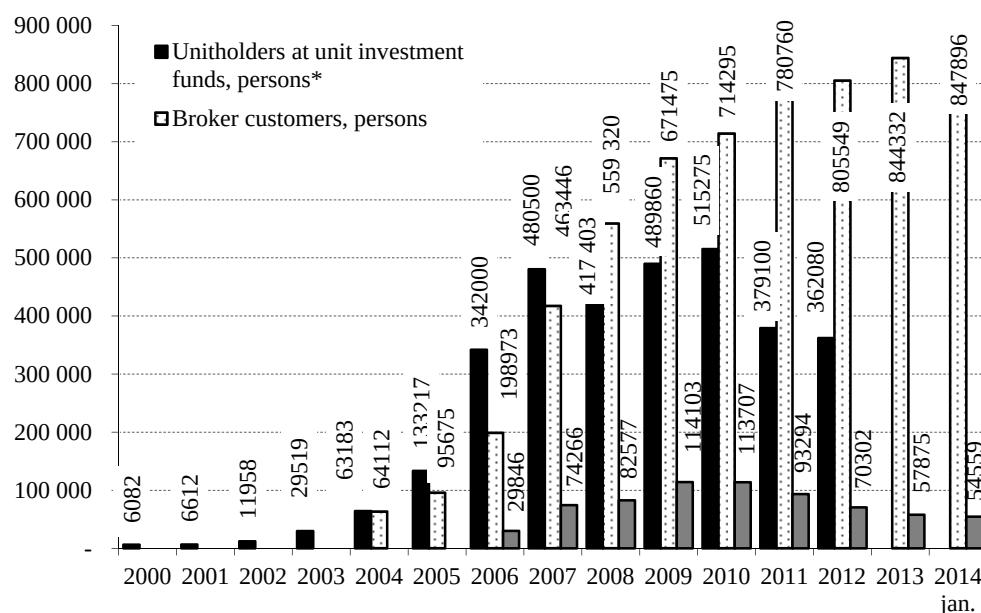
persons specializing in gambling in the stock exchange. A new model of growth requires attracting long-term investors to the market, which cannot be done without creating an efficient system of pension accruals and reconstructing the model of services provided by financial institutions.



* Rosstat's data, net of savings in deposits denominated in foreign currencies and savings in foreign exchange.

Source: the estimations are based on the data supplied by Euromonitor International.

Fig. 44. Household saving rate, as percentage of disposable income



* Expert Rating Agency's data for 2013 still remains to be published.

Source: the author's estimates based on the data supplied by the Moscow Exchange, Russia's National League of Management Companies, and Expert Rating Agency.

Fig. 45. The number of market retail customers covered by asset managers and brokers

The adoption of revolutionary amendments to the applicable legislation which provide for introducing from January 1, 2013 substantial personal income tax allowances in taxation of yields on securities which are held for a period of at least three years, as well as, from January 1, 2015, allowances on individuals' contributions to so called personal investment accounts (PIA)¹ became the most remarkable event in the realm of private savings in 2013.

Under the Federal Law of December 28, 2013, No. 420-FZ On Making Amendments to Article 27.5-3 of the Federal Law "On the Securities Market" and Parts 1 and 2 of the Tax Code of the Russian Federation, returns from investment in newly purchased securities will be exempted from taxation to the extent that a physical body holds such securities for a period of three years and beyond. At present, all returns which individuals generate from investment in securities – through unit investment funds (UIFs), trust management, or direct holding through broker's accounts – are subject to personal income tax at a 13% rate. The maximum amount to be deducted from the tax base is Rb 3m per each year of shareholding (unitholding). The personal income tax allowance is not applied to income as dividends on shares and coupon payments on bonds, except in cases where a person is holding securities indirectly through an open-end unit investment fund. For this reason it is unitholders at open-end unit investment funds specializing in long-term investment who will benefit most from this tax allowance.

Furthermore, a concept of individual investment accounts which private investors will be able to open with brokers and asset managers from 2015 was introduced into the Federal Law "On the Securities Market" and the Tax Code of the Russian Federation. The national may have only one agreement to maintain a PIA. This account can be credited up to Rb 400,000 on an annual basis. The PIA owner may choose one of the two available options of investment deduction. The first option suggests that when a PIA is closed not earlier than after three years from the opening date, the investor is entitled to a tax exemption of 13% of total contributions made. The second option makes no provision for tax deduction from contributions, however, when the PIA is balanced, the entire amount paid to the PIA owner is exempted from personal income tax.

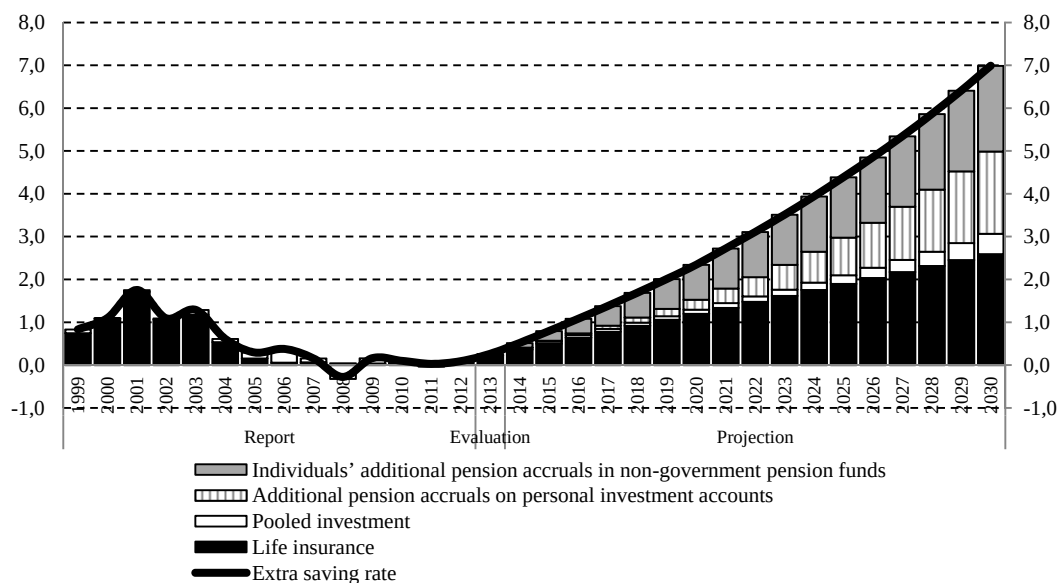
Both tax allowances, in our opinion, provide strong incentives for private investors investing in securities for a period of at least three years. We tried to assess the effect of the measures aimed at promoting household savings through growth in individuals' extra pension contributions to non-state pension funds and PIAs, growth in individuals' investment in life insurance policy and units of open-end and interval unit investment funds (UIFs). Additionally, benchmark values of growth in life insurance, collective investment, and non-state pension funds were calculated on the basis of the proposals made by representatives of respective industries during a strategic session Financial Market Regulation Policy Guidelines as part of the project on the creation of a Moscow Financial Center with the participation of the head of the Bank of Russia Financial Markets Service (FMS)². The data on growth in the assets on PIAs were calculated separately on the basis of understanding this market potential, the assumption that the level of this product penetration among middle class would be about

¹ Judging by their status, these accounts resemble two investment arrangements which are popular in many countries, namely individual retirement accounts (IRAs) which are used extensively in the United States, Poland, the Republic of Korea, Canada etc., as well as individual savings accounts (ISAs) which are widely used in Great Britain.

² More details are available at <http://mfc-moscow.com/index.php?id=119>.

40% by 2030, average saving rate on PIAs of their owners would gradually reach 10% of income, while average nominal return on investment in 2014–2030 would be 8% p.a.

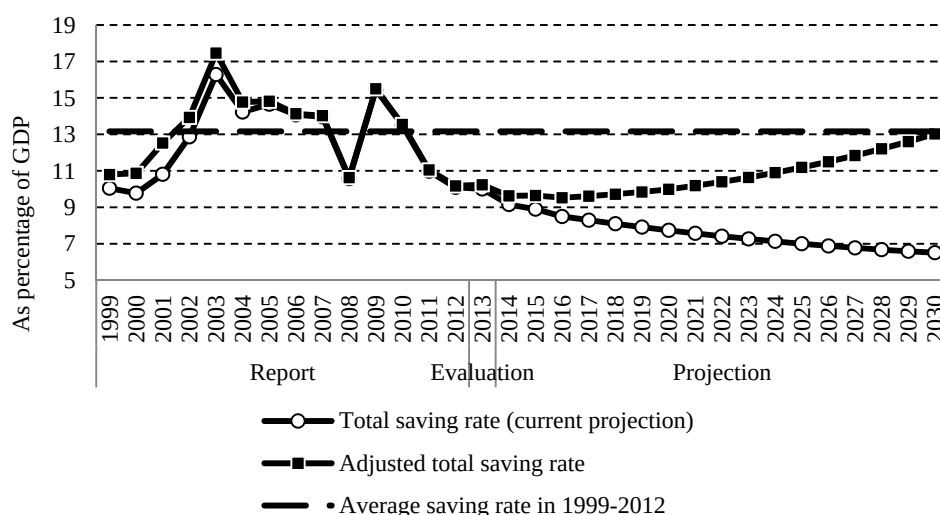
Fig. 46 presents the main results of the calculations made. Under the reference forecast, gross extra saving rate might be 0.5% of GDP in 2014, 2.3% in 2020, and about 7.0% in 2030. Such products as life insurance, voluntary contributions to non-state pension funds and personal investment accounts will grow most.



Source: the author's estimates.

Fig. 46. Structure of extra savings, as percentage of GDP

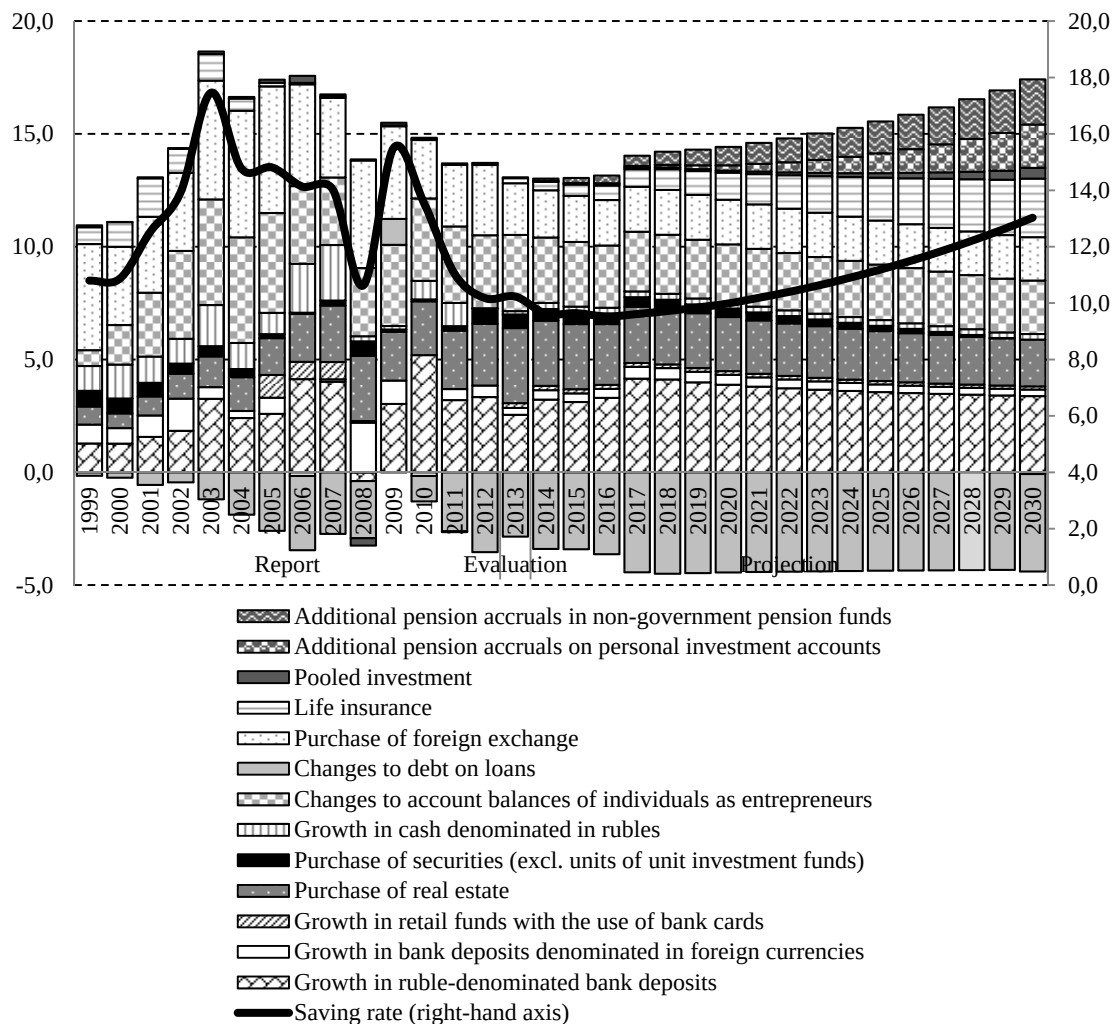
The average household saving rate for the period between 1999 and 2012 was used as natural constraint to growth in the savings rate in our forecast (see *Fig. 47*). Furthermore, if the reference scenario of the development of extra long-term household savings was realized, the adjusted rate (as percentage of GDP) would return to its natural average value in 2030.



Source: calculations made by the authors of the study.

Fig. 47. Current and adjusted household saving rates, as percentage of GDP

Fig. 48 shows an approximate structure of household savings if the reference scenario of growth in voluntary savings with institutional investors was realized.



Source: calculations made by the authors of the study.

Fig. 48. Household savings structure factoring in extra forms of savings, as percentage of GDP

Our estimates show that if traditional forms of savings such as bank deposits, individual entrepreneurs' cash reserves, purchasing foreign exchange and real estate keep prevailing, new types of savings through institutional investors will play a more important role and exceed substantially savings as direct investment in securities. Household savings through institutional investors are expected to reach Rb 3 trillion in 2020 and about Rb 17 trillion by 2030.

3.6.3. Foreign conservative investors

Major foreign institutional investors' behavior towards the Russian stock market still remains conservative. This conclusion is supported by the data on investment in Russian JSCs shares by California Public Employees' Retirement System (Calpers), U.S. largest public pension fund whose assets were \$258bn worth in 2013 (see Table 16).

Table 16

**Calpers investment in depositary receipts and shares (equity securities)
of Russian companies, millions of US dollars**

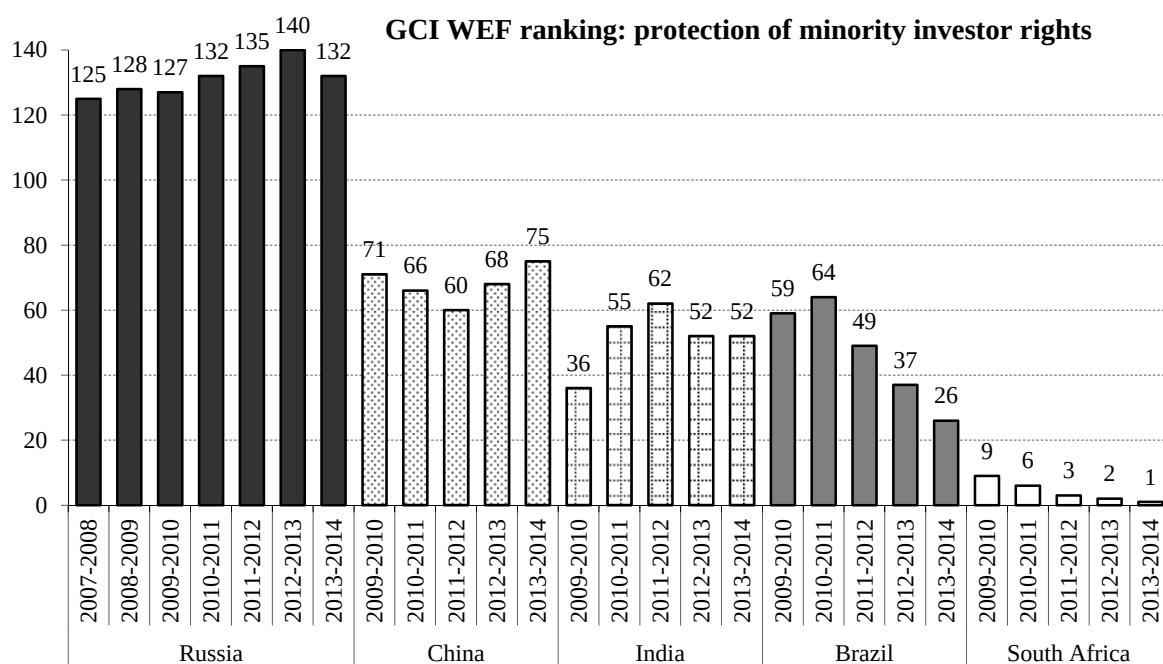
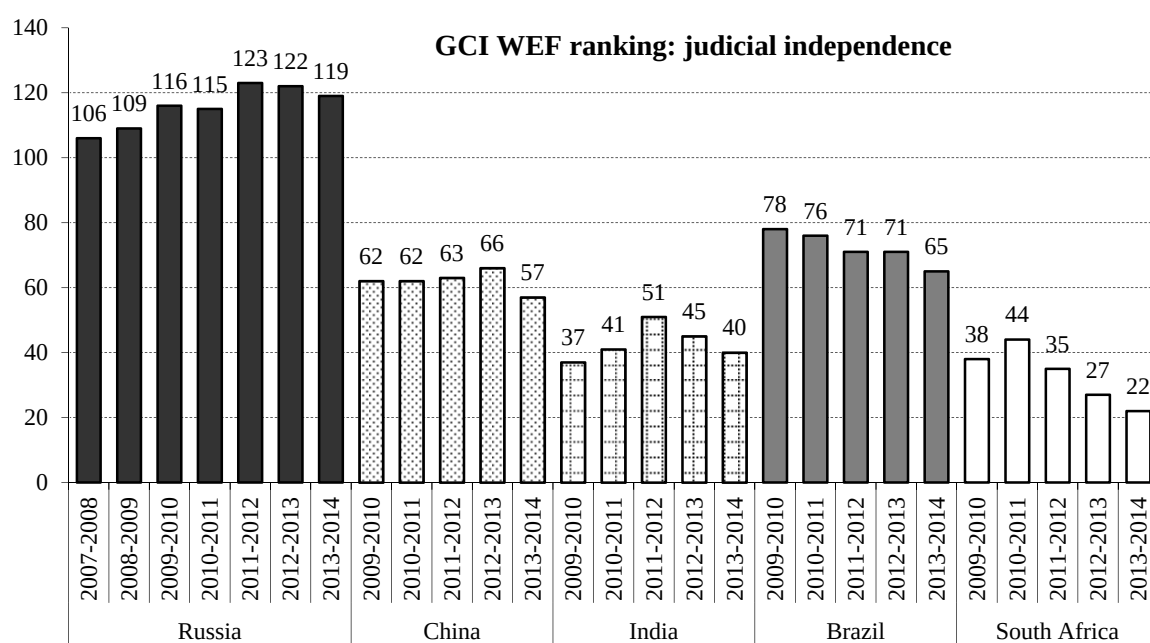
	2008*	2009*	2010*	2011*	2012*
Gazprom	144,7	46	55,1	154,4	56,4
Lukoil	189,1	93,5	80,6	78,7	68,2
Mechel	9,1	1	1,8	9,8	0,6
Norilsk Nickel	4,6	1,4	14,3	12,1	0,0
OAO Novatek		20,6	10,4	45,4	36,2
JSC Novorossiysk Commercial Sea Port	10,3	8,4	7,7	6,3	4,4
Rosneft	11,4	31,4	15,7	59,7	26,4
Plus Gold		5,5	2,3	5,8	0,0
Rostelecom		3,4	1	16,4	14,0
Sberbank of Russia	5,5	30,8	9,3	53,7	114,3
Severstal	7	4,7	7	9,4	6,5
Sistema JSFC	9,7	3,8	62	71,9	50,3
Surgutneftegaz	4,5	20,5	18,9	23,5	21,7
Wimm-Bill-Dann		20,2	2,2	0	0,0
Magnit		7,3	15,5	37,5	38,7
Magnitogorsk Iron and Steel Works		6,1	2	2,8	1,8
VTB	31,6	6,9	14,3	22,8	12,5
LSR Group		2,9	4,4	4,5	4,1
Other OJSCs			12,9	60,1	72,0
Receipts and shares of Russian companies – total	427,4	314,4	337,4	674,8	528,0
Equity securities purchased in domestic and external markets – total	122 281,2	80 728,6	91 776,3	117 640,8	112 299,4
The share of receipts and shares of Russian companies in the Calpers portfolio	0,35	0,39	0,37	0,57	0,47
These share of Russian companies' shares in global capitalization	1,23	1,80	2,51	2,31	1,97

* fiscal year ending in June; detailed information on the Calpers portfolio composition and structure which is available on the Calpers official website is posted with about a year's lag, most likely to prevent copying the portfolio strategy of the pension fund.

Source: based on the Calpers investment report for a few years.

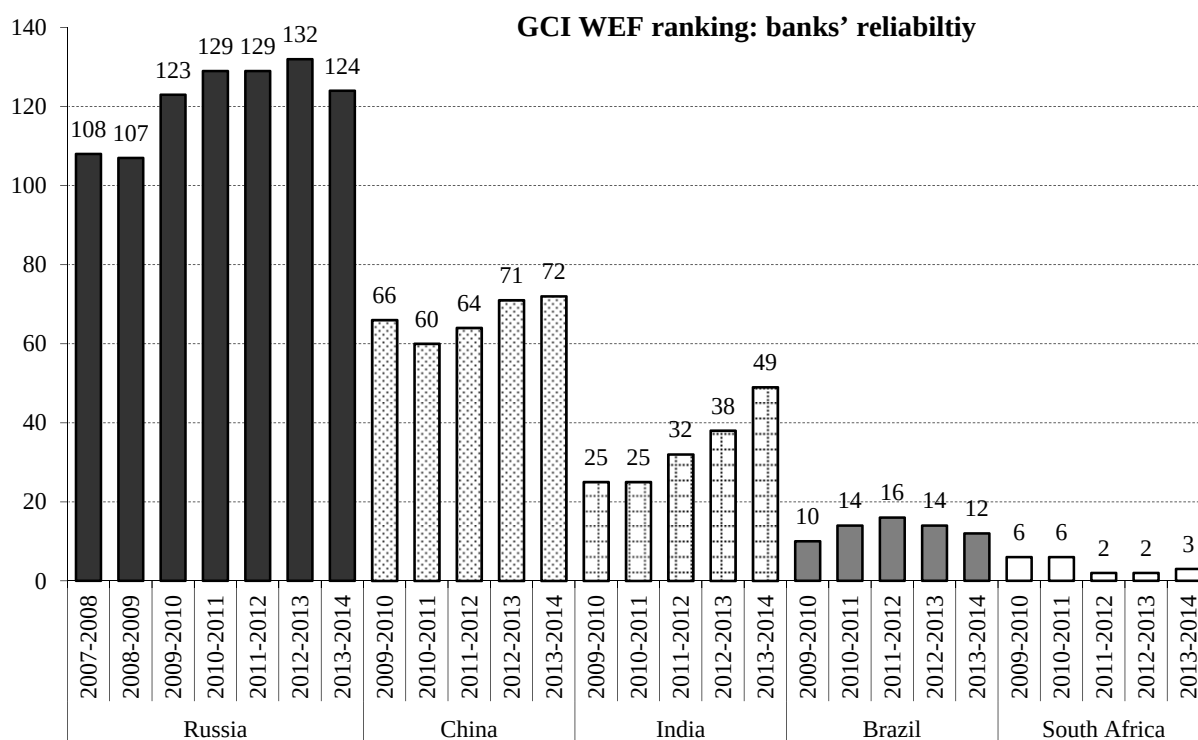
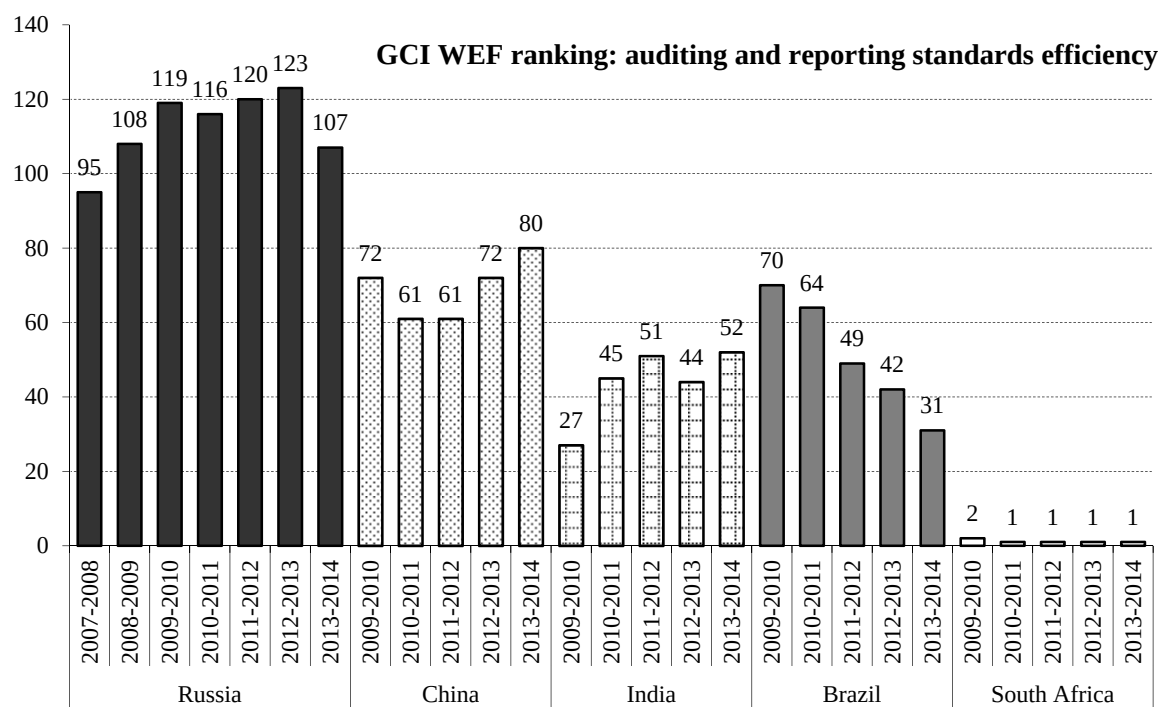
Calpers investment in Russian companies' shares is subject to limits. The investment increased from \$427m, or 0.35% of the pension fund's portfolio of stocks, in 2008 to \$528m, or 0.47% of the pension fund's portfolio, in 2013. To compare, Russian companies' shares accounted for 1.23% of global capitalization in 2008, and 1.97% in 2013. The weight of the Calpers Russian equity securities portfolio is underestimated, which is indicative of Calpers concerns about risks it might be exposed to through investing in such securities.

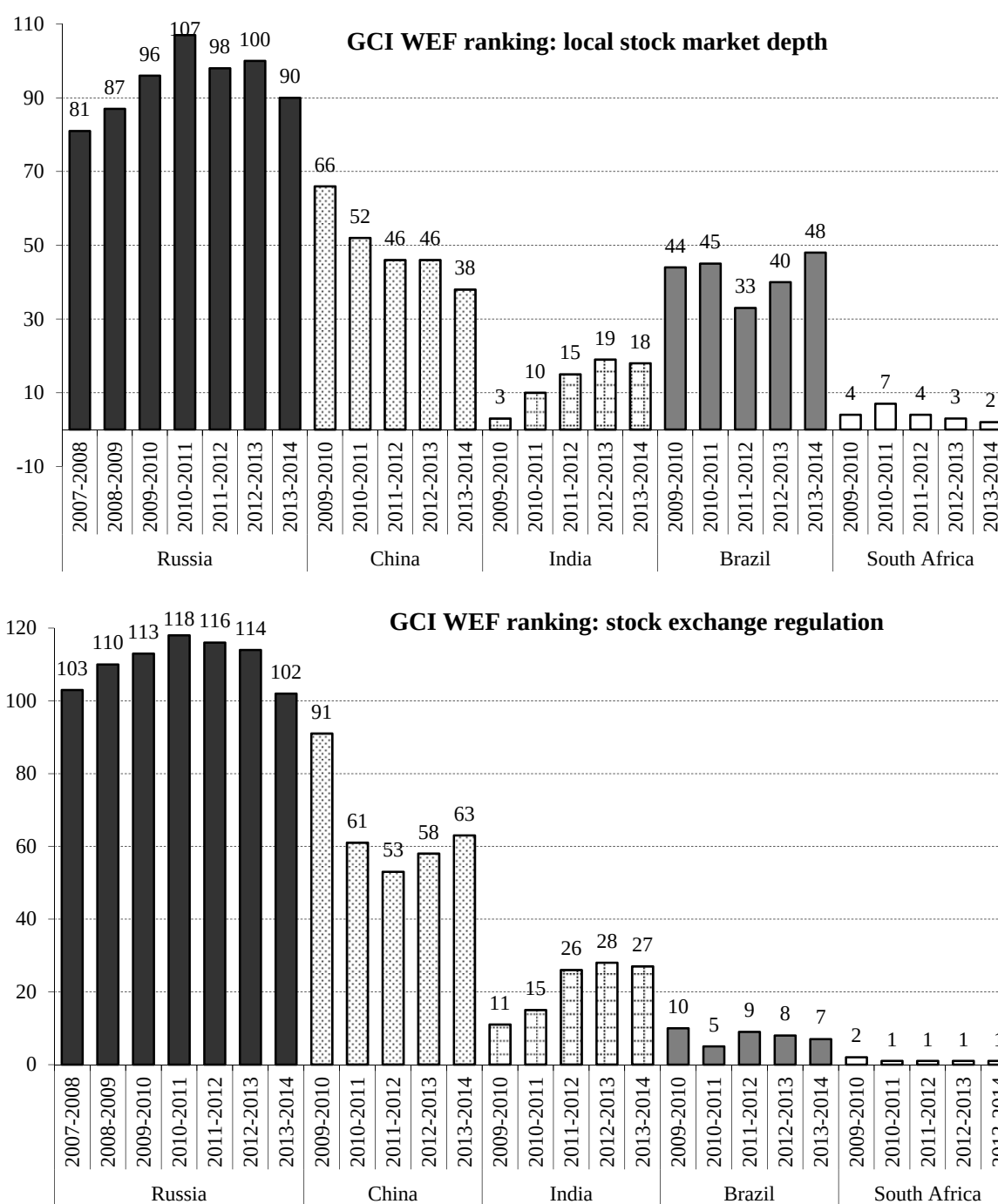
It was not until 2008 when Calpers began to invest in depositary receipts and stocks of Russian JSCs. Within many years prior to 2008 Calpers employed the method of making investment rankings for emerging markets to see whether it can invest in such markets. Russia has long been ranked as an emerging market, but emerging market were not eligible for investment by the Californian pension fund. In 2007, Calpers decided not to follow strictly to this method, allowing portfolio managers in emerging markets to decide whether or not to invest in shares of some of other issuers. However, analysis of the previous method allowed us to highlight key factors which for many years prevented Calpers from investing in Russia. These factors and their assessment by using the method of global competitiveness ranking of the World Economic Forum are shown in Fig. 49.



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Source: World Economic Forum's Global Competitiveness Ranking for several years.

Fig. 49. BRICS's countries in Global Competitiveness Ranking of the World Economic Forum on a series of criteria eligible for making decisions by conservative portfolio investors

Russia has been far behind the markets of other BRICS's countries in addressing the most challenging issues such as judiciary independence, protection of minority investors, auditing and reporting standards, stock market depth, effectiveness of stock exchange regulation, and reliability of banks. Additionally, in 2012, Russia's scores worsened on the four of the

foregoing criteria. In 2013, Russia's ranking inched up on all the six criteria, however the gap between Russia and other BRICS's countries has not yet been eliminated.

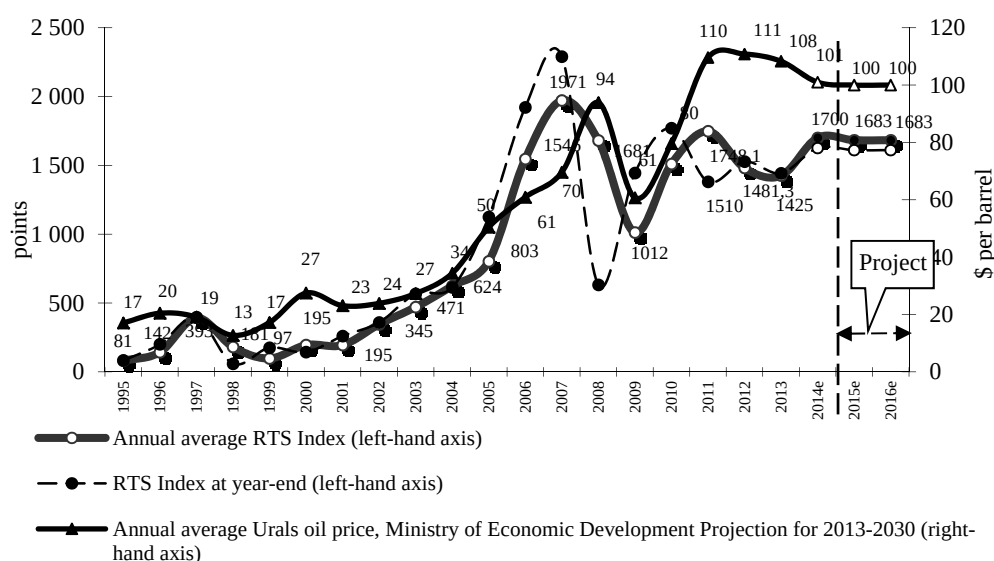
3.7. Risks in the financial market

The following factors govern the principal risks in the financial market. Stock market stagnation because of no growth in prices of energy resources; risks associated with foreign capital outflow; the ruble devaluation risk; outstripping growth in external debts owed by banks and non-financial sector; carry trading renewal; growth in trading volumes in the Forts market against insufficient security of transactions.

3.7.1. Prices of shares and dynamics of crude oil prices

As shown in section 3.3.1, Russian stock market depends on crude oil prices. These prices describe the situation in global economy, financial system stability, and cash liquidity in that system. The recent projections of the Ministry of Economic Development of Russia and international financial institutions, both of which show that crude oil prices will not go up in the mid-term through the development of new technologies in oil and gas production allowing many countries to gradually switch to a self-sufficient oil and gas supply.

If we apply the equation of relationship between crude oil prices and index, as shown in *Fig. 12*, to the mid-term forecast of crude oil prices made by the Ministry of Economic Development for a period of 2014–2016, then the annual average RTS Index would grow, at slow rates though. In 2014, it may increase to 1700 points against 1425 points in 2013, i.e. the annual average index would grow by 19.3%.



Source: the author's estimates based on the data supplied by the Ministry of Economic Development of Russia and the Moscow Exchange.

Fig. 50. RTS Index projection until 2016 based on the Ministry of Economic Development's oil prices forecast

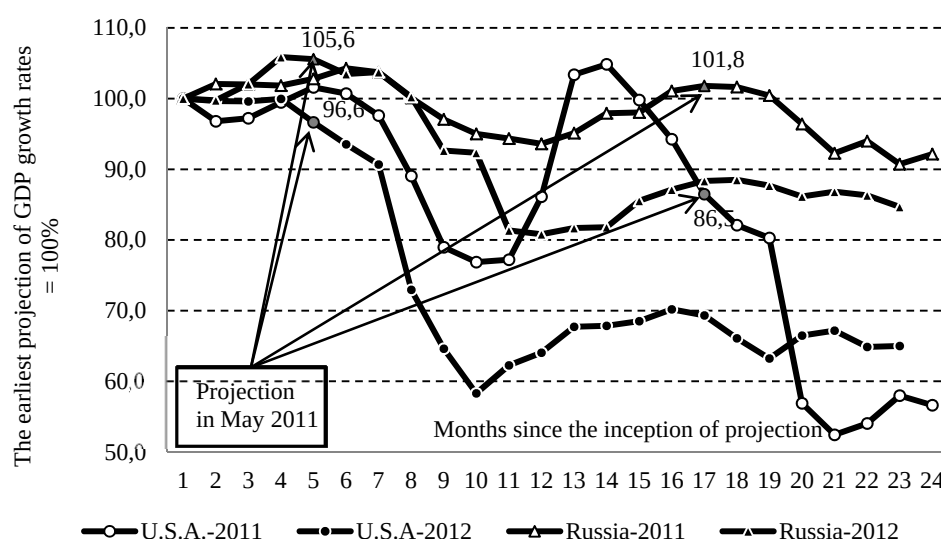
The presented method of forecasting growth in the annual average stock index is not ideal, however, just like any other method of forecasting stock market indicators. The reason for the weakness of a forecast relying upon the historical relationship between crude oil prices and

the RTS Index is that foreign investment outflow from Russia has the strongest downward effect on the RTS Index since its inception.

3.7.2. Foreign capital outflow

Section 3.3.2 presents analysis of the relationship between the Russian stock market and capital movement in foreign investment foundations investing in Russia. It shows with referenced to an IMF's study that portfolio investors make their decisions on the basis of the dynamics and volatility of GDP growth forecasts, evaluation of exchange rate volatility, indices of anticipated volatility in mature and emerging markets.

In 2013, the trend towards capital outflow from foreign foundations specializing in investment in Russia continued since May 2011. It is shown in *Fig. 51* that capital outflow from the foundations began in May 2011 and coincided with drastic worsening of forecasts for the U.S. economy for 2012, supporting our hypothesis that changes to global economic growth forecasts registered in the Consensus Economics base have a stronger effect on the behavior of foreign portfolio investors who invest in foundations specializing in investment in Russia. In January 2013, the IMF 2013 forecasts downgraded again projections of global economic growth. The 2013 GDP growth forecast for Russia and the United States was downgraded by 0.1 p.p., being indicative of that in the first half of 2013 the Russian market is likely to see a small outflow of portfolio investors' capital, which cannot be stopped as soon as economic growth forecasts for 2013–2014 are upgraded.



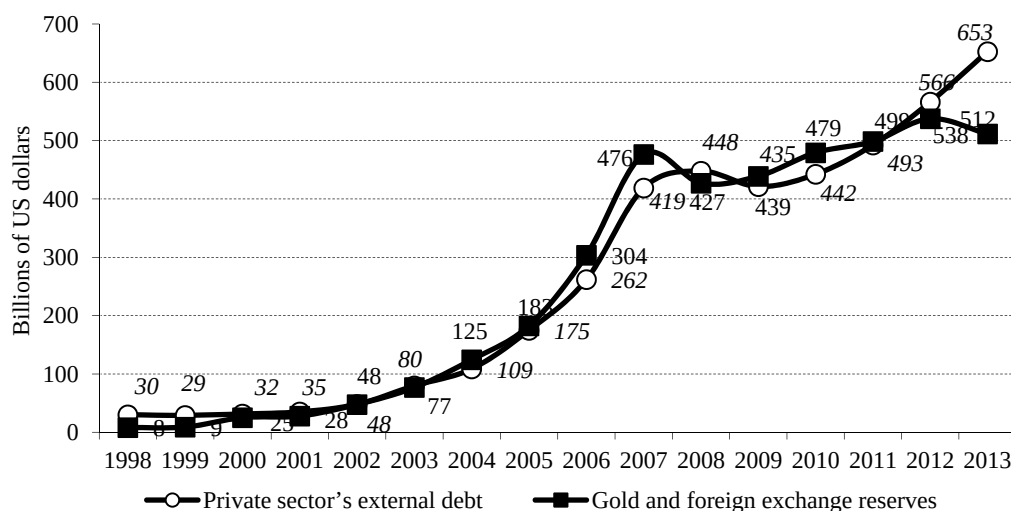
Source: the author's estimates based on the data supplied by Consensus Economics.

Fig. 51. Changes to analysts' consensus projections of GDP growth in 2011 and 2012

3.7.3. Risks related to banks' and non-financial businesses' external debt

Russian banks' and non-financial companies' external debt increased \$87bn, or by 15.4%, in 2013, continuously overtaking the value of the gold and foreign exchange reserves of the Russian Federation (see *Fig. 52*). It amounted to \$653bn as compared to \$512bn of foreign exchange reserves. On the one hand, outstripping growth in businesses' external borrowings can be regarded as positive trend towards intensive fundraising required for economic growth

and development. On the other hand, accruing businesses' external debt in values exceeding substantially the value of foreign exchange reserves reduces the ability of the state to support businesses in case of a crisis and depreciation of assets. Additionally, cheaper borrowings in foreign markets vs. the domestic market lead to carry trading, which eventually, at a high level of inflation, impedes the development of internal institutional investors and their investment at a real interest rate.

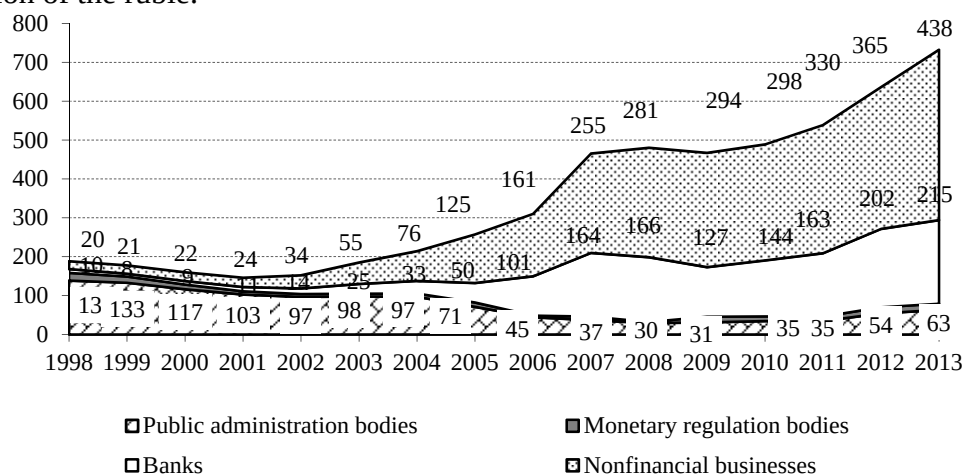


Source: the author's estimates based on the data on balance of payments over a few years.

Fig. 52. Growth in private sector's debt and state cash surplus

Fig. 53 presents data on external debt owed by banks and non-bank companies separately. Banks' external debt increased from \$202bn in 2012 to \$215bn in 2013, or by 6.4%.

Non-bank companies' debt increased from \$365bn in 2012 to \$438bn in 2013, or by 20.0%. In 2013, like in the previous year, the private sector's external debt increased despite substantial net capital outflow from Russia. Capital outflow from Russia is associated with a set of factors including weak institutional environment, slowdown in growth, and anticipated devaluation of the ruble.



Source: based on the data on balance of payments over a few years.

Fig. 53. Russian Federation's external debt in 1998–2012, billions of US dollars

3.7.4. Risks related to carry trading as speculative strategy

In 2012 and early in 2013, the financial market saw lots of signs of reviving carry trading strategy which already brought Russia into the crises in the banking system in 1998 and 2008. Technological conditions have been created for speculative foreign capital inflow to the market through accounts with international clearing and settlement systems, regulations imposing limits on banks in borrowing from nonresidents have been relaxed. Banking sector's external debt has been mounting at outstripping rates, the banking sector has increasingly been active in using financial leverage for building up the credit portfolio.

How dangerous the carry trading strategy is? What consequences may it bring about? There are three aspects that are worth mentioning: growing risks of a liquidity crisis in the banking system; the threat of wasting the national gold and foreign exchange reserves through support to ineffective businesses; reducing internal incentives for individuals to make long-term savings using ruble-denominated bonds.

In the banking system the foregoing strategy tends to lead to mounting imbalance between banks' foreign exchange assets and liabilities, when the value of foreign exchange liabilities overtakes substantially over that of foreign exchange assets. This is the key factor of exposure to a liquidity crisis in the banking system. In developing countries banks involvement in carry trading for the purpose of funding growth in retail lending, according to IMF experts, is one of the principal risks the financial markets in these countries are exposed to¹.

3.7.5. Transaction risks in the stock market and Forts market

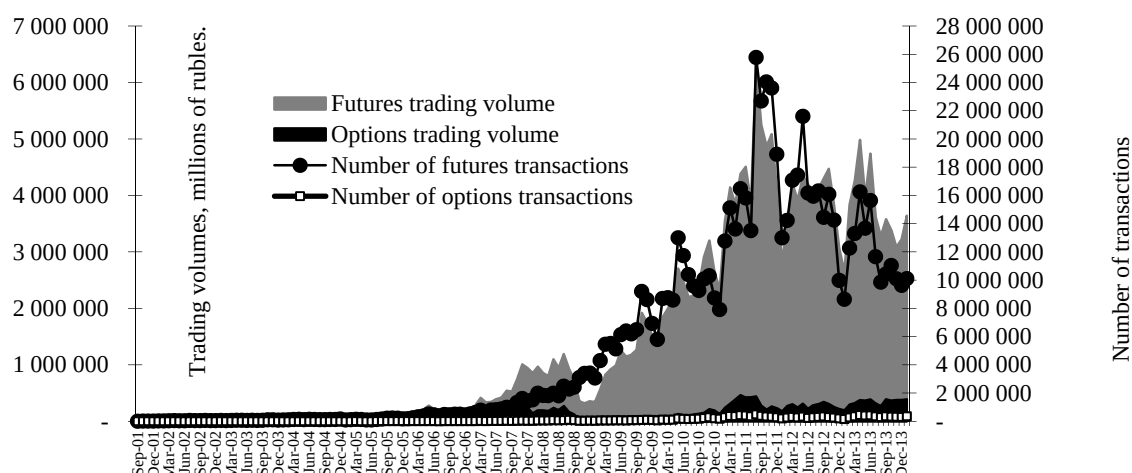
Outstripping growth in trading volumes vs. assets of market participants and their customers has been the stock market's specific feature over the recent years. High-speed trading has been gaining ground. Annual best private investor contents among stock exchanges have turned into hidden advertisement of high-speed trading. The data on customers transactions which is published from time to time by mass media allows one to assume that major brokers' private customer fully renews his/her portfolio within 2 to 3 days on average².

Not only does intensive trading activity often than not interferes with investment results of most private investors, but it also creates higher transaction risks for trading systems. Every year the stock exchange has increasingly been engaged in a battle for processing ever growing flow of applications, being challenged by about 700 participants having all the resources required for increasing transaction activity. There is no knowing, however, whether or not such a competition has an impact on growth in issuers' capitalization, new fundraising, better investment performance. Therefore, infrastructural organizations are expected to face more operational problems in the years to come, which might bring up a question of taking further measures aimed at regulating high-speed trading.

The Forts market raises the same concerns. The number of transactions and trading volumes have been growing fast (see *Fig. 54*), customers' assets have been increasing at slower rates, information on the number of participants in the market and their transaction activity is nontransparent.

¹ IMF. Global Financial Stability Report. Financial Market Turbulence: Causes, Consequences, and Policies. September 2007, pp. 22–25.

² BKS makes plans. *Vedomosti*, June 22, 2010.



Source: the author's estimates based on the data supplied by the Moscow Exchange.

Fig. 54. Trading volumes and the number of transactions in the Forts market the Moscow Exchange in the period of 1.09.2001 thru 31.01.2014

3.8. Regulation and supervision problems

The State Program, *The Development of Financial and Insurance Markets, Creation of International Financial Center*, developed by the Ministry of Finance of Russia as part of the results-based principle of budgeting was a positive event in 2012 and early in 2013. However, the effectiveness of these measures remains to be seen. The State Program is of fragmentary nature, ignoring to cover such market sectors as pension reserves and accruals, pooled investment, investment companies, fiscal measures of providing incentives to internal investors, expansion of Russian financial business to other countries. It is unclear from the State Program what kind of role self-regulating organizations should play in the market development, and only departments are listed as entities which should implement the Program. It is not quite clear who is going to implement the State Program which was designed by one department (the Ministry of Finance of Russia) for another department (mega-regulator). A set of program's quantitative indicators and the method of their calculation is incomplete and not optimal. For example, whether volume indicators cover only on-market stock transactions or they should be calculated factoring in other, over-the-counter transactions (repo, negotiated transactions etc.). Most of the targets set by the State Program were found to be unachieved at 2013 year-end, thereby raising the question of having to make adjustments thereto.

Pursuant to the Russian President Order of July 25, 2013 No. 645, September 1, 2013 the RFMS of Russia was abolished and its regulation, control, and financial market supervision powers were delegated to the Bank of Russia. Respective amendments were made by the Federal Law of July 23, 2013 No. 251-FZ. The Bank of Russia Financial Markets Service (FMS) was established to ensure that the Bank of Russia can perform its regulation, control, and supervision functions in financial markets.

The establishment of a mega regulator in Russia is in line with global changes in global financial markets. This measure may facilitate solution of the key issues related to the development of the internal financial market and building up investors' confidence in it; improvement of skills of the personnel being in charge of financial market regulation,

supervision, and development. Using the experience of prudential supervision over banks will enhance the effectiveness of supervision over nonbank financial institutions. Creating a mega regulator helps get rid of duplication of the same functions state executive authorities are vested with. For example, a new assignment of duties has put an end to diffusion of responsibility in regulation and supervision over non-government pension funds.

Financial regulation includes prudential supervision and business conduct supervision. Prudential supervision is intended to make sure that financial institutions are stable and reliable, mitigate systemic risks. Business conduct supervision, or regulation, is designed to support competitive markets and protect the rights of financial services consumers.

Financial regulation should create a balance different objectives of prudential supervision and regulation. Excessive prudential supervision may undermine competition, whereas deregulation often makes financial institutions less stable. According to the estimates made by a few authors, excessively strict prudential requirements may force institutional investors to increasingly focus on shorter-term (short-termist) interests¹, which can be manifested through a shorter holding period of financial assets and increase in the investment portfolio turnover rate, less investment in less liquid and more risk-bearing assets, for example, infrastructure and venture projects, portfolio managers' propensity for the "gregarious behavior". The Green Paper on the long-term sources of financing of the European economy, which was prepared by EU experts as part of the implementation of the Europe Development Strategy until 2020, poses the question of the need to conduct monitoring of prudential reforms in order to minimize adverse effects on long-term investment². In particular, regulation and supervision systems should support competition between banks and institutional investors.

Indeed, there is no optimal model for organization of regulation and supervision. In terms of the level of integration the World Bank underlines six categories of prudential supervision systems and five categories of regulation systems (see *Table 17*). The higher is the level of integration of supervision and regulation, the bigger is the serial number of respective models.

Table 17

Countries classification by degree of regulation and supervision integration

Prudential supervision	Serial number	Regulation	Serial number
Sectoral supervision: supervision over banks and nonbank organizations out of the central bank's scope	1	Lack of regulation in banking business ^a	1
Sectoral supervision: within the central bank's scope – only supervision over banks; other supervision outside the central bank's scope	2	Regulation is performed by an agency other than prudential supervision body ^b	2
Partially integrated supervision outside the central bank's scope	3	Sectoral regulation ^c	3
Partially integrated supervision within the central bank's scope	4	Regulator is a body which performs integrated supervision	4
FSA – integrated prudential supervision outside the central bank's scope	5	Twin Peaks – integrated regulation by a special body which is not a supervisory body	5
Integrated prudential supervision within the central bank's scope	6		

Notes. This classification includes no regulation and supervision over pension funds and retirement schemes.

^a It is assumed that there is no body in place authorized to perform the regulation including provision of competition and consumer rights protection, above all, in the banking sector. Additionally, agencies engaged in stock markets and insurance business may be vested with specific regulating functions.

¹ Croce R. D., Stewart F., Yermo J. (2011). Promoting Longer-Term Investment by Institutional Investors: Selected Issues and Policies // OECD Journal: Financial Market Trends. Vol. 2011, No. 1.

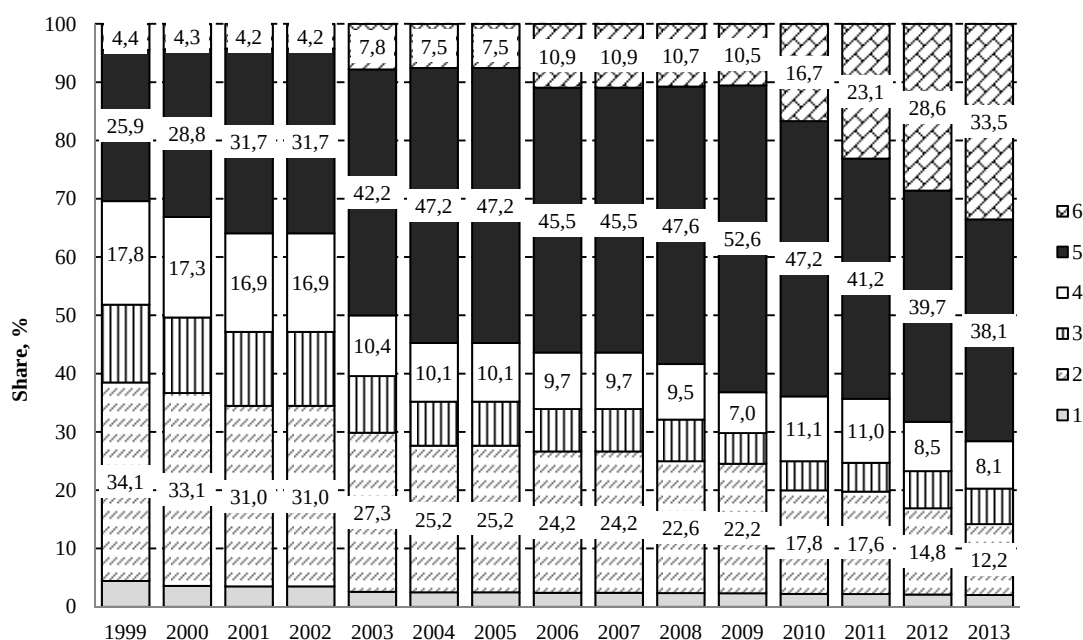
² European Commission (2013). Green Paper. Long-Term Financing of the European Economy. Brussels, 25.3.

^b Fragmentary market regulation, when a country has an organization authorized to protect financial services consumer rights, including bank customers.

^c A “special” prudential supervision body is assigned to different types of financial business and simultaneously vested with regulating functions.

Source: World Bank, 2013.

We used this classification for a sample comprising 50 countries for 1999–2013¹ a trend towards growth in the number of countries employing more integrated prudential supervision models was observed prior to the crisis in 2008 (see *Fig. 55*). The share of countries with supervision fully integrated within the scope of the central bank (Group 6) increased from 4.4% in 1999 to 10.7% in 2008, outside the central bank’s scope (Group 5) from 25.9% to 47.6%. After the crisis, the share of countries in Group 6 continued to grow, reaching 33.5% in 2013, whereas the share of countries in Group 5 declined to 38.1%. This implies that the crisis didn’t discourage countries from adopting the concept of integrated prudential supervision, although many countries believe that central banks are better prepared vs. any other public agencies to perform integrated prudential supervision.



Note. The symbols in the legend describe prudential supervision models as they are numbered in *Table 17*. The higher is the index number, the higher is the level of integration prudential supervision.

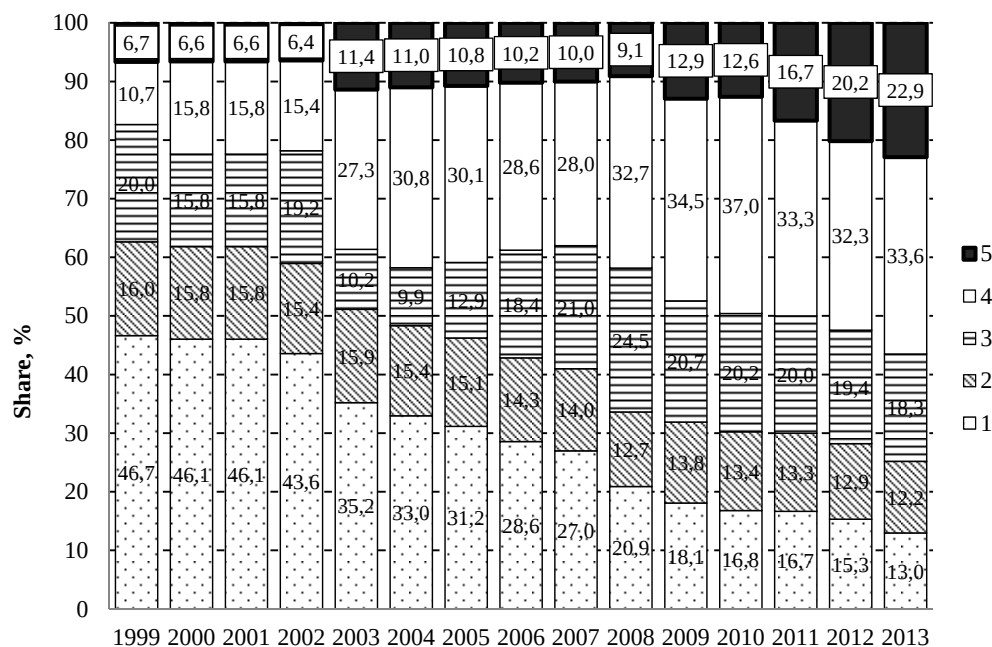
Source: estimated based on the data supplied by Abramov A., Radygin A., and Chernova M.

Fig. 55. Structure of countries with different prudential supervision models in 1999–2013

It is shown in *Fig. 56* that the share of countries where the agency in charge of integrated prudential supervision acted as regulator increased most prior to the crisis (Group 4). The share increased from 10.7% in 1999 to 32.7% in 2008. The countries where regulation and

¹ The sample was made on the basis of the World Bank’s data on 1999–2010. (<http://data.worldbank.org/data-catalog/global-financial-development>) and the data on 2011–2013 on the basis of our analysis of the information on regulators in 50 countries. More details on the results of this study are available in the article of Abramov A., Radygin A., Chernova M. Financial market regulation: models, evolution, effectiveness. *Voprosy Ekonomiki*. No. 2, 2014.

supervision are assigned to a single state department (agency) made up the biggest group in the sample of 50 countries. The share of countries employing the Twin Peaks approach (Group 5) increased moderately over the same period from 6.7% in 1999 to 9.1% in 2008. In 2008, the approach was employed only by Australia and the Netherlands. The post-recession period saw sweeping changes in regulation. The share of countries employing the Twin Peaks approach increased to 22.9% by 2013. Growth in the share of countries in Group 4 tumbled, reaching 33.6% in 2013. Along with assigning the integrated prudential supervision function to the central bank, countries began to switch to Twin Peaks, assigning the regulation function to agencies not related with the central bank. The objective was to make sure that the creation of integrated supervision is not interfering with competition, the development of all financial institutions, and comprehensive protection of the rights of financial service consumers. Finland, Belgium, New Zealand, and Great Britain fully or partially switched to the Twin Peaks by 2013. However, the Twin Peaks is still being under discussion in the United States, South Africa, Mexico etc.



Note. The symbols in the legend describe prudential supervision models as they are numbered in *Table 17*. The higher is the index number, the higher is the level of integration prudential supervision.

Source: estimated based on the data supplied by Abramov A, Radygin A., and Chernova M.

Fig. 56. Structure of countries with different regulation models in 1999–2013 (%)

The foregoing sample was used to study the effect of 18 macroeconomic and financial indicators on countries' decision to choose a model of integration of prudential supervision and regulation, as well as the probability of Russia choosing the financial regulation model was looked into.

In projecting the probability of Russia falling into each group of countries with different models of prudential supervision, the highest probability was detected for Group 2 (see *Table 17*), which corresponds to the historical data observed prior to September 1, 2013. Furthermore, there is lowest, almost zero probability of falling into Group 6 with highest

integration of supervision within the central bank's scope. However, since September 1, 2013 Russia has virtually switched to the mega regulator model on the basis of the Bank of Russia.

Table 18

**Factors having an effect on the decision to choose a regulation
and supervision model**

Factors
Population size, the share in the population in 50 countries, %
Income per capita in constant dollars 2005
Export of goods and services (as percentage of GDP)
Country effectiveness index
The number of registered countries in the listing as per 10000 persons
Asset concentration of top-5 largest banks (%)
Bank deposits (as percentage of GDP)
Deposited money among bank assets (as percentage of GDP)
Z-score
Pension funds' assets (as percentage of GDP)
Mutual funds' assets (as percentage of GDP)
Life insurance premiums (as percentage of GDP)
The value of outstanding internal private debt securities (as percentage of GDP)
Depository institutions' capital adequacy (%)
Securities market capitalization (as percentage of GDP)
Total volume of traded securities (as percentage of GDP)
Regulation quality index
Saving rate (%)

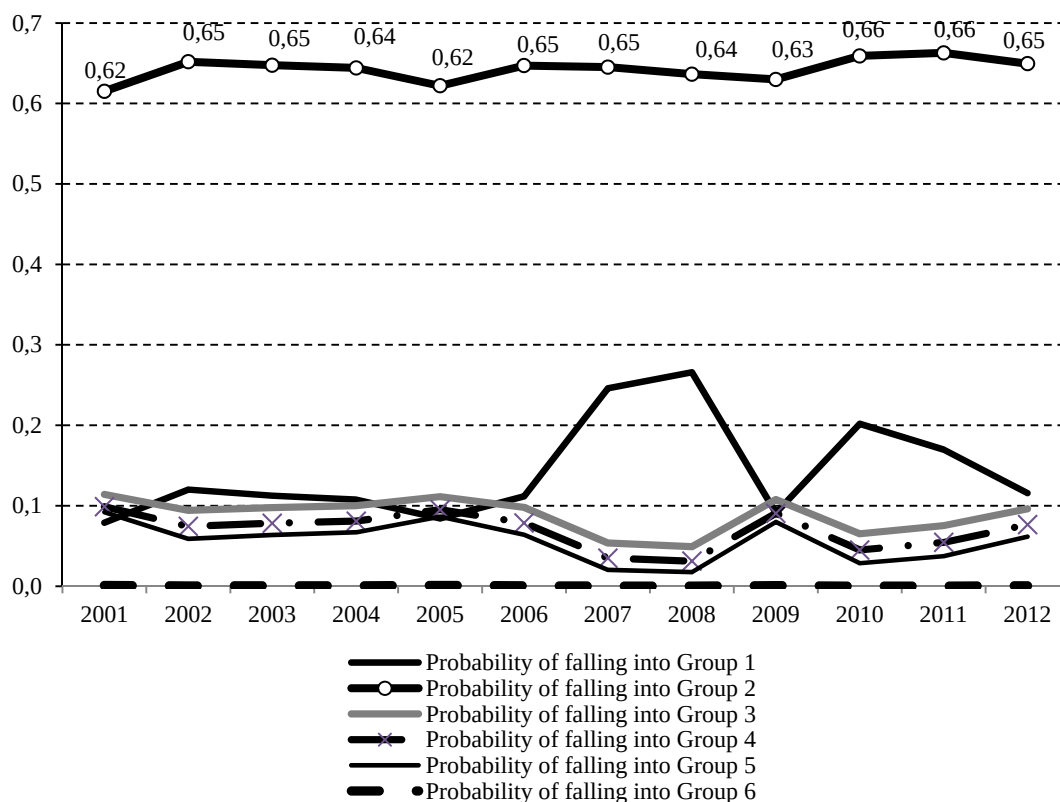


Fig. 57. Predicted probability of Russia falling into each group in accordance with the prudential supervision classification

In projecting the probability of Russia falling into each group of countries with different regulation models, the highest probability was detected for Group 1 (see *Table 17*), which corresponds to the historical data observed in 1999–2012. The Probability of falling into Group 4 inched up and remained close to zero, being indicative of inconsistency between Russia's indicators and parameters throughout the entire period. However, in 2013 Russia did fall into this group providing for concentration of regulating functions in a single body in charge of consolidated prudential supervision (see *Fig. 58*).

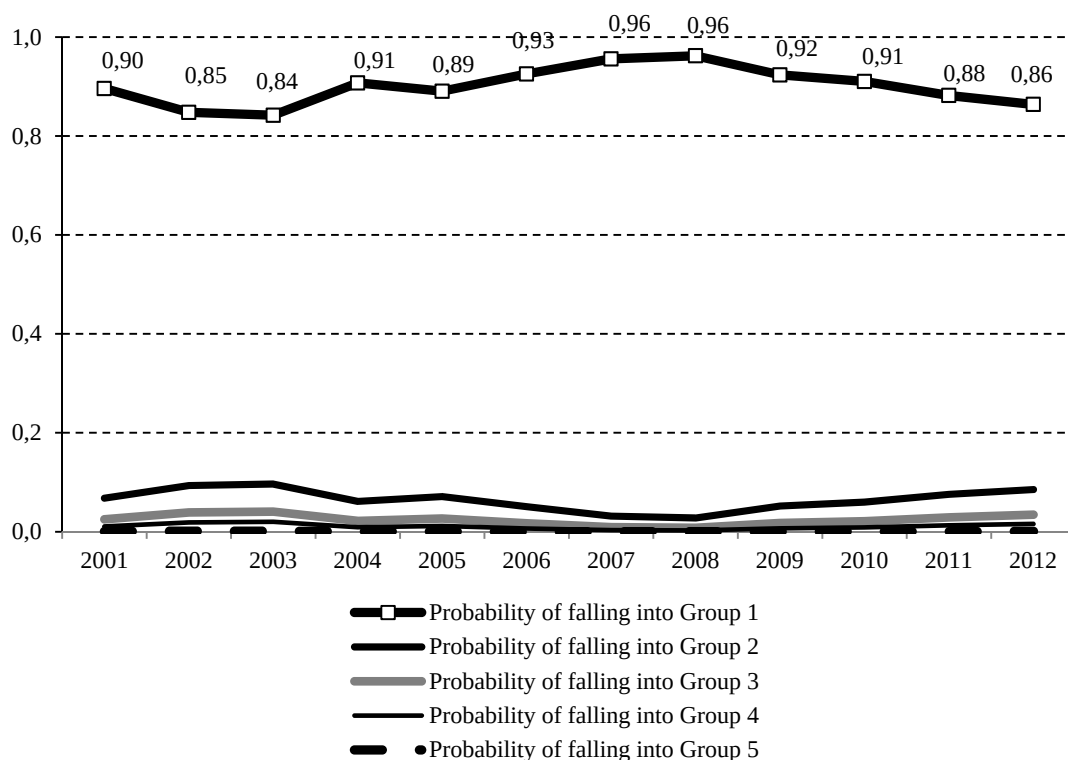
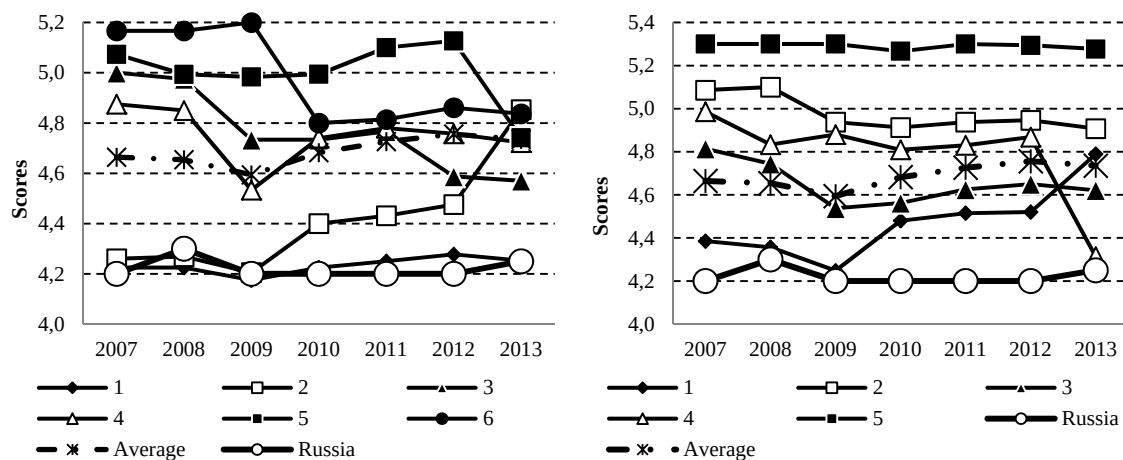


Fig. 58. Predicted probability of Russia falling into each group based on the regulation classification

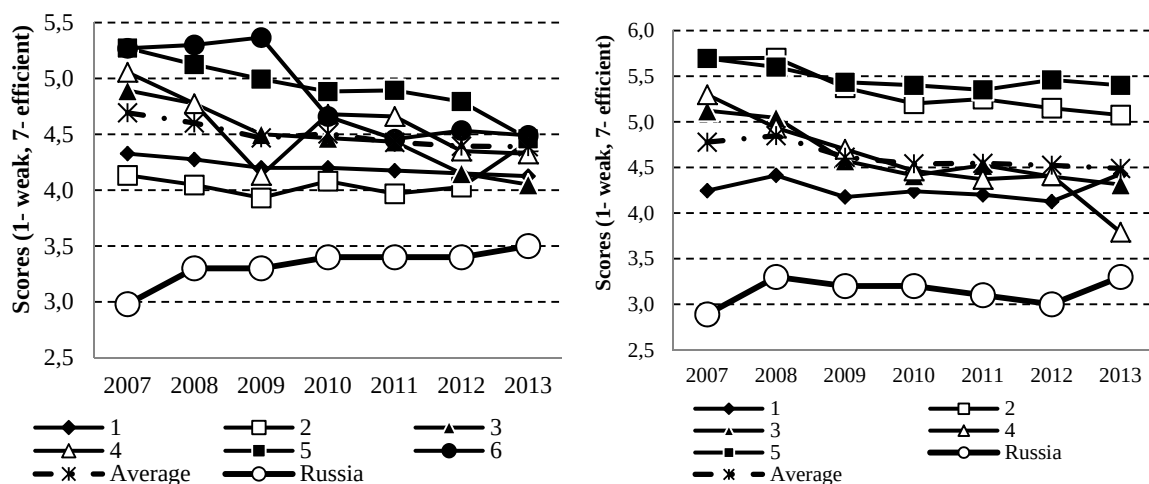
Although countries with more integrated supervision and partially regulation models tend to receive higher scores in rankings on competitiveness and public administration effectiveness, countries with the least consolidated supervision and regulation have recently been showing positive dynamics on the criteria in question. At 2013 year-end the group of countries with sectoral supervision model (Group 2), which Russia exited (see *Fig. 59*), received the best average score in the World Economic Forum (WEF) global competitiveness ranking. In terms of regulation, the countries of Group 2 were an inch behind the countries with the Twin Peaks. Additionally, the countries in Group 4, which Russia entered in 2013, showed average competitiveness results a lot worse than those of the countries with the least integrated regulation, i.e. the group of countries which Russia exited last year.

Countries in Group 2 of supervision and regulation also achieved best results in the field of anti-monopoly regulation together with the countries with most consolidated supervision and regulation of the economy, (see *Fig. 60*).



Source: the author's data.

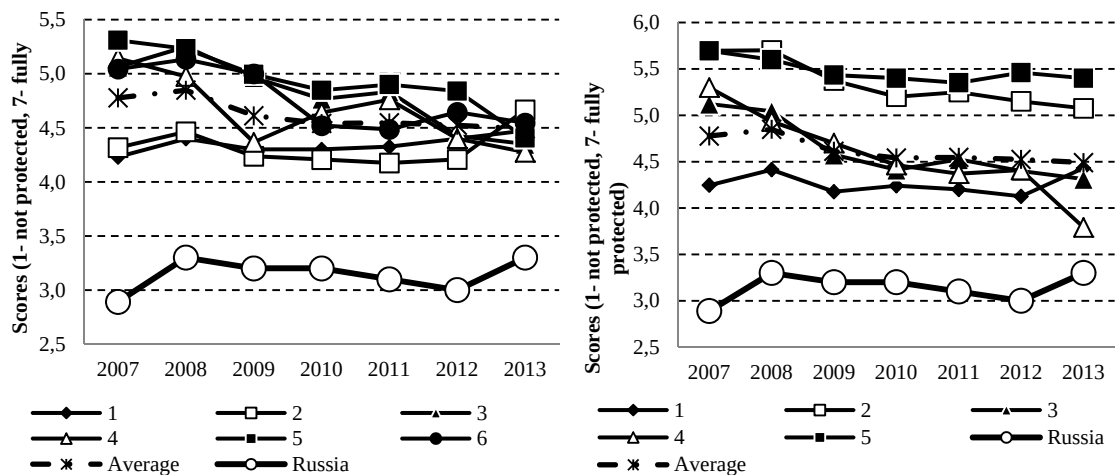
Fig. 59. Final score in the WEF global competitiveness ranking (prudential supervision models on the left; regulation models on the right)



Source: the World Bank - <http://data.worldbank.org/data-catalog/global-financial-development> and the author's data on 2011–2013 based on analysis of the data available on the official websites of regulating agencies in 50 countries

Fig. 60. Anti-monopoly regulation effectiveness under the WEF global competitiveness ranking (prudential supervision models on the left; regulation models on the right)

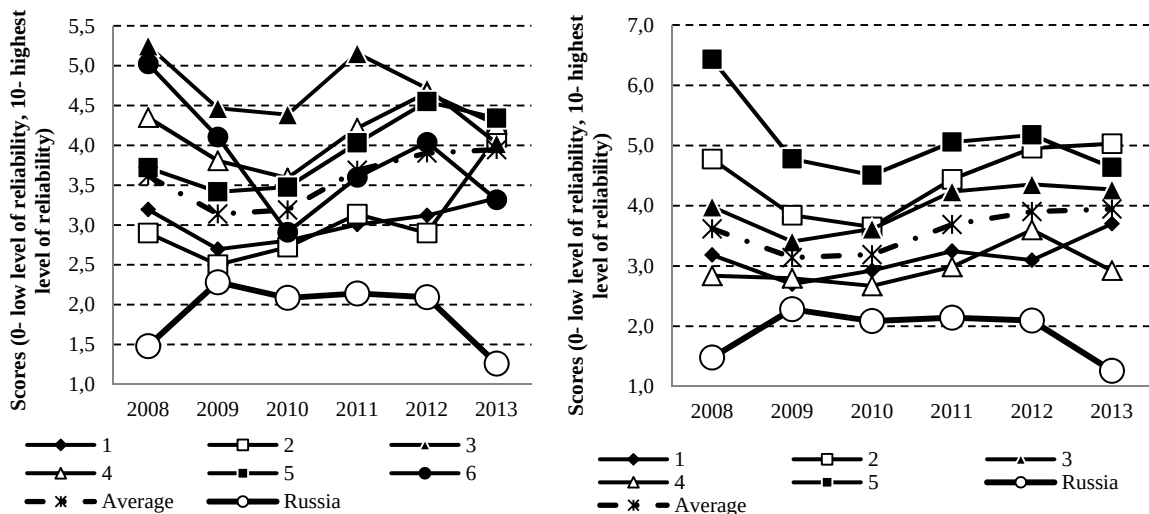
Countries in Group 2 showed best results in supervision systems on protection of minority investor rights, and Group 2 is only behind the Twin Peaks group in countries with different regulation models (see Fig. 61).



Source: the author's estimates based on the World Bank's data.

Fig. 61. Protection of minority shareholder rights under the WEF global competitiveness ranking (prudential supervision models on the left; regulation models on the right)

Finally, a trend towards achieving high scores on competitiveness of countries with low and moderate consolidation of the systems of prudential supervision and regulation vs. countries with highly integrated models can be perfectly seen through the indicators of reliability of pension systems in the Swiss IMD business school rankings (see Figure 62).



Source: the author's estimates based on the data supplied by WCY IMD (Switzerland).

Fig. 62. The score of pension system reliability under the WCY IMD business school ranking (Switzerland) (prudential supervision models on the left; regulation models on the right)

The results of the analysis made allow for the assumption that Russia is closer to the sectoral prudential supervision model and relatively simple regulation model under which nonbank financial institutions are regulated by different bodies while there is no special

regulator of competition between banks and protection of the rights of bank service consumers. True, it doesn't mean that the model of mega regulator based on the Bank of Russia which has been chosen in Russia since the end of 2013 is incorrect. However, a special emphasis should be placed on the effectiveness of the regulating function which provides for creating conditions for fair competition between all financial market participants and protection of the rights of financial service consumers. For instance, institutional investors whose development level in Russia is substantially behind that of commercial banks may find themselves in a difficult situation amid maximum consolidation of regulation and supervision in the absence of mature institutions designed to resolve conflicts of interests. In its turn, regulatory and institutional barriers to accelerated development of institutional investors lead to shortage of long money sources.

Modern financial systems are characterized by stronger integration of the regulation and prudential supervision models, creation of an optimal balance between financial systems' sustainability, and ensuring fair competition between its participants. The level of integration of the foregoing models is to a large extent determined by a level of economic development and the financial system, as well as the effectiveness of public administration. Creating a mega regulator on the basis of the Bank of Russia in the Russian financial market in 2013 provides for the transition to the highest level of integration of regulation and supervision exclusive of economic and financial development specifics in the country. This creates higher risks of both excessive administrative pressure upon yet underdeveloped nonbank financial organizations and competitive environment weakening. The foregoing issues can be resolved through major efforts of state agencies and financial market participants.

3.9. The Russian banking sector

3.9.1. Main trends

For the banking system 2013 was marked by a slowdown of development in almost all directions. The previous year's forecast¹, which had predicted the slowdown of growth rates for key parameters of the banking sector, proved correct. The aggregate assets of the banking sector grew by 16% (previous year's forecast predicted 15-17%), corporate loans grew by 13% (forecast: 12-15%), loans to individuals by 28% (forecast: 25-30%) (*Fig. 63*).

The formation of the resource base of the banking sector in 2013 depended on funds of individuals and loans of the Bank of Russia to a larger extent than in the previous year. The funds of private clients accounted for one third of the growth of banking sector resources compared to 28% in the previous year, while funds of the regulator accounted for 24% compared to 18%. The role of the corporate sector in the formation of bank liabilities increased significantly, their contribution growing from 14 to 22%. At the same time, the inflow of foreign credits and loans to the banking sector almost stopped. Foreign liabilities accounted for only 3% of the banking sector resources (*Fig. 64*).

¹ See review "Russian Economy in 2012. Trends and Prospects" (Issue 34), Moscow, the E.T.Gaidar IEP, 2013.

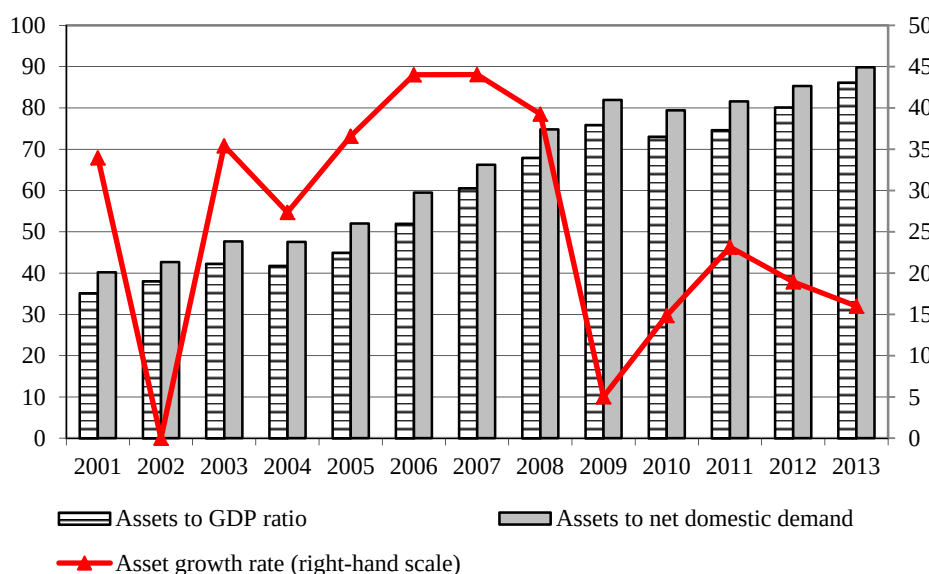


Fig. 63. Growth in bank's assets and the ratio to GDP and net domestic demand¹ (%)

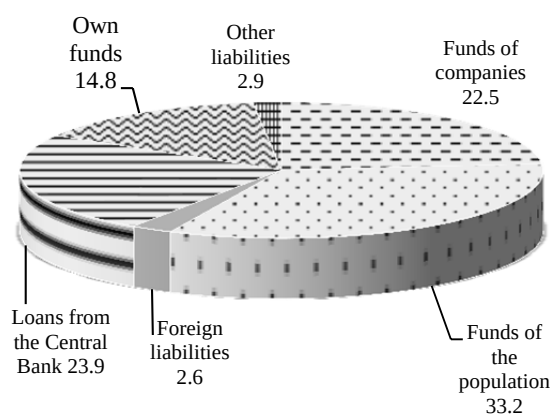


Fig. 64. Structure of banking sector resources (growth in liabilities and decrease in assets) in 2013, as % of the total

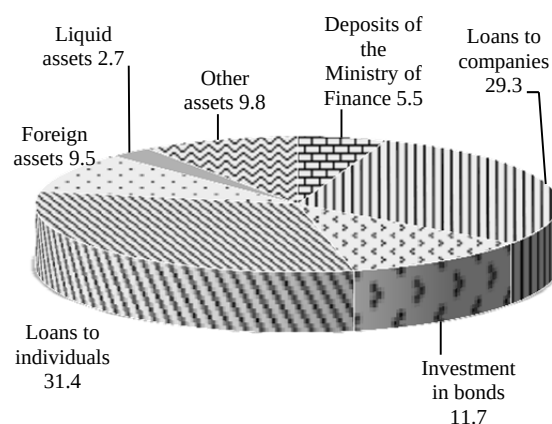


Fig. 65. Structure of the use of banking sector resources (growth in assets and decrease in liabilities) in 2013, as % of the total

The previous year's trend in the lending sector, towards displacement of lending to corporate borrowers by retail lending, continued. As a result, in 2013 the growth in loans to individuals exceeded the growth in corporate lending in absolute terms for the first time. Of banks' financial resources, 31% were provided as loans to individuals while 29% went as loans to business (Fig. 65).

¹ Net domestic demand (NDD) is calculated as GDP without net export and constitutes a measure of domestic consumption in the economy.

3.9.2. Banks and households

The following key trends, which in many respects continued the tendencies of the previous year, dominated in the relationship between banks and individuals in 2013:

1. Consumption by households continued to become increasingly dependent on bank loans.
2. The load on household available income, related to the servicing of bank debt, continued to grow.
3. By the end of 2013 a sharp slowdown in the growth in deposits occurred, with their simultaneous redistribution in favour of the state-owned banks.

Growth of credit dependency of the population

There was a decline in growth of the retail segment of bank lending in 2013, after the record (post crisis) levels of 2012 (Fig. 66). The volume of individual indebtedness under consumer loans showed the fastest growth (as in previous years), with a 31.3% growth rate. Indebtedness under loans for the purchase of residential property, including mortgage loans, grew by 29.8% during the year, while car loans grew by 22.3%.

The volume of loans to individuals increased by 21.5% in 2013, totaling Rb 8.8 trillion, out of which Rb 1.4 trillion accrued to mortgage loans while Rb 7.4 trillion went to other loans (consumer loans, including car loans). The ratio of provided consumer loans in proportion to household consumer expenditure grew from 21.7% in 2012 to 23.5% in 2013. This means that almost every fourth ruble spent on the purchase of goods and services was loaned by Russian banks.

The greatest concern in respect of risks relating to the insolvency of borrowers and, hence, the stability of banks is not the rate of growth of the loan portfolio itself — in certain periods before the crisis, loan volumes grew even faster — but the increased level of debt burden on the income and assets of households. For example, the ratio of total debt under bank loans to the income of households has already exceeded the crisis maximum (17.8% in September 2008), having reached 24.7% by the end of the year.

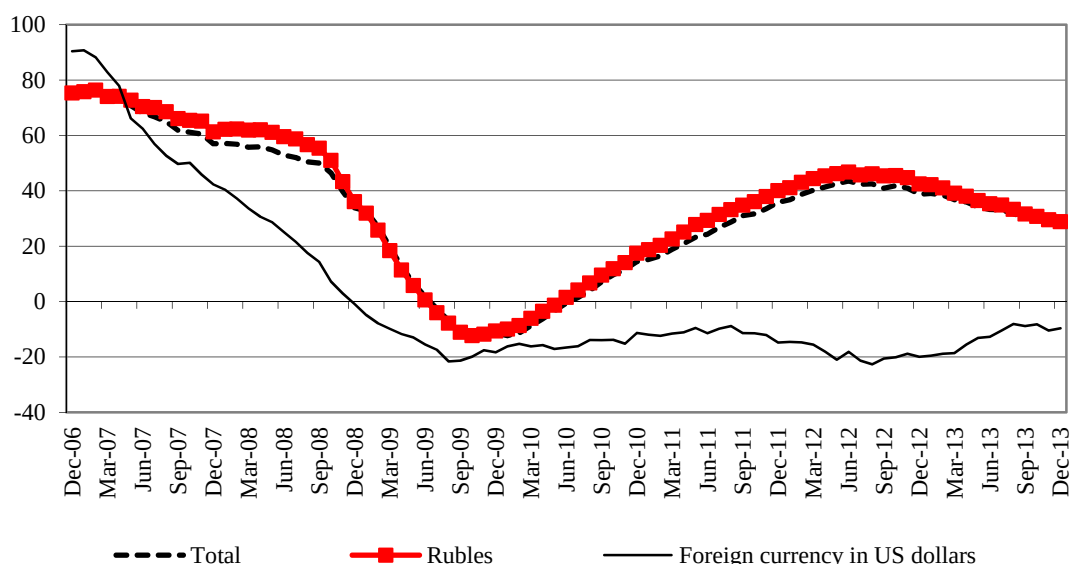


Fig. 66. Rates of growth of lending to individuals for 12 months (%)

The current load on the disposable income of households relating to servicing bank debt (the amount of obligatory payments of the principal amount and of interest) has continued to grow. While in 2012 individuals had to pay 9.5% of their available income to banks, in 2013 this figure increased to 11.3%.

Savings rate of households

The growth rates of the deposit base have remained stable for almost two years. As early as late October 2013 the annual growth rate of the funds of individuals in banks was around 20%. However, based on the results of 2013, private deposits had grown by only 17% at the year end, and in January 2014 the slowdown continued.

The main factor causing increased public distrust of the banks was, oddly enough, the policy of the Bank of Russia aimed at putting the banking sector in order. In summer 2013 the licenses of a number of banks were revoked, including the fairly large Master Bank and Investbank, which were in the top 100 in terms of the size of their assets. In total, the Bank of Russia revoked the licenses of 32 banks, with two more banks subjected to reorganisation. Of them, 26 banks held licenses for transactions with individuals and the deposits with these banks were insured through the Deposit Insurance Agency (DIA). The banks that lost their licenses in 2013 held private deposits of over Rb 170bn and the DIA liability under these insured events was Rb 125bn (*Fig. 67*).

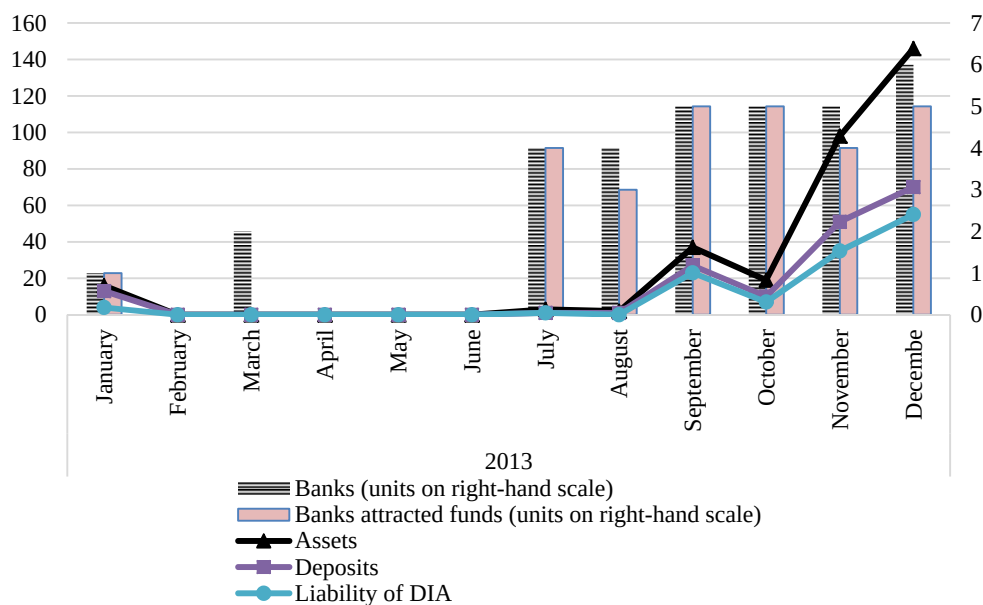


Fig. 67. Range of indicators for banks whose licenses were revoked in 2013

Firstly, this caused a general slowdown of the inflow of funds of private individuals to banks and, secondly, the floating of funds from small and medium-sized banks to large, mainly state-owned, banks. Household savings in banks in November-December 2013 grew by 5.2% (RUR 820bn), while in the corresponding period of 2012 the growth in deposits was 8.3% (RUR 1,088bn) (*Fig. 68*). At the same time, the deposit growth rate of the 30 largest banks remained almost unchanged (8.6% in November-December 2013 against 8.9% in November-December 2012) and the deposit growth rates of state-owned banks, taking into

account Sberbank, increased from 8.7% at the end of 2012 to 10.9% at the end of 2013. In the medium-sized and small banks during November-December 2013 the funds of individuals decreased by Rb 208bn (5.3%), as compared to the increase by Rb 214bn (6.5%) in the corresponding period of 2012.

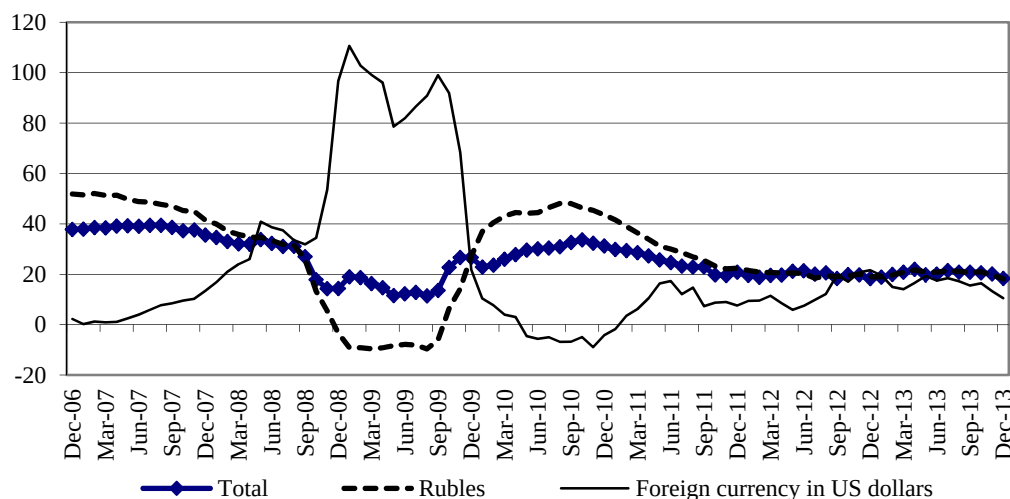


Fig. 68. Growth rates of deposits by individuals per 12 months (%)

3.9.3. Banks and the corporate sector

The relationship between banks and corporate clients in 2013 were characterised by the following trends:

1. Slowdown in the growth of lending to companies and organisations.
2. Increase in the growth of balances on the accounts of corporate clients;
3. Increase in “non-performing” assets in the corporate sector.

In 2013, there was a slowing of the rise in the level of debt of companies and organisations to banks under loans and credits. While the 2012 growth had been 16%, growth rates for the corporate segment of the credit market decreased to 13% (Fig. 69). Furthermore, the nominal volume of debt increase in 2013 for the retail segment overtook the corporate debt: company debt grew by Rb 2.4 trillion while individual debt grew by Rb 2.5 trillion.

However, the quality of the credit debt of corporate clients was gradually increasing during the year. The volume of reserves against possible loss grew only by 2.9%, while the value of arrears decreased by 0.4%. The yearly results also showed a decrease both in the share of overdue debt in the total debt (from 4.6 to 4.1%) and in the ratio of reserves to loan debt (from 7.5 to 6.8%). At the same time, these formal indicators of the quality of corporate customers’ debt still remained much higher than the pre-crisis minimum values, when the share of overdue debt did not exceed 1% of the total debt and the volume of reserves was about 3% of the total volume of loans.

In 2013, the intensity of flow of the funds of corporations to bank accounts and deposits increased (Fig. 70). After a reduction to 10% in 2012, in 2013 the volume of corporate clients’ funds grew by 16%. In absolute terms the annual inflow of funds from enterprises to banks increased by 1.5 times from Rb 1.07 trillion in 2012 to Rb 1.62 trillion in 2013.

In this respect, the total of funds placed on term deposits, constituting the “non-performing” assets of the corporate sector withdrawn from the current economic turnover, continued to dominate in the total funds of corporations in the banking sector. Throughout the year their share in the total funds of corporate customers exceeded 50%, at certain points reaching 55% of the total funds of corporations in banks. Moreover, a considerable part of the term deposits of legal entities was placed in banks for a term of over 1 year. For the term deposits of non-financial organisations their share slightly increased during the year from 38.2% as of 1 January 2013 to 39.6% as of 1 January 2014.

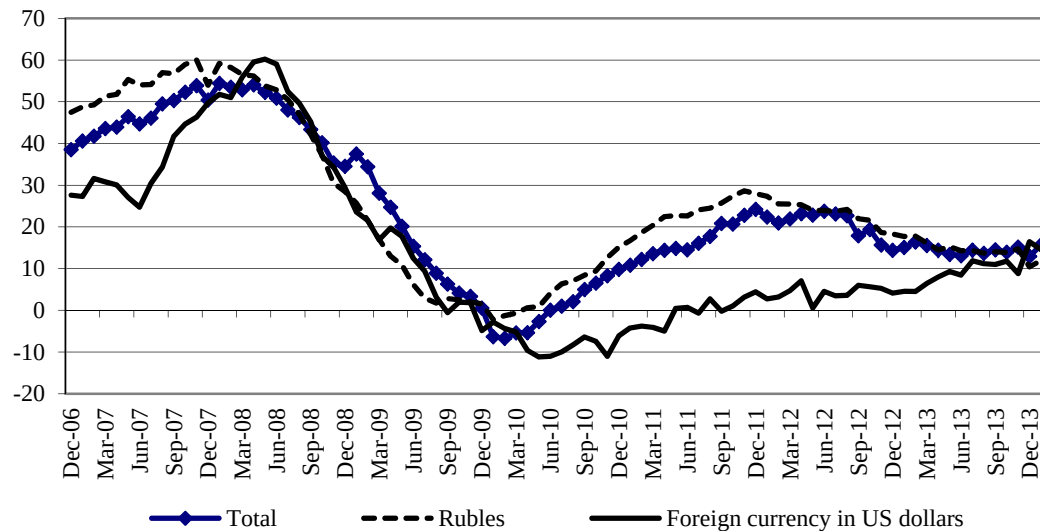


Fig. 69. Rates of growth in lending to companies per 12 months (%)

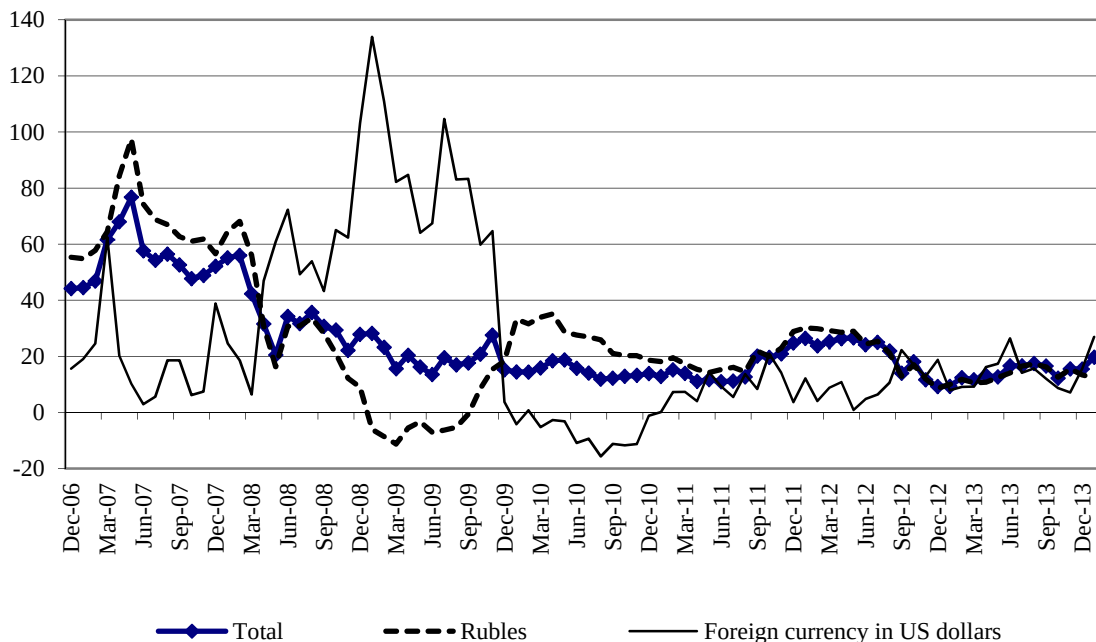


Fig. 70. Rates of growth of company funds per 12 months, %

3.9.4. Banks and the outside world

Based on the results of 2013 the balance of transactions of the banking sector with non-residents continued to change in favour of the net placement of foreign assets. The volume of foreign liabilities grew by only Rb 4bn and foreign assets grew by Rb 21bn. The net investments of banks in foreign assets, thus, grew by Rb 16bn during the year, reaching Rb 58bn (*Fig. 71*).

In 2013, simultaneously with the growth of net foreign assets, the net balance foreign exchange position of the banking sector, i.e. the excess of foreign exchange assets over foreign exchange liabilities, grew. It grew by Rb 14bn during the year.

The fact that the dynamics of the foreign exchange position followed that of net foreign assets shows that the foreign exchange balance, in bank transactions with the internal economy sectors, was preserved. Almost the entire increase in foreign currency accounts and the deposits of residents (Rb 25bn) was placed in internal foreign exchange assets, which increased by Rb 23bn. The growth in the foreign exchange position of banks was due to the accumulation of currency liquidity of foreign banks, and the major part of the increase in foreign assets accounted for loans to foreign banks. This strategy was justified under the conditions of depreciation of the national currency in 2013. During the year the ruble lost 7.5% against the US dollar and 12% against the euro, which brought Rb 50bn of net income from the revaluation of accounts in foreign currencies.

The Bank of Russia's gradual exit from the foreign exchange market continued in 2013 and the increased uncertainty in the medium-term dynamics of the ruble exchange rate discouraged banks from assuming additional foreign exchange risks. It makes it pointless to undergo a possible repeat of the banking sector growth strategy that prevailed before the crisis: growth of credit expansion in the country by attracting cheap (in foreign currency terms) resources from foreign financial markets.

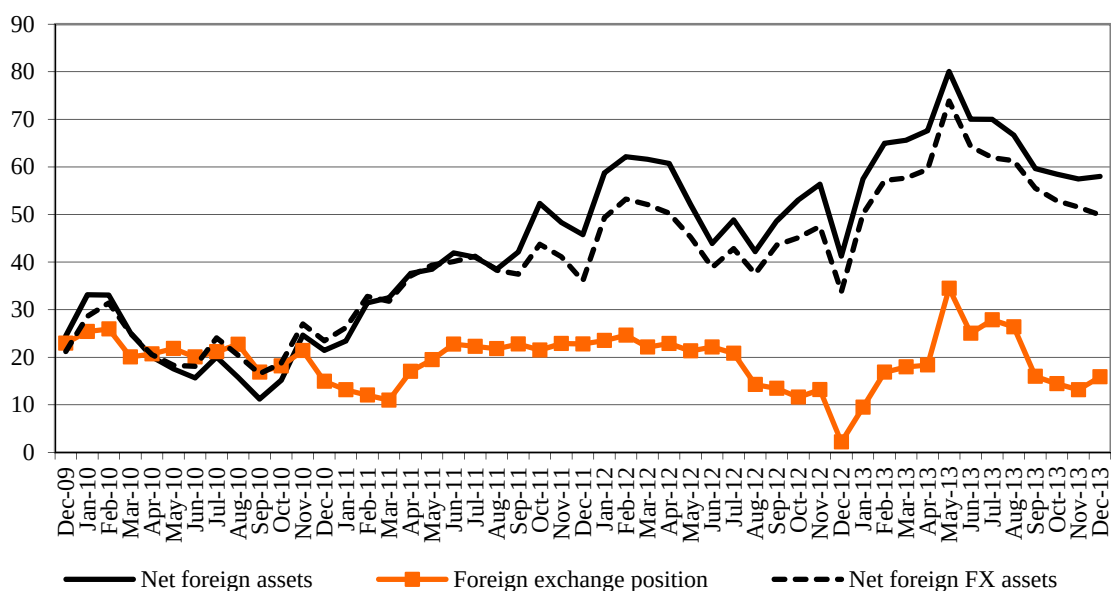


Fig. 71. Net foreign assets and foreign exchange position of the banking sector, billion USD

3.9.5. Banks and the state

Starting from 2011 the main factor in the formation of money supply in the Russian economy has been the refinancing of the banking sector by the Bank of Russia. The scale of growth of the debts of commercial banks to the regulator, today, considerably exceeds the increase in the broad definition monetary base (as an indicator of the dynamics of the money supply) due to the substantial outflow of liquidity through other channels, principally as a result of the sterilisation of the funds of enlarged government accounts in the Bank of Russia.

So, for 2011–2013 the volume of the broad definition monetary base increased by Rb 2.3 trillion; refinancing of the banking sector grew by Rb 4.1 trillion; Rb 3.2 trillion were received to the budgetary accounts in the Bank of Russia; and operations with reserve assets provided a ruble issue in the amount of Rb 0.6 trillion (with an additional Rb 0.8 trillion through loans by the Central Bank of the Russian Federation to the Deposit Insurance Agency, a decrease in the balances of the accounts of organisations in the Central Bank of the Russian Federation and other factors).

The same situation will continue in the medium term. The dynamics of the key elements of the balance of payments, coupled with the declared policy of the Bank of Russia for minimisation of its presence in the internal foreign exchange market, will lead to minor changes in the size of the reserve assets of the Bank of Russia in absolute terms. In some years, they could be both positive and negative, but in any event their amount will be insufficient to provide the banking sector with the required volume of liquid assets.

The budgetary factor will keep its sterilising influence on the money market. In accordance with the Law on the Federal Budget for 2014 and the Planning Period of 2015 and 2016 it is planned to reduce the federal budget deficit to 1% of GDP. According to estimates by the Ministry of Economic Development, as laid out in the forecast of long-term social and economic development of the Russian Federation for the period until 2030, the balance of the budget system in general for this period will be close to zero. At the same time, it is planned that internal state debt will continue to grow to 10.8% of GDP by 2016. Together, these factors will determine the continuation of the sterilising effect of the budget system on the dynamics of money supply until 2016.

Thus, the refinancing of the banking sector by the Bank of Russia will remain the only stable source of growth of money supply in the future, at least until 2016. According to our estimates, in the period from 2014 to 2016 the amounts owed by credit institutions to the regulator will increase by more than Rb 6 trillion, reaching 14% of the total assets of the banking sector.

At the same time, the level of dependency of the banking sector on monetary regulators continues to grow. In nominal terms, state support for the banking sector has already exceeded the crisis values of early 2009 and its relative level (although it has not returned to the crisis maximum) is still quite high. Based on the results for 2013, the aggregate volume of bank debt to the regulators has reached 8% of assets and 7% of GDP (*Fig. 72*).

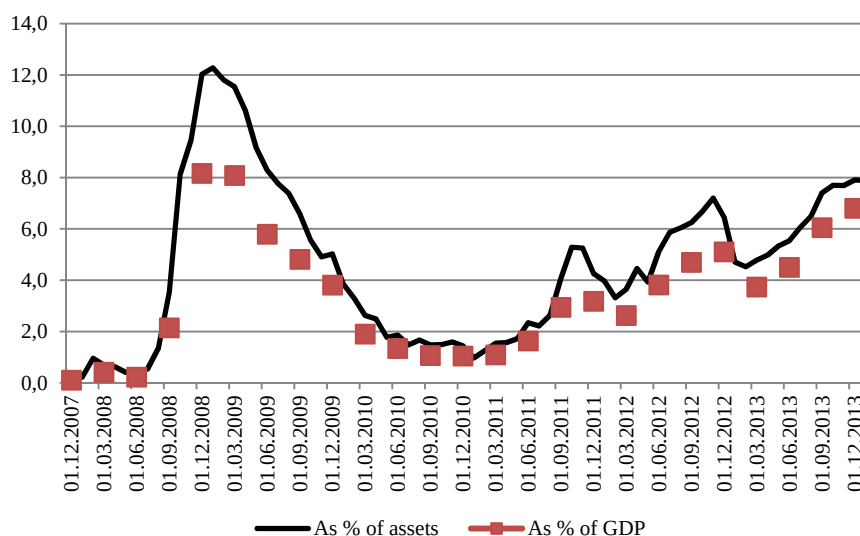


Fig. 72. Funds of the Bank of Russia and the Ministry of Finance of Russia, attracted by banks

3.10. The Market for Municipal and Subfederal Borrowings

3.10.1. The Dynamics of the Market's Development

The annual consolidated regional budget and the budgets of territorial state off-budget funds for 2013 were executed with a deficit of Rb 625.5bn (or 0.94% of GDP). The amount of consolidated regional budget deficit as a percentage of GDP increased more than twice on 2012. Thus, in 2012 the amount of territorial budget deficit was Rb 273.1bn (or 0.44% of GDP).

In 2013, the budgets of subjects of the Russian Federation were executed with a deficit of Rb 599.8bn; the budgets of city districts – with a deficit of Rb 43.4bn; the budgets of intra-city municipal formations of Moscow and St Petersburg – with a deficit of Rb 0.7bn; the budgets of municipal raions – with a deficit of Rb 5.7 bn; the budgets of urban and rural settlements – with a surplus of Rb 7.7bn; the budgets of territorial state off-budget funds – with a surplus of Rb 16.5bn.

In 2012, the budgets of subjects of the Russian Federation were executed with a deficit of Rb 251.1 bn; the budgets of city districts – with a deficit of Rb 31.0bn; the budgets of intra-city municipal formations of Moscow and St Petersburg – with a surplus of Rb 0.4bn; the budgets of municipal raions – with a deficit of Rb 1.1bn; the budgets of urban and rural settlements – with a surplus of Rb 4.3bn; the budgets of territorial state off-budget funds – with a surplus of Rb 5.4bn.

Table 19

The Territorial Budget Surplus (Deficit) to Budget Expenditure Ratio (as %)

Year	Consolidated regional budget*	Regional budgets
1	2	3
2013	-6.4	-8.1
2012	-3.0	-3.5
2011	-0.2	-0.3
2010	-1.4	-1.6
2009	-5.3	-5.3

Cont'd

1	2	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

* January state off-budget funds.

Source: Ye. T. Gaidar Institute for Economic Policy's calculations based on data released by the Federal Treasury.

Table 20

The Territorial Budget Surplus (Deficit) to Budget Expenditure Ratio in 2007–2012 (as %)

Year	Budgets of intra-city municipal formations of Moscow and St Petersburg	Budgets of city districts	Budgets of municipal raions	Budgets of urban and rural settlements
2013	-3.47	-2.61	-5.59	2.24
2012	2.26	-2.01	-0.08	1.34
2011	6.15	-2.10	1.13	0.64
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

Source: Ye. T. Gaidar Institute for Economic Policy's calculations based on data released by the Federal Treasury.

As of 1 January 2014, the consolidated budget was executed with a deficit (including territorial state off-budget funds) for 77 RF subjects (in 2012 – for 68 regions). The amount of total deficit was at the level of Rb 655.0bn, or 8.1% the amount of their budget revenue (in 2012 – Rb 347.3bn, or 4.6%).

The average amount of consolidated budget deficit was at the level of 8.0% of the relevant budget's revenue amount. The highest budget deficit to revenue ratio was observed in Chukotka AO – 49.4%, in Tyumen Oblast – 23.4%, in Krasnodar Krai – 20.4%, and in Novgorod Oblast – 19.2%. Moscow accounted for more than 13.5% of total consolidated budget deficit, or Rb 47.0bn (*Table 22*).

In 2013, the consolidated budget was executed with a surplus for 6 subjects of the Russian Federation (against 15 RF subjects in 2012). The amount of total budget surplus displayed by these regions was Rb 29.5bn, or 2.6% of the amount of their budget revenue (in 2012 – Rb 74.2bn, or 6.1% of budget revenue). The average budget surplus index amounted to 1.7% of budget revenue.

The highest consolidated budget surplus to revenue ratio was achieved in the Republic of Altai – 5.2%.

The bulk (94.1%) of the aggregate consolidated regional budget surplus was achieved due to the budget results displayed by two subjects of the Russian Federation: St Petersburg (50.5% or Rb 14.9bn) and Moscow Oblast (43.6% or Rb 12.9bn).

3.10.2. Cumulative Debt Structure

According to data released by the Ministry of Finance of the Russian Federation, the amount of total net borrowing by the subjects of the Russian Federation in 2013 went up by 386.1 bln rubles and amounted to 1,737.5 bln rubles, the volume of the cumulative debt of the

municipalities went up by Rb 43.5 bn and came to Rb 288.9 bn. Meanwhile, the ruble equivalent of the volume of cumulative external borrowing of the regional consolidated budgets increased by Rb 1.2 bn and amounted to Rb 181.3 bn (*Table 21*).

Table 21

Net Borrowing in Regional and Local Budgets (as % of GDP)

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Net borrowing by subfederal and local authorities	-0.29	-0.04	0.47	0.37	0.26	0.09	0.21	0.17	0.29	0.74	0.51	0.21	0.33	0.61
Including:														
Refundable loans received from budgets of other levels	-0.03	0.04	0.12	-0.1	-0.02	-0.03	-0.04	-0.01	0.03	0.33	0.37	0.15	0.01	0.06
subfederal (municipal) bonds	-0.27	-0.07	0.16	0.31	0.29	0.09	0.14	0.08	0.17	0.24	0.07	-0.11	0.06	0.12
other borrowings	0.01	-0.02	0.19	0.6	...	0.03	0.11	0.10	0.09	0.17	0.07	0.17	0.26	0.43

Source: Ye. T. Gaidar Institute for Economic Policy's calculations based on data released by the Federal Treasury.

3.10.3. Structure of Borrowing

Cumulative volume of borrowing by the regions and municipalities came to Rb 1,195.4 bn. Biggest borrowers were: Omsk Oblast – Rb 75.5 bn, Nizhniy Novgorod Oblast – Rb 75.3 bn, Moscow Oblast – Rb 58.9 bn, Novosibirsk Oblast – Rb 58.1 bn, Krasnodarsky Krai – Rb 50.6 bn, Krasnoyarskiy Krai – Rb 38.6 bn, Arkhangelsk Oblast – Rb 30.9 bn. In comparison with 2012 the volume of borrowing in nominal terms went up by Rb 364.4 bn or by 43.9%.

In the overall volume of borrowing of the consolidated regional budget issue of securities came to 12.9%, for loans from upper level budgets (budgetary loans) – 11.1%, other types of borrowing (borrowing from commercial banks and international credit organizations) – 76.0%.

The overall volume of net borrowings of the consolidated regional budget came to Rb 404.6 bn. The highest net borrowing to budget revenue ratios were demonstrated by Chukotka AO – 45.6%; the Republic of Udmurtia – 17.3%; and by Smolensk Oblast and Pskov Oblast – 14.1%. (*Table 22*).

The largest net borrowers were: Krasnodarskiy Krai – Rb 35.8 bn, Krasnoyarskiy Krai – Rb 19.9 bn, Kemerovo Oblast – Rb 16.6 bn, Sverdlovsk Oblast – Rb 16.1 bn, and Novosibirsk Oblast – Rb 15.4 bn.

Due to the higher amount of previously received and redeemed loans vs. the amount of new loans, the amount of cumulative debt declined in four subjects of the Russian Federation: in Moscow Oblast – by Rb 13.1bn, in the city of Moscow – by Rb 11.1bn, in St Petersburg – by Rb 2.6bn and Smolensk Oblast – 14.1%.

Table 22

The Execution of Consolidated Budgets of Subjects of the Russian Federation in 2013

	Budget revenue (m Rb)	deficit (surplus) (m Rb)	Deficit (surplus) to revenue ratio, %	Attracted borrowing to revenue ratio, %	Net borrowing to revenue ratio, %	Repaid debt to revenue ratio, %	Net borrowing to deficit (surplus) ratio, %
1	2	3	4	5	6	7	8
Central Federal District							
Belgorod Oblast	86,795.1	9,828.4	11.32	17.92	8.07	6.08	71.26
Briansk Oblast	52,611.4	3,616.9	6.87	13.43	6.28	7.15	91.33

cont'd

1	2	3	4	5	6	7	8
Vladimir Oblast	59,979.0	2,796.6	4.66	5.38	4.39	0.99	94.20
Voronezh Oblast	105,900.9	8,317.5	7.85	15.49	8.06	5.21	102.67
Ivanovo Oblast	43,142.2	2,951.6	6.84	20.40	7.14	13.16	104.29
Tver Oblast	65,839.2	3,805.8	5.78	37.18	7.55	29.63	130.69
Kaluga Oblast	57,423.4	4,552.6	7.93	18.18	7.96	9.70	100.34
Kostroma Oblast	29,770.8	1,906.6	6.40	35.44	7.68	23.94	119.85
Kursk Oblast	54,284.4	2,194.2	4.04	5.46	3.50	1.68	86.69
Lipetsk Oblast	53,494.4	5,202.0	9.72	14.49	7.52	5.11	77.34
Moscow Oblast	509,135.0	-12,855.3	-2.52	11.58	-2.57	11.19	101.66
Orel Oblast	36,025.3	2,876.0	7.98	16.76	6.83	9.76	85.49
Ryazan Oblast	53,568.0	6,752.9	12.61	29.26	7.45	20.47	59.07
Smolensk Oblast	42,784.2	7,303.1	17.07	61.99	14.06	45.57	82.38
Tambov Oblast	50,409.4	4,731.7	9.39	17.54	4.07	12.02	43.36
Tula Oblast	72,638.3	4,388.5	6.04	15.25	8.31	6.36	137.50
Yaroslavl Oblast	71,016.6	7,565.6	10.65	30.49	10.23	20.05	96.07
Moscow	1,592,594.4	44,582.1	2.80	1.86	-0.70	1.61	-25.00
Financial administration, Baikonur city government	3,851.5	0.1	0.00	0.00	0.00	0.00	0.00
Total	3,041,263.5	110,516.7	3.63	9.39	1.51	6.52	41.55
North Western Federal District							
Republic of Karelia	37,499.1	5,566.8	14.85	33.97	9.36	21.95	63.05
Republic of Komi	72,490.3	13,192.8	18.20	15.52	9.73	5.30	53.44
Arkhangelsk Oblast	86,572.0	5,591.0	6.46	35.66	8.16	25.81	126.35
Vologda Oblast	61,509.2	4,839.7	7.87	21.64	6.67	10.35	84.82
Kaliningrad Oblast	53,200.2	6,089.2	11.45	16.77	6.42	5.76	56.06
Leningrad Oblast	104,107.8	5,048.6	4.85	7.19	4.48	2.18	92.32
Murmansk Oblast	65,824.9	6,983.8	10.61	18.13	6.74	7.78	63.56
Novgorod Oblast	31,856.9	6,103.3	19.16	34.10	10.50	21.91	54.79
Pskov Oblast	32,012.5	4,937.0	15.42	17.11	14.13	2.24	91.61
St Petersburg	453,242.6	-14,901.9	-3.29	0.02	-0.58	0.30	17.62
Nenets AO	16,908.2	700.6	4.14	0.00	0.00	0.00	0.00
Total	1,015,223.6	44,151.0	4.35	11.13	3.89	5.94	89.43
Southern Federal District							
Republic of Kalmykia	12,063.1	1,575.9	13.06	7.79	1.26	2.07	9.65
Krasnodar Krai	251,325.7	51,178.9	20.36	20.13	14.24	5.89	69.93
Astrakhan Oblast	46,040.6	2,482.7	5.39	40.10	6.54	31.33	121.35
Volgograd Oblast	97,471.6	10,980.0	11.26	22.24	11.55	9.94	102.50
Rostov Oblast	180,375.2	8,642.3	4.79	4.57	3.24	1.34	67.59
Republic of Adygeya (Adygeya)	19,124.3	325.2	1.70	7.94	2.33	3.15	136.95
Total	606,400.6	75,185.0	12.40	16.73	9.32	6.95	75.14
North Caucasus Federal District							
Republic of Dagestan	102,541.9	3,068.1	2.99	8.15	3.70	2.93	123.59
Republic of Kabardino-Balkaria	31,265.1	1,061.4	3.39	10.18	2.18	8.00	64.29
Republic of North Ossetia – Alania	28,611.7	1,844.9	6.45	17.64	3.42	8.25	53.01
Republic of Ingushetia	22,949.0	3,533.9	15.39	4.09	4.09	0.00	26.59
Stavropol Krai	109,247.1	8,074.8	7.39	13.98	5.42	8.01	73.30
Republic of Karachay-Cherkessia	23,207.3	-77.1	-0.33	10.99	2.02	4.51	-607.52
Chechen Republic	72,755.8	-175.4	-0.24	1.61	0.16	0.00	-67.79
Total	390,577.8	17,329.7	4.44	9.35	3.30	4.52	74.42
Volga Federal District							
Republic of Bashkortostan	181,472.2	17,024.4	9.38	6.06	3.80	2.26	40.53

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1	2	3	4	5	6	7	8
Republic of Mari El	29,307.2	1,686.9	5.76	15.58	5.10	8.91	88.63
Republic of Mordovia	41,817.5	4,102.8	9.81	33.88	7.97	21.12	81.20
Republic of Tatarstan (Tatarstan)	231,127.5	160.8	0.07	2.49	0.09	2.38	127.37
Republic of Udmurtia	71,434.8	9,498.2	13.30	38.74	17.36	19.46	130.59
Republic of Chuvashia	51,006.4	1,375.6	2.70	11.28	0.35	9.25	12.85
Nizhny Novgorod Oblast	159,876.0	10,986.3	6.87	47.11	7.75	37.66	112.82
Kirov Oblast	59,811.9	6,608.7	11.05	27.18	8.02	18.83	72.56
Samara Oblast	174,388.0	10,799.6	6.19	14.01	3.08	10.23	49.80
Orenburg Oblast	92,591.5	10,986.8	11.87	18.78	9.34	9.11	78.68
Penza Oblast	57,721.7	5,851.3	10.14	28.16	10.24	17.22	101.04
Perm Krai	138,841.8	9,843.1	7.09	0.09	0.01	0.08	0.16
Saratov Oblast	95,516.3	6,713.5	7.03	29.05	7.77	19.87	110.56
Ulianovsk Oblast	49,397.7	5,983.6	12.11	13.44	9.06	3.58	74.76
Total	1, 434,310.4	101,621. 5	7.09	17.64	5.13	11.73	72.38
Urals Federal District							
Kurgan Oblast	39,821.3	1,983.8	4.98	7.21	5.35	1.26	107.39
Sverdlovsk Oblast	237,404.5	26,630.3	11.22	10.48	6.77	3.34	60.33
Tyumen Oblast	138,852. 6	32,454.5	23.37	0.00	0.00	0.00	0.00
Cheliabinsk Oblast	155,510.7	10,974.5	7.06	9.22	5.18	3.77	73.41
Khanty-Mansi AO	212,338.6	35,548.1	16.74	6.45	4.89	1.56	29.21
Yamalo-Nenets AO	146,339.9	20,266.8	13.85	15.40	9.59	5.81	69.27
Total	930,267.6	127,857.9	13.74	8.42	5.45	2.81	39.64
Siberian Federal District							
Republic of Buryatia	60,962.1	126.8	0.21	8.71	4.36	1.80	2 097.19
Republic of Tyva	24,625.7	2,138.9	8.69	5.88	3.30	2.58	38.00
Altai Krai	104,330.5	985.3	0.94	1.75	0.80	0.95	84.63
Krasnoyarsk Krai	203,604.1	33,385.6	16.40	18.97	9.76	9.19	59.51
Irkutsk Oblast	142,834.9	13,953.3	9.77	1.29	0.52	0.30	5.30
Kemerovo Oblast	133,298.0	17,138.7	12.86	16.54	12.35	1.59	96.03
Novosibirsk Oblast	149,144.1	17,342.1	11.63	38.95	10.30	27.93	88.60
Omsk Oblast	92,286.7	8,631.1	9.35	80.70	8.25	71.64	88.23
Tomsk Oblast	63,211.5	6,955.8	11.00	32.19	8.65	21.13	78.61
Republic of Altai	18,048.6	-947.4	-5.25	8.92	0.52	7.03	-9.82
Republic of Khakassia	27,291.4	3,913.9	14.34	32.88	13.66	19.14	95.27
Transbaikals Krai	61,923.5	4,931.2	7.96	19.12	8.16	10.62	102.43
Total	1, 081,561. 0	108,555.2	10.04	22.78	7.28	14.63	72.49
Far Eastern Federal District							
Republic of Sakha (Yakutia)	169,230.6	10,412.0	6.15	6.46	4.64	1.44	75.48
Maritime Krai	112,742.9	9,470.9	8.40	9.84	6.24	3.60	74.24
Khabarovsky Krai	120,812.0	3,686.7	3.05	11.37	8.31	2.80	272.17
Amur Oblast	83,341.2	2,966.5	3.56	26.54	10.04	14.68	282.05
Kamchatka Krai	63,830.4	-537.4	-0.84	2.94	0.17	2.65	-19.77
Magadan Oblast	30,394.9	2,445.6	8.05	8.38	5.30	2.96	65.83
Sakhalin Oblast	102,195.8	1,932.7	1.89	8.30	2.05	5.74	108.18
Jewish AO	15,581.0	352.4	2.26	7.77	5.39	1.10	238.37
Chukotka AO	19,346.3	9,555.2	49.39	46.52	46.52	0.00	94.19
Total	717,475.1	40,284.7	5.61	11.29	6.54	4.29	116.51
Total, Russian Federation	9, 217,079.6	625,501.7	6.79	12.97	4.39	7.61	64.69

Source: Ye. T. Gaidar Institute for Economic Policy's calculations based on data released by the Federal Treasury.

Domestic Bond Loans

In 2013, new issues of bond loans were registered in 28 RF subjects and in 1 municipal formation (vs. 27 regions and 4 municipalities in 2012). In the course of the same year, the RF Ministry of Finance registered prospectuses for the offering and listing of bond loan issues placed by: Volgograd Oblast; Krasnoyarsk Krai; the Republic of Karelia; Nizhny Novgorod Oblast; Tver Oblast; St Petersburg; Tomsk Oblast; the Republic of Sakha (Yakutia); Yaroslavl Oblast; the Republic of Udmurtia; Samara Oblast; Stavropol Krai; the Republic of Bashkortostan; Stavropol Krai; the Republic of Bashkortostan; Belgorod Oblast; Lipetsk Oblast; Voronezh Oblast; Tula Oblast; Orenburg Oblast; Kostroma Oblast; Moscow; Novosibirsk Oblast; the Republic of Mordovia; Smolensk Oblast; Omsk Oblast; Kemerovo Oblast; the city of Novosibirsk.

In 2013, the total volume of placed bonds amounted to Rb 154.6bn, thus having increased on 2012 by one-third. So, over that year the total volume of newly issued subfederal and municipal bonds rose from 0.19% to 0.23% of GDP (*Table 23*).

The biggest placements of securities were made by: Moscow – to the value of Rb 29.7bn, or 19.8% of the total domestic borrowing volume; Krasnoyarsk Krai – to the value of Rb 11.0bn, or 7.4% of the total domestic borrowing volume; Nizhny Novgorod Oblast – to the value of Rb 10.0bn, or 6.7% of the total domestic borrowing volume; and Voronezh Oblast – to the value of Rb 9.8bn, or 6.5% of the total domestic borrowing volume.

Table 23

Issuance of Subfederal and Municipal Securities (as % of GDP)

Year	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Issue volume	0.19	0.17	0.27	0.46	0.47	0.37	0.28	0.26	0.43	0.41	0.25	0.10	0.19	0.23
Redemption	0.46	0.23	0.10	0.15	0.19	0.28	0.14	0.18	0.26	0.16	0.18	0.21	0.13	0.12
Net financing	-0.27	-0.07	0.16	0.31	0.29	0.09	0.14	0.08	0.17	0.24	0.07	-0.11	0.06	0.12

Source: Ye. T. Gaidar Institute for Economic Policy's calculations based on data released by the RF Ministry of Finance.

Thus, the four biggest bond issuers accounted for 40.4% of the total volume of placed regional and municipal bonds (*Table 24*).

Table 24

Placement of Subfederal and Municipal Securities in 2013

RF Subject	Issue volume (bn Rb)	Issuer's share in total bond issue volume (%)	Issue volume to total domestic borrowing volume ratio (%)
1	2	3	4
Central Federal District			
Belgorod Oblast	3.5	2.3	27.4
Voronezh Oblast	9.7	6.5	74.5
Tver Oblast	3.0	2.0	12.9
Kostroma Oblast	3.0	2.0	33.0
Lipetsk Oblast	3.0	2.0	42.3
Ryazan Oblast	2.5	1.7	16.3
Smolensk Oblast	3.0	2.0	12.5
Tula Oblast	5.0	3.3	53.2
Yaroslavl Oblast	5.0	3.3	30.6
Moscow	29.7	19.8	100.0
North Western Federal District			
Republic of Karelia	2.0	1.3	23.5
St Petersburg	0.95	0.1	100.0

Cont'd

1	2	3	4
Southern Federal District			
Volgograd Oblast	7.0	4.7	41.7
North Caucasus Federal District			
Stavropol Krai	5.0	3.3	35.2
Volga Federal District			
Republic of Bashkortostan	5.0	3,3	57,0
Republic of Mordovia	3.0	2,0	21,7
Republic of Udmurtia	2.0	1,3	8,2
Republic of Chuvashia	1.5	1,0	32,3
1	2	3	4
Nizhny Novgorod Oblast	10.0	6,7	17,3
Samara Oblast	8.3	5,5	60,7
Orenburg Oblast	5.0	3,3	29,7
Urals Federal District			
Sverdlovsk Oblast	3.00	2,5	46,8
Siberian Federal District			
Krasnoyarsk Krai	11.0	7,4	39,4
Kemerovo Oblast	1.0	0,7	4,9
Novosibirsk Oblast	5.0	3,3	10,6
Omsk Oblast	5.0	3,3	9,8
Tomsk Oblast	5.8	3,9	45,4
Republic of Khakassia	3.0	2,0	35,0
Far Eastern Federal District			
Republic of Sakha (Yakutia)	2.5	1.7	24.3
Russian Federation – total:	149.6	100.0	15.1

Source: Ye. T. Gaidar Institute for Economic Policy's calculations based on data released by the Federal Treasury.

The highest securitization level (100%) is observed in regions with the most highly developed borrowing markets – Moscow and St Petersburg.

The total net borrowing volume in the securities market in 2013 amounted to Rb 77.6bn, thus having doubled on 2012 (Rb 38.2bn). (Table 25).

Table 25

The Volume of Net Borrowing in the Market for Domestic Subfederal and Municipal Securities (m Rb)

	Consolidated regional budget	Regional budgets	Municipal budgets
1	2	3	4
2013			
Net borrowing	77,610.5	75,454.0	2,156.5
Attracted funds	154,642.0	149,641.8	5,000.2
Principal repayment	77,031.5	36,187.5	2,843.7
2012			
Net borrowing	38,175.9	36,797.5	1,378.5
Attracted funds	119,855.0	115,953.2	3,901.9
Principal repayment	81,679.1	79,155.7	2,523.4
2011			
Net borrowing	-58,202.6	-57,113.1	-1,089.5
Attracted funds	55,050.7	53,366.2	1,684.5
Principal repayment	113,253.3	11,479.3	2,774.1
2010			
Net borrowing	29,774.6	28,611.9	1,162.6
Attracted funds	111,106.3	105,854.3	5,251.9
Principal repayment	81,331.7	77,242.4	-4,089.3
2009			
Net borrowing	95,457.6	97,916.5	-2,458.9
Attracted funds	158,114.0	153,992.5	4,121.5
Principal repayment	62,656.5	56,076.1	6,580.4

Cont'd

1	2	3	4
2008			
Net borrowing	68,851.3	72,984.9	-4,133.7
Attracted funds	178,565.7	177,324.4	1,241.4
Principal repayment	109,714.5	104,339.4	5,375,048.0
2007			
Net borrowing	25,867.0	23,691.970	2,175.0
Attracted funds	84,159.2	79,889.761	4,269.4
Principal repayment	58,292.2	56,197.791	2,094.4

Source: Ye. T. Gaidar Institute for Economic Policy's calculations based on data released by the Federal Treasury.

The majority of those regions that had been regularly issuing debt securities, continued to do so in 2013. Since 1999, on an annual basis, bond issues have been placed by Volgograd Oblast; since 2003 – by Krasnoyarsk Krai; since 2004 – by the Republic of Karelia and Nizhny Novgorod Oblast. Their first issues of debt securities were placed in 2013 by the Republic of Mordovia, Smolensk Oblast, Omsk Oblast, and Kemerovo Oblast (*Table 26*).

Table 26

Registration of New Issues of Subfederal and Municipal Securities in 1999–2013

Issuer	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
RF Subject															
Volgograd Oblast	*	*	*	*	*	*	*	*	*	*	*	*	*	*	*
Krasnoyarsk Krai					*	*	*	*	*	*	*	*	*	*	*
Republic of Karelia						*	*	*	*	*	*	*	*	*	*
Nizhny Novgorod Oblast						*	*	*	*	*	*	*	*	*	*
Tver Oblast				*	*		*	*	*	*	*	*	*	*	*
St Petersburg	*	*	*	*	*	*	*	*	*	*		*	*	*	*
Tomsk Oblast		*	*	*	*	*	*	*	*	*		*	*	*	*
Republic of Sakha (Yakutia)				*	*	*	*	*	*	*		*	*	*	*
Yaroslavl Oblast					*	*	*	*	*	*		*	*	*	*
Republic of Udmurtia							*		*	*		*	*	*	*
Samara Oblast					*		*	*	*	*	*		*	*	*
Stavropol Krai			*							*			*	*	*
Republic of Bashkortostan			*	*		*	*	*	*				*	*	*
Stavropol Krai			*							*			*	*	*
Republic of Bashkortostan			*	*		*	*	*	*				*	*	*
Belgorod Oblast				*	*		*	*		*				*	*
Lipetsk Oblast						*	*	*	*	*				*	*
Voronezh Oblast						*	*	*	*					*	*
Tula Oblast								*						*	*
Orenburg Oblast														*	*
Kostroma Oblast				*	*		*		*				*		*
Moscow	*	*	*	*	*	*	*	*	*	*	*	*			*
Novosibirsk Oblast	*				*	*	*		*						*
Republic of Mordovia				*											*
Smolensk Oblast															*
Omsk Oblast															*
Kemerovo Oblast															*
Sverdlovsk Oblast												*	*	*	
Republic of Chuvashia	*	*	*	*	*	*	*	*	*	*	*		*	*	

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1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
Kaluga Oblast						*		*	*	*			*	*	
Vologda Oblast													*	*	
Krasnodar Krai						*			*			*		*	
Republic of Khakassia												*		*	
Ryazan Oblast												*		*	
Irkutsk Oblast			*	*	*	*	*	*	*	*	*			*	
Republic of Mari El														*	
Republic of Komi		*	*	*	*	*	*	*		*		*	*		
Ivanovo Oblast									*				*		
Republic of Buryatia													*		
Murmansk Oblast				*	*							*			
Khanty- Mansi AO				*	*						*				
Penza Oblast								*	*	*					
Ulianovsk Oblast									*	*					
Kurgan Oblast								*		*					
Moscow Oblast				*	*	*	*	*	*	*					
Republic of Kalmykia									*						
Khabarovsk Krai				*	*	*	*								
Republic of Kabardino- Balkaria		*					*								
Leningrad Oblast			*	*	*	*									
Yamalo- Nenets AO					*	*									
Briansk Oblast						*									
Sakhalin Oblast				*											
Kursk Oblast				*											
Maritime Krai		*													
Municipalities															
Novosibirsk					*	*	*	*				*	*	*	*
Volgograd	*	*	*	*	*		*	*		*	*	*	*	*	
Krasnoyarsk					*	*	*		*	*	*	*	*	*	
Tomsk					*	*		*	*	*		*		*	
Kazan							*	*	*		*	*	*		
Krasnodar												*	*		
Ufa				*	*	*						*			
Elektrostal, Moscow Oblast									*		*				
Smolensk											*				
Lipetsk								*	*	*					
Magadan								*	*	*					
Bratsk										*					
Novorossiisk										*					
Yekaterinburg		*	*	*	*	*	*	*	*						
Klin raion, Moscow Oblast							*	*	*						
Noginsk raion, Moscow Oblast						*		*	*						
Blagoveshchensk								*	*						
Cheboksary	*						*		*						
Balashikha, Moscow Oblast									*						
Odintsovo raion, Moscow Oblast							*	*							
Astrakhan								*							
Briansk								*							
Voronezh								*							

Cont'd

1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
Orekhovo-Zuevo, Moscow Oblast								*							
Yaroslavl								*							
Yuzhno- Sakhalinsk					*	*	*								
Novocheboksarsk	*		*			*	*								
Angarsk							*								
Vurnar raion, Republic of Chuvashia							*								
Shumerlia, Republic of Chuvashia							*								
Barnaul						*									
Perm						*									
Nizhny Novgorod				*											
Kostroma	*	*													
Arkhangelsk	*														
Dzerzhinsky	*														

Source: RF Ministry of Finance.

Section 4. The Real Sector of the Economy

4.1. Macrostructure of production

4.1.1. Post-crisis dynamics of the Russian economy in 2009-2013

The global economic crisis impacted on the Russian economy in the following areas: (1) there was a sharp drop in prices and in foreign demand for the basic commodities that form the basis of export potential; (2) domestic demand decreased due to falling revenues for the economy and falling population incomes; (3) narrowed supply of imported goods, which form more than one third of domestic market resources; and (4) changes in the direction of investments, with a sharp drop in the domestic investment in capital assets and an intensive outflow of capital abroad.

Analysis of the dynamics of the national economic indicators shows that the gradual decline in the pace of economic growth was followed by increasing disparities in production, consumption and finance, as well as by reduced innovation activity by manufacturers, strengthening of the problems connected with imbalances in the technical and technological characteristics of the fixed assets, and investment in capital assets and in basic economic activities. Expansion of demand from domestic consumers was supported by an increase in wages significantly above increasing productivity. Growth of investment in capital assets did not result in a corresponding increase in output per worker or per unit invested. (*Table 1*). Development based on the extensive use of the principal factors which increase production costs and a high proportion of imports in the domestic market resources have reduced the competitive ability of the Russian economic as well as the dynamics of growth.

Prior to the crisis in 2008 the Russian economy was characterised by a simultaneous expansion of external and domestic demand, with the cumulative effect of the internal factors, regulating the level of business activity offsetting the impact on economic growth of the weakening external demand. The reasons for the far-reaching extent and prolonged reaction to the global crisis of 2008-2009 had an inner nature. In the acute phase of the crisis in 2009 the decrease in domestic demand was deeper, so the recovery process took almost two years, while, in 2010, external demand exceeded the pre-crisis index of 2008 (*Fig. 1*).

Table 1

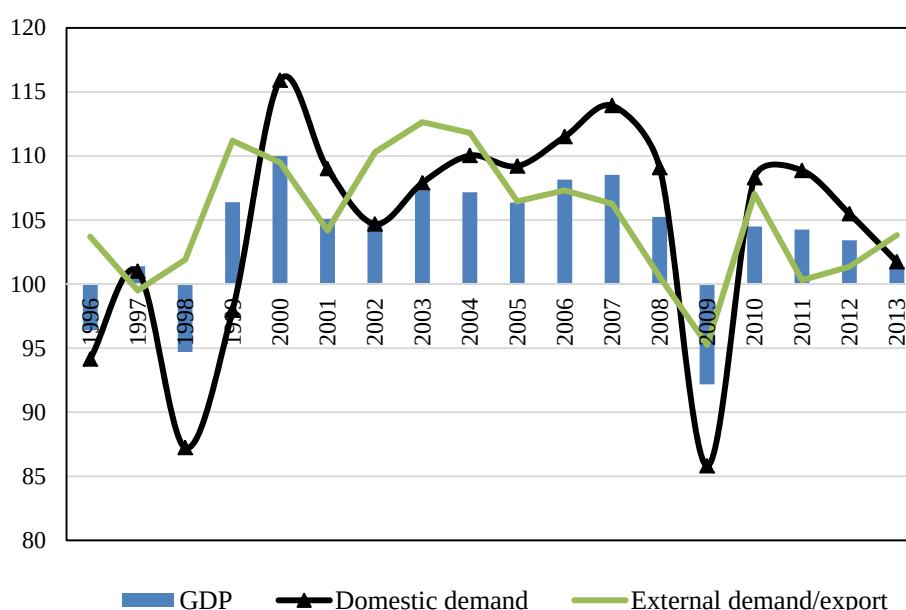
**Main macroeconomic indicators of social and economic development
in 2008-2012 as % of the previous year**

	2008	2009	2010	2011	2012	2013
1	2	3	4	5	6	7
GDP	105.2	92.2	104.5	104.3	103.4	101.3
Industrial production index	100.6	90.7	107.3	105	103.4	100.4
Mining and quarrying	100.4	99.4	103.8	101.8	101	101.1

Cont'd

1	2	3	4	5	6	7
Manufacturing industries	100.5	84.8	110.6	108	105.1	100.5
Agricultural production	110.8	101.4	88.5	123.0	95.2	106.2
Investments in capital assets	109.9	84.3	106.0	110.8	106.6	99.7
Retail trade turnover	113.7	94.9	106.5	107.1	106.3	103.9
Fee-based services to citizens	104.3	97.5	101.5	103.0	103.7	102.1
Exports	134.6	63.7	132.1	131.3	102.7	98.8
Imports	129.4	63.7	133.6	129.7	105.4	102.6
End of year consumer price index	113.3	108.8	108.8	106.1	106.6	106.8
End of year producer price index	93.0	113.9	116.7	112.0	105.1	103.4
Real disposable incomes	102.4	103.0	105.9	100.5	104.6	103.3
Real accrued salary	111.5	96.5	105.2	102.8	108.4	105.2
Level of general unemployment, in %	6.2	8.3	7.3	6.5	5.5	5.5

Source: Federal State Statistics Service.

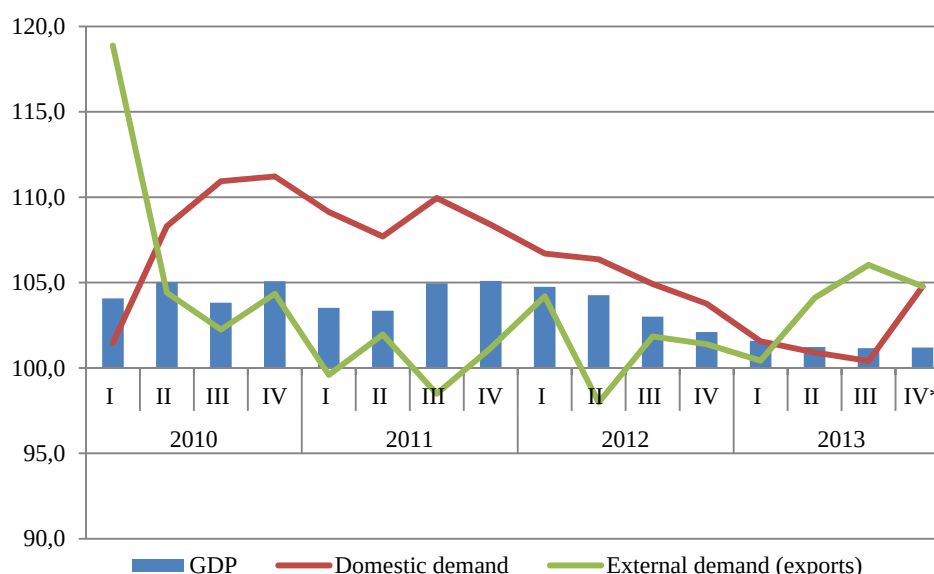


Source: Federal State Statistics Service.

Fig. 1. The changing of dynamics of the GDP components of domestic and external demand in 1996-2013, as % of previous period

Differences in the rates of recovery of individual components of the aggregate demand determined the features of the functioning of the economy in 2011-2013. While the results from the last four years indicate accelerated growth in domestic demand relative to GDP and external demand, the quarterly dynamics shows how these changes altered and constrained the development of the Russian economy (*Fig. 2*). The overall cause of stagnation in the Russian economy in 2013 was a slowdown in the growth of domestic demand in the third quarter of 2011. A further factor in the reduction in growth of GDP was the decrease in export dynamics from the second quarter of 2010 until the first quarter of 2013. Despite the increase in external demand from the second quarter of 2013 in relation to the corresponding period of the previous year, this failed to stimulate the rate of GDP growth, since the dynamics of domestic demand weakened sharply in 2013, and, in fact, it was only the export of goods and services which helped to preserve the positive nature of the GDP dynamics, albeit, weakly. In 2013 the

growth in domestic demand was 1.7% while that of external demand was 3.8%, against 5.5% and 1.4%, respectively, in 2012.



Source: Federal State Statistics Service.

Fig. 2. Changing dynamics of GDP components of domestic and external demand in 2010-2013, as % of the corresponding quarters of the previous year

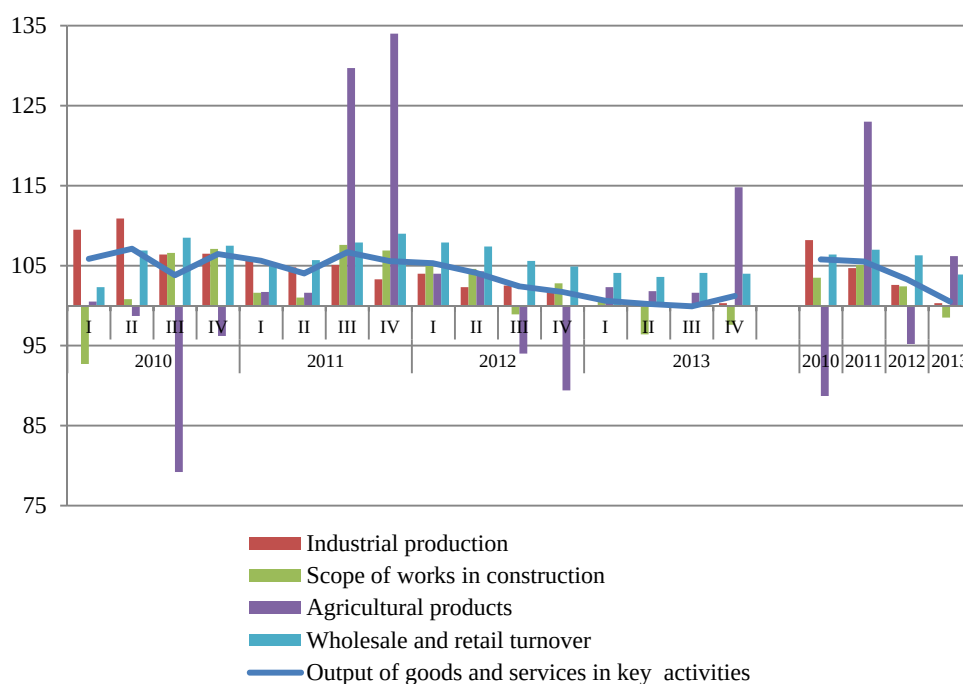
Compared with 2012, the 2013 index of output goods and services for key economic activities was 100.5%. In 2013 the volume of industrial production increased by only 0.4% on the previous year. During Q2 and Q3 of 2013 negative annual and quarterly growth rates were recorded in relation to the corresponding periods of the previous year in manufacturing activities orientated mainly towards the domestic market. December 2013 was only the third time within the year that there was growth in manufacturing output (1.6% on an annualised basis) but this suspended the downturn of the IV quarter and stabilised the growth for the year at around the level seen in 2012. Weak growth in mining activity amid unfavourable weather forecasts for the winter of 2013-2014 started to influence industrial dynamics from Q2 of 2013, mainly due to increased demand in the domestic market and from traditional importing-countries as the heating season approached. In 2013 the index of physical production volume in the mining sector was 101.2% of the previous year.

This extremely negative influence on the macroeconomic situation in the Russian economy had a slowdown effect on business activity in construction and the investment complex from Q4 of 2011, so that by 2013 the volume of construction works began to decline. In Q2 and Q3 of 2013 the fall in investments in capital assets reached 1.4%, while, for the whole year it was 0.3% in relation to the corresponding period of 2012, with the volume of construction works being reduced by 1.5% in annual terms.

Other fields of the real sector of the economy also negatively influenced the dynamics of the overall national economy. Low industrial growth and in the consumer and investment markets, a stagnation of demand for transport services, as well as the slowing down of growth in communications services to 4.5% in 2013, against 5.6% in the previous year could all be noted.

There was also slowing of consumer demand and wholesale turnover. The growth of retail turnover in the last three years reached its peak in Q4 of 2011 but steadily slowed during 2012-2013 yet still remained the main driver of economic growth (*Fig. 3*). In 2013, retail turnover increased by 3.9% having increased by 6.4% in the previous year, while the wholesale trade had increased by 0.9% and 3.4% respectively.

Despite the downward trend, sales in 2013 were some of the steadiest against the risks in the economic development sectors.



Source: Federal State Statistics Service.

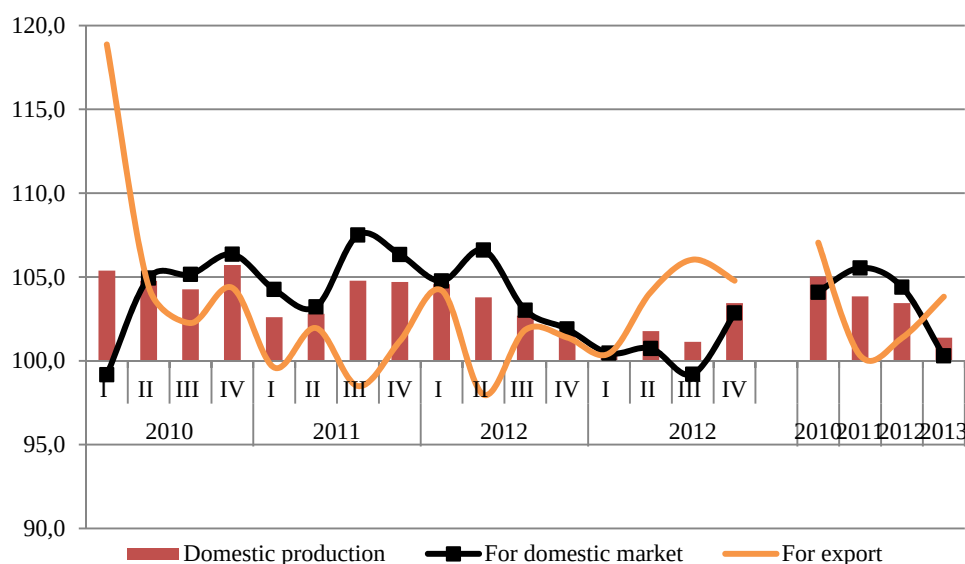
Fig. 3. Indices of output of goods and services in key economic activities for 2010-2013, as % of the corresponding period of the previous year

A positive factor maintaining the positive growth of GDP in 2013 was an increase in agricultural production by 6.2% compared with 2012. As a result this sector managed to reach the level of 2011.

The dynamics of the domestic market were defined by the ratio of growth of domestic production for domestic consumption and external markets, on the one hand, and the dynamics and structure of imports, on the other. The post-crisis recovery of domestic production for the domestic market was extremely slow, though its fall during the acute phase of the crisis in 2009 was not as abrupt as the fall in imports. The sharp drop in domestic production was due both to the low competitiveness of domestically-produced goods and services compared to imported ones, and to the low efficiency of production in the non-tradable goods and services sector compared to the export oriented sector of the economy.

The level of external demand for minerals and raw materials is of fundamental importance for the Russian economy as is the direction of use of the income from foreign trade. An increase of income concentration in the manufacturing sector oriented towards exports puts pressure to on the domestic market. If we consider that the rapid growth of the export sector of the economy in 2010 determined the strength of recovery of domestic production for the

domestic market, then in 2011-2012 even the acceleration of the average annual growth of domestic production, up to 5.0%, was not enough to prevent the consequences of a slowdown in export growth to 0.8%. In 2013 the situation was compounded when the pace of domestic production slowed to 0.3% against 4.4% of a year earlier, while exports fell to 98.8% of those of the previous year.

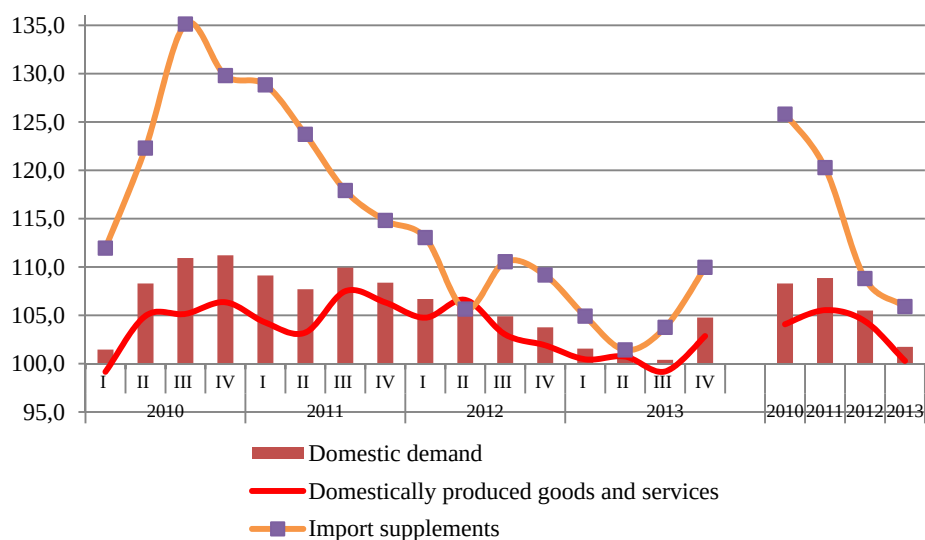


Source: Federal State Statistics Service.

Fig. 4. Domestic production dynamics in 2010–2013, as % of the corresponding quarter of the previous year

While noting the importance of the domestic market dynamics, as the dominant factor in the development of the Russian economy in 2010-2013, one must take account of the details affecting the domestic market resources. The starting conditions of the recovery were characterised by the quantum index of the volume of basic manufacturing activities within the economy having fallen by 9.8% in 2009 compared to the previous year while the import volume had fallen by 30.4%. This massive decline in imports in 2009 determined the structural changes of the domestic market; i.e. with decreased consumer demand and incomes and the weakening of the ruble, there was a transient increase in the share of domestically manufactured goods (*Fig. 5*). However, given that the Russian economy had, for the previous ten years, been operating under accelerated growth of imports relative to domestic production, during the recovery from the crisis the structure of domestic market resources in 2010 was repeating the structure of the 2007 pre-crisis level. Later, in 2011-2013 the domestic market resource structure changed (for the worse) due to an increase in the share of imported goods in domestic market resources from 24.9% to 26.7%. In 2013, the share of imported capital goods accounted for 6.2% of investments and 44% of the retail trade commodity resources.

In the absence of reserves of competitive capacity, import substitution in 2010-2012 concentrated in the manufacturing sector with a high proportion of industrial assembly. This determined the change in proportions between the imports of investment and intermediate goods. In particular, the increase in the share of intermediate consumption goods stimulated the recovery of the assembly machine industry from the crisis, but at the same time reflected the inadequate localisation of production of the main components.



Source: Federal State Statistics Service.

Fig. 5. Dynamics of domestic demand components in 2010–2013, in % to corresponding quarter of the previous year

Table 2

**Structure of imports by functional nature of utilisation
(balance of payments methodology) % of total**

	Goods		
	Consumer	Investment	Intermediary
2006	46.2	17.0	36.8
2007	44.4	18.9	36.7
2008	41.8	23.8	34.4
2009	44.3	19.7	36.0
2010	40.7	19.5	39.8
2011	36.6	21.4	42.0
2012	38.1	24.9	37.0
2013	37.6	24.3	38.0

Source: Federal State Statistics Service.

The increasing share in the import structure of investment and intermediate goods in 2010–2012 with a decrease in the share of consumer goods was qualitatively new process for the Russian economy. *Ceteris paribus*, the dynamic growth in imports was to promote the change in the competitive environment, where the further development of the real sector in this situation would depend on the intensity of investment in fixed assets, focused on the modernisation and diversification of production. However, the high share of imports in the retail trade and in the volume of investments in fixed assets increased the dependence of the gross resources balance of the economy on changes in the external economic situation. In 2013, a fall in investments in fixed assets led to a simultaneous decrease in demand for domestic and imported capital goods and increased the development of negative tendencies in the domestic market.

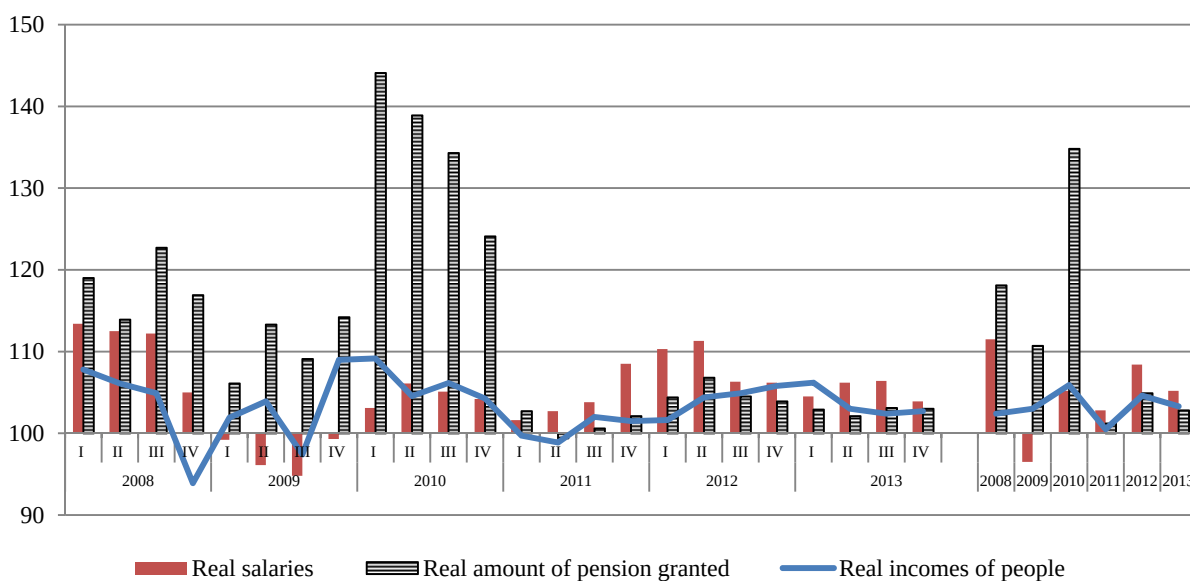
4.1.2. Main features of GDP use in 2009–2013

The model of recovery from the crisis in 2008 which was adopted was primarily focused on the implementation of state social guarantees and obligations. In order to maintain the

standard of living and social stability, governance costs in 2009 rose to 20.8% of GDP; and, in the period 2010-2013, remained above the pre-crisis level.

In 2009-2013, the growth rate of real income and real wages remained stable and positive; which represented a crucial difference from the situation of recovery from the consequences of the 1998 crisis.

The structure of real incomes in 2009-2010 changed under the influence of the advanced growth of real pensions by 1.5 times compared to the pre-crisis levels in 2008 with the recovery of real wages. In 2010, the share of social benefits in the monetary income of the population was 17.7% having increased by 6.1 percentage points compared to 2007 with a decrease in the share of wages by 2.3 percentage points, and of the income from property and business by 3.2 percentage points. In the period of 2011-2013 the situation changed and an acceleration in the growth of real wages could be noted, including an increase in the level of wages in the budget sector of the economy. For pensions, this growth was much slower than in the period of 2009-2010. In 2013, the growth in real household disposable incomes compared to 2010 was 8.6%, while of real wages, 17.2%, and of real pensions, 9.1%. The share of wages in 2013 amounted to 65.9% of cash earnings; and social benefits to, 18.4% (+0.7 percentage points compared to the indices of 2010) with a further decrease in the contribution of income from property and entrepreneurship.



Source: Federal State Statistics Service.

Fig. 6. Dynamics of real incomes in 2008–2013, as % of the relevant period of previous year

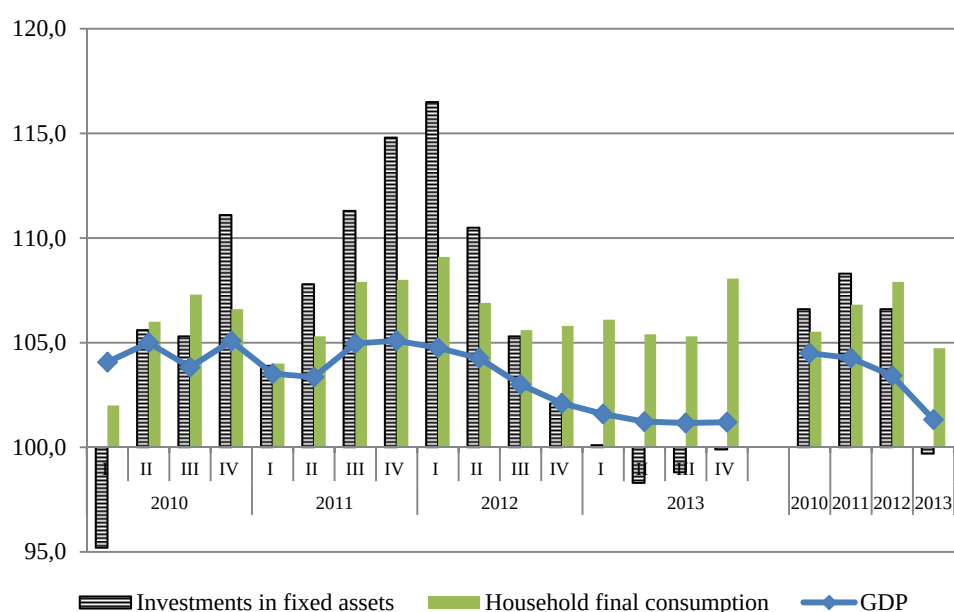
Income growth was one of the key factors in maintaining the positive dynamics of the domestic market. In 2010, household final consumption reached the pre-crisis level of 2008, and average annual growth in 2011-2012 reached 107.3%. However, in the second half of 2012 a slowdown became apparent, and in 2013 there was further slowdown of household final consumption expenditure to 104.7% compared to the previous year. While, in 2010-2012, the domestic market had operated with simultaneous expansion of investment and consumer demand, in 2013 household final consumption became the exclusive factor

maintaining the domestic market and positive GDP growth. The share of final consumption in 2013 reached 71.6% of GDP and was the highest for the last fourteen years, except for in the acute phase of the crisis in 2009.

Table 3

Structure of utilised GDP in 2008–2013, in actual prices, % of total

	2007	2008	2009	2010	2011	2012	2013
Gross Domestic Product	100	100	100	100	100	100	100
Including:							
Expenditure on the final consumption	66.1	66.7	75.4	70.2	67.4	69.5	71.6
Households	48.2	48.4	54.1	51.0	48.9	49.9	51.7
Public Administration	17.3	17.8	20.8	18.7	18.2	19.2	19.5
Non-Profit Organisations servicing households	0.6	0.5	0.6	0.5	0.4	0.4	0.4
Gross Savings	24.2	25.5	18.9	22.6	25.1	24.6	23.2
Gross Investment in Fixed Assets	21.0	22.3	22.0	21.6	21.5	22.0	21.5
Change in Inventories Stock	3.2	3.2	-3.1	1.0	3.7	2.6	1.8
Net Export	8.6	9.2	7.4	8.1	8.6	7.4	5.6
Statistical Discrepancy	1.1	-1.5	-1.8	-0.9	-1.2	-1.5	-0.4



Source: Federal State Statistics Service.

Fig. 7. Dynamics of household final consumption and the investments in fixed assets in 2010–2013, as % of the relevant period of the previous year

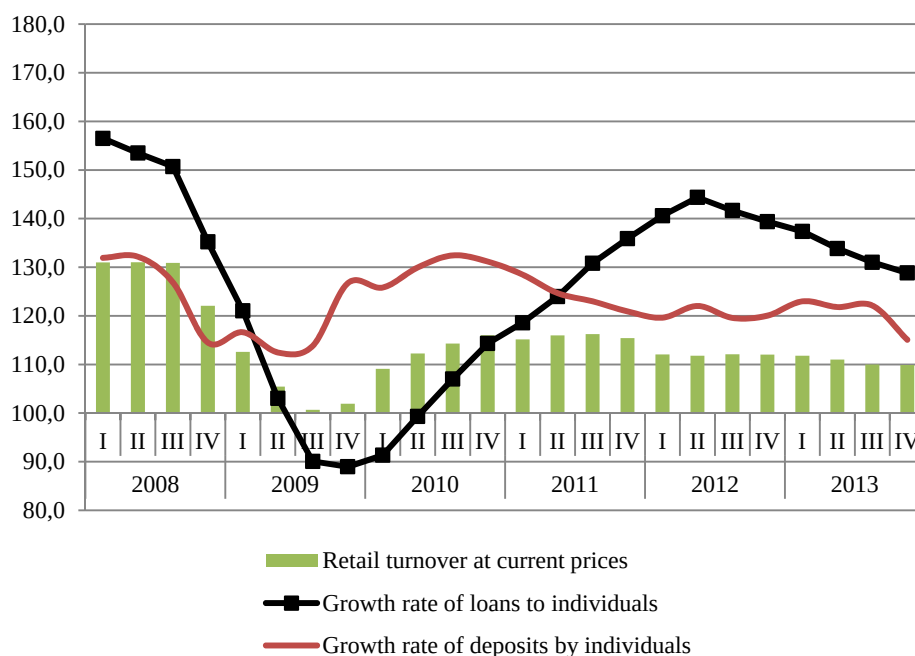
In 2013, retail trade turnover showed a slowdown caused by a general decline in economic growth and a narrowing of the retail credit market. However, the main factor slowing the turnover of the retail trade was a decrease in the growth of incomes of the population compared to 2012. Real incomes for 2013 increased by 3.3% which was 1.3 percentage points lower than for the growth of the same indicator in 2012.

By the end of 2013 retail trade turnover had increased by 3.9% compared to 2012 when the index had been 4.6% compared with the year earlier. This included food products (2.5% against 3.6%); and non-food products (5.0% vs. 8.6%). It should be noted that the slowdown in retail turnover was not accompanied by a significant change in the pattern of consumer behavior; the share of savings income of the population remained at 10% - the level of the

previous year. The major changes were not changes in savings but in the proportions of foreign currency purchased and an increase of cash on hand of the population in favour of the latter. Typical of 2013 was the fact that, along with a slowdown in sales in the non-food sector, the structure of household consumption expenditure changed, with the proportion of food products significantly decreasing. Thus, in times of financial instability, the public does not always reduce their expenses, but begins to make purchases more efficiently.

In 2013, against the background of an apparent deterioration in the economic dynamics, and in an effort to minimise social risks, the public was rather reluctant to purchase many types of services. From the 2013 results we can see that the volume of paid services to the population increased by only 2.1%, against 3.7% of the year before. In the structure of paid services to the population the public utilities and transport and communications services continued to dominate. The negative impact on the level of demand helped prices and tariffs; the consumer price index for services in January–December 2013 compared with January–December 2012 amounted to 108.1%, against 105.4%. As a result, in 2013, in the structure of population income to the share of paid services was 14.8%, that is, 0.4 percentage points lower than in 2012. The then current trends in the Russian economy had an impact on the development of most types of paid services for the population.

The market dynamics for household services were determined by the gradual expansion of demand for the services of qualified professionals. In 2013 the entire volume of household services increased by 5.9%. The share of household services in the structure of the paid services market sector was about 10%. The most succinct sectors were those for two types of service: the maintenance and repair of vehicles, machinery and equipment; and for the repairs and construction of housing and other buildings, amounting to 60.8% of the total volume.



Source: Federal State Statistics Service.

Fig. 8. Volumes and dynamics of loans to the public; and of deposits in 2008–2013, as % of the relevant quarter of the previous year

Demand from the public was supported by the growth of consumer and mortgage lending. Slight weakening in the growth of household deposits was observed only in the acute phase of the crisis. The peak of population credit activity fell towards Q4 of 2009; followed by rapid increase until Q2 of 2012 with a gradual slowdown in growth in subsequent periods. Despite the decreasing lending activity, the nature of income use in 2013 was affected by problems with loan repayments, resulting in a slowdown in savings and in expenditure for current consumption.

The structure of GDP use was determined by the changing proportions between final consumption and gross savings. Comparative analysis of the GDP dynamics by end-use components illustrates the decline in the share of gross savings and net exports. Influenced by a sharp drop in the share of gross income in the economy, in 2013, the share of gross savings in the GDP dropped to 28.4%, against 32.6% in 2011, while the share of fixed asset investments remained at the average of the period 2010-2013 and amounted to 19.8% of GDP.

The capital account balance of payments illustrates the asymmetry of saving resources and the use of savings for investment purposes. Characteristic of the Russian investment model are significant amounts of savings, where the problem is not in finding resources but in the efficient transformation of them into capital investments. Please, note that analysis of the capital transactions account shows that, over the last decade, the Russian economy is a net creditor. In 2013, net capital outflows amounted to \$62.7bn and \$8.1bn.

Table 4

Key indicators of the investment potential in the period 2008–2013, as % of GDP

	2008	2009	2010	2011	2012	2013
GDP	100.0	100.0	100.0	100.0	100.0	100.0
Gross savings	33.3	24.6	29.8	32.6	30.5	28.4
Gross capital formation	25.5	18.9	22.6	25.1	24.6	23.2
Of which						
Gross formation of fixed capital	22.3	22.0	21.6	21.5	22.0	21.5
Changes in stock inventories	3.2	-3.1	1.0	3.7	2.6	1.8
Investments in fixed assets	21.3	20.6	19.8	19.4	20.3	19.8
Reserve fund	9.8	4.7	1.7	1.5	3	4.3
National Welfare Fund	6.3	7.1	5.8	5	4.3	4.3
Deposits by individuals	14.3	19.3	21.2	21.3	22.8	24.7

Source: Federal State Statistics Service.

4.1.3. Changes in structure of GDP by sources of income

The low competitiveness of the Russian economy is due to the persistence of high costs for the production of goods and services. Analysis of the goods and services account balance of payments shows that for the period of 2001-2011 the share of intermediate consumption averaged 41.8% of the gross economic resources, with limiting deviations from the mean, of +1.1% in 2009 and -1.8% in 2002. Thus, the share of value added at basic prices changed very insignificantly as was determined by the retention of a high material intensity of production. The structure of production costs and of services costs illustrates the increase in the share of material costs at the expense of raw materials and the fuel and energy component. Changes in final demand had a determining influence on the dynamics of the volume of gross output for all types of business activity. Changes in the structure of gross value added production for the whole period of 2009-2013 were determined by the decrease in the share of industry with an increase in the contribution of trade, construction, the financial sectors of the economy, and the real estate market. It should be noted that the post-crisis economic

developments in the implementation of anti-crisis measures to maintain social and strategic industries generally contributed to a mirroring of the proportions typical of 2007 which then became one of the factors slowing economic growth in 2011-2013.

Another factor determining the increase of production costs was the increasing cost of labour. The dynamics of the domestic market of 2009-2013 were based on a redistribution of income from business to the population. The share of wages in GDP in 2013 increased to 52.0% as against 50.5% in 2012. It should be noted that, after 2008, the manufacturing business sector already faced restrictions on the further increase in expenditure on wages as a result of the sharp slowdown in growth of production and productivity. Before the crisis of 2008 there had been the possibility for correcting the dynamics of wage costs due to changes in the price and tariff policy. However, in 2011-2013 the use of this factor was limited by the narrowing of effective demand in the domestic market.

Table 5

**Structure of GDP formation by income sources in 2007–2012, % of total,
at current prices**

	2007	2008	2009	2010	2011	2012	2013
Gross Domestic Product	100	100	100	100	100	100	100
Including:							
Compensation of employees, including hidden wages and mixed income	46.7	47.4	52.6	49.6	49.7	50.5	52.0
Net taxes on production and imports	19.2	20.0	16.6	17.8	19.5	19.9	19.2
Gross economy income and gross mixed income	34.1	32.6	30.8	32.6	30.8	29.6	28.8

Source: Federal State Statistics Service.

Opportunities for further growth in labour costs have become quite rigidly limited by changes in the competitive environment in the commodity markets due to increased pressure from imports and a decrease in the financial performance of businesses and organisations. In 2012-2013, profitability in the economy remained below pre-crisis levels. With an overall downward trend in domestic effective demand, restrained business pricing policies did not lead to an increase in output or an increase in production costs, due to the increased cost of fuel and electricity which provoked a decrease in the financial performance of their activities.

Moreover, the reduction in the financial performance of businesses and organisations in 2013 increased their current restrictions on financing and investment activities. Reduction in the net financial result of the economy led to a critical slowing in earnings growth at the disposal of enterprises, amounting to 4.7% in the first nine months of 2013 versus the 26.3% of a year earlier. Between January - September 2013, the net financial result for the whole economy grew by 83.3% from a year earlier: including in mining, by 96.9%; in manufacturing industries, by 68.3%; in the production and distribution of electricity, gas and water, by 74.5% and in transport, by 83.3%. In general, the economy return on items sold in January-November of 2013 amounted to 7.7% and was 2.3 percentage points lower than the previous year. The deterioration in financial performance relative to the previous year can be explained by cost inflation. In manufacturing activity during January-September of 2013, the proportion of loss-making enterprises increased to 29.7%, which was 2.3 percentage points greater than the previous year. The most significant influences were the fall in the net financial result, lower profitability in the engineering industry and in the production of construction materials due to reduced demand from the construction industry. In January-September 2013 the producer price index in the manufacturing sector amounted to 103.1% (104.2% in the

previous year), with the rate of price growth in the mining sector at a level of 11.9% (24.4%); in the production and distribution of electricity, gas and water it was 9.8% (7.2%).

In the production of fuel and energy minerals a decrease in profitability was amplified due to the shift of production to regions with more complex and costly conditions for fossil fuel extraction.

Table 6

**Return on sold goods, products and services; and return on assets of businesses
by type of economic activity for January-September 2012–2013, in %**

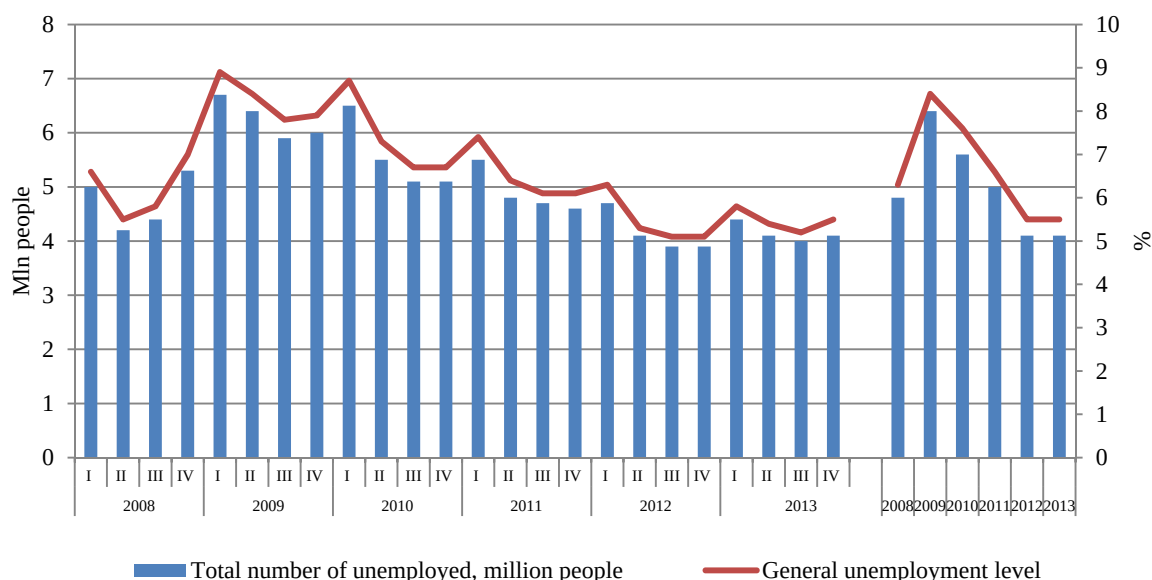
	Profitability of			
	Sold goods, products and services		Assets	
	2012	2013	2012	2013
Total	9,7	7,7	6,8	5,0
Including:				
Agriculture	11,7	6,3	4,8	2,5
Fishing, fish farming	21,4	21,5	18,7	15,1
Mining operations	31,0	25,1	15,3	12,7
Including:				
Production of fuel and energy resources	28,8	24,1	15,2	13,1
Manufacturing	11,0	9,5	8,1	4,9
Of which:				
Food production	11,1	10,1	6,8	6,1
Textile and clothing industry	12,3	7,1	5,0	3,5
Production of leather, leather goods and footwear	8,1	6,2	3,9	1,8
Wood processing and production	5,3	8,1	2,1	1,8
Pulp and paper production;	10,5	9,0	6,7	3,7
Production of coke and refined petroleum	11,3	9,6	12,7	6,0
Chemical production	22,9	16,7	15,8	7,5
Manufacture of rubber and plastic products	9,1	8,7	8,3	6,0
Non-metallic mineral products	12,4	9,8	6,5	3,6
Metallurgical production and manufacture of finished metal products	11,8	9,9	7,8	4,9
Machinery and equipment	7,7	7,5	4,5	3,5
Manufacture of electrical, electronic and optical equipment	8,1	8,9	6,0	5,6
Transport vehicles and equipment	6,0	5,8	2,7	2,3
Production and distribution of electricity, gas and water	4,7	4,7	2,1	1,3
Construction	3,8	3,5	1,7	1
Wholesale and retail trade	8,2	7,1	7,9	7,2
Hotels and restaurants	8,4	6,7	5,6	4,2
Transport and communication	12,2	9,9	5,7	4,1
Of which:				
Railway transport activity	3,5	1,4	2,7	0,7
Road-transport activity	–0,8	–4,7	1,7	0,2
Transport via pipelines	14,9	13,3	6,6	5,7
Communications	26,7	26,0	8,3	8,4

Source: Federal State Statistics Service.

Low efficiency in the use of production factors is one of the main reasons for the sharp slowdown in economic growth and the reduction in the competitiveness of the Russian economy. In the short-term, changes in economy income and in inflation will be completely determined by the dynamics of growth in labour productivity and by the efficiency of investments. Given the dynamics of the fixed capital investments, demographic factors, labour efficiency, and fixed asset, energy output ratio, the growth potential of the Russian economy is between 1.5 - 2.0%. The problem of limited growth potential can be solved by the active implementation of structural reforms.

4.1.4. Key trends and changes in the efficiency of use of labour resources

For the last fifteen years the average annual numbers of employees has grown weakly to maintain a reasonably stable trend towards a higher level of economic activity within the population, and a reduction in the total of the registered unemployed. The crisis of 2008-2009 had no negative impact on the labour market as a result of the implementation of a set of measures to maintain the standard of living and to help the employment figures. The anti-crisis measures adopted helped to avoid negative trends in the labour market. Although the unemployment rate rose to 8.3% in 2009, in 2010 there was, however, a recorded steady decline in the number of unemployed. The number of the economically active and of employed members of the population in 2013 averaged 75.5 million and 71.4 million respectively, which corresponds broadly to the parameters of 2012. The unemployment rate for 2012-2013 remained at 5.5% (using ILO methodology); although in the second half of 2013 the decline in unemployment halted. In 2013 the average number of people employed in the economy had recovered almost to the pre-crisis level of 2008, while the overall unemployment rate fell to a historic low for the entire observation period since 1990.



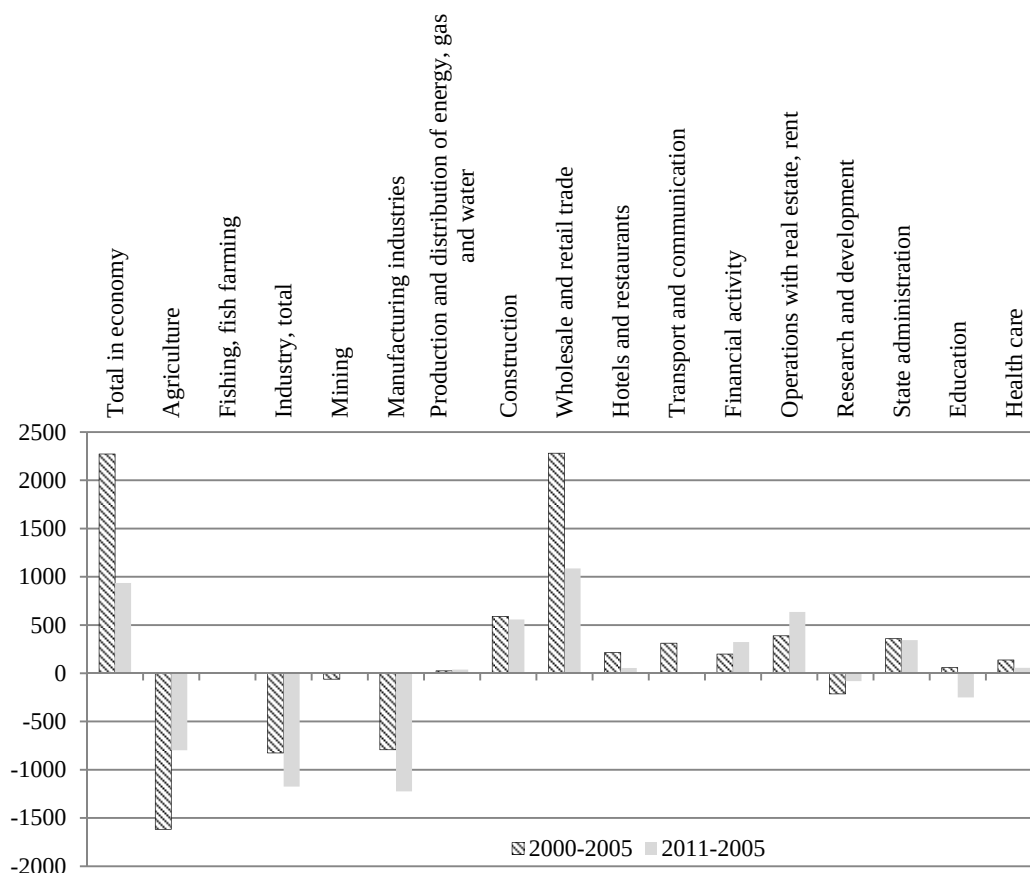
Source: Federal State Statistics Service.

Fig. 9. Total number of unemployed in 2008–2013, million people

On average, in 2013, employment offices reported 15% fewer unemployed people than in 2012. Throughout 2013 the number of vacancies listed by employment offices exceeded the number of registered unemployed. However, employers' requirements for workers had started to decline in June 2013. At the end of December 2013, the data bank of the employment services indicated that there were 1.4 million job vacancies. The tension coefficient, based on 100 reported vacancies, decreased from 91.3 persons in late December 2012 to 56.5 persons in June 2013 and rose to 76.1 persons at the end of December 2013.

A characteristic feature of the Russian economy at the moment is a further reduction in the average number of employees in industry and agriculture, with an expansion in demand for workers in trade, construction, finance, and public administration. Alarmingly there is also a

reduction in the numbers employed in science and education, as well as weak demand for health care staff.



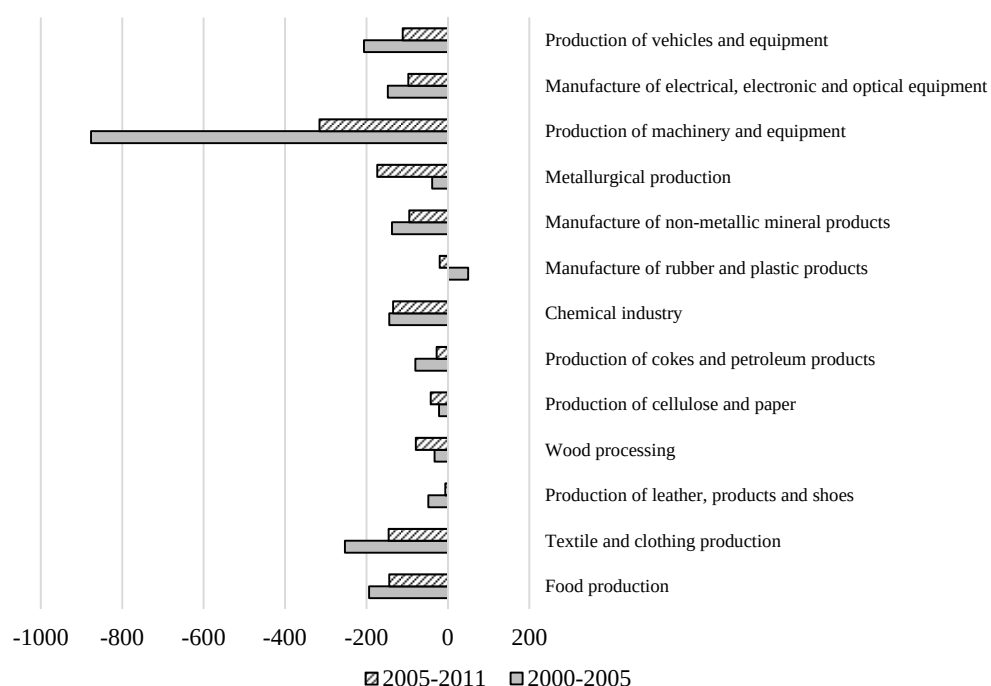
Source: Federal State Statistics Service.

Fig. 10. Change in employment by type of economic activity in the periods 2000–2005 and 2005–2011, (thousands of employees)

The number employed in industry has declined the most rapidly, especially in manufacturing industry. The structure of employment in the manufacturing industries has been determined by the dynamic reduction of employment in the engineering and consumer sectors.

It should be noted that the high level of differentiation of wages by type of economic activity had a significant effect on the change in employment by type of economic activity.

Wages in manufacturing industry remain below the average for the economy with the most significant gap in the consumer complex sector. In 2012, only the wage levels in the machine-building complex approached the economy average and exceeded the general wage-level in manufacturing industry. For the past fifteen years the leading wages in the economy have been for the extractive industries, the production of petroleum products, and the financial sector. In recent years, a reduction in the wage gap in the R&D sector has been recorded. In education and health care the level of pay is below average for the economy. In 2011-2013, with the increase in the level of public sector wages, this sector saw an increased inflow of staff.



Source: Federal State Statistics Service.

Fig. 11. Change in employment numbers in the manufacturing industries in 2000–2005 and 2005–2011, (thousands of employees)

Since 2003, a weakening trend in the growth of labour productivity has been reported with a reduction of return on investment in fixed capital and fixed assets.

Table 7

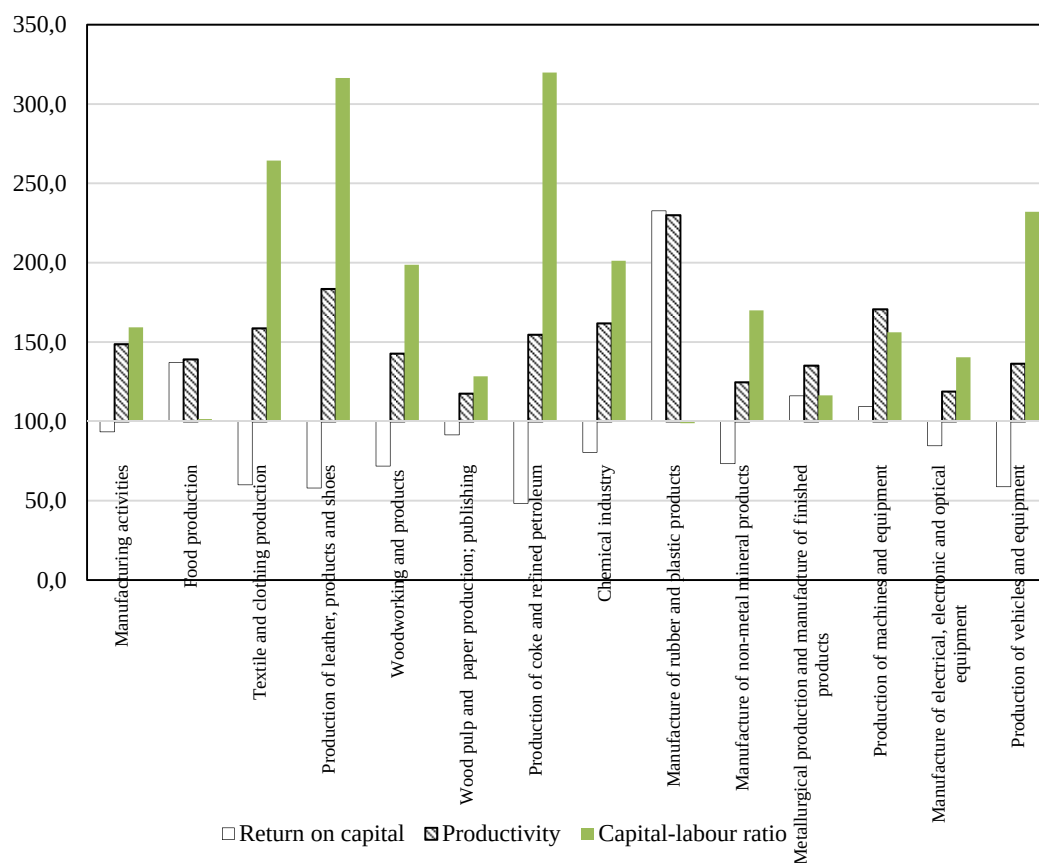
Dynamics of growth in labour productivity by type of business activity in 2003–2012, as % of the previous year

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013*
Economy in general	107.0	106.5	105.5	107.5	107.5	104.8	95.9	103.2	103.8	103.1	101.0
Of which:											
Agriculture, hunting and forestry	105.6	102.9	101.8	104.3	105.0	110.0	104.6	88.3	115.1	98.1	104.2
Fishing, and fish farming	102.1	104.3	96.5	101.6	103.2	95.4	106.3	97.0	103.5	103.1	105.0
Manufacturing	108.8	109.8	106.0	108.5	108.4	102.6	95.9	105.2	104.7	103.6	101.7
Production and distribution of electricity, gas and water	103.7	100.7	103.7	101.9	97.5	102.1	96.3	103.0	100.3	99.7	98.0
Construction	105.3	106.8	105.9	115.8	112.8	109.1	94.4	99.6	102.2	99.6	94.8
Wholesale and retail trade	109.8	110.5	105.1	110.8	104.8	108.1	99.0	103.6	102.1	105.2	102.4
Hotels and Restaurants	100.3	103.1	108.5	109.2	108.0	109.2	86.7	101.7	99.5	101.8	100.0
Transport and communication	107.5	108.7	102.1	110.7	107.5	106.4	95.4	103.2	105.5	100.8	98.1
Real estate, renting and service activities	102.5	101.3	112.4	106.2	117.1	107.5	97.5	104.0	102.7	101.7	95.3
For reference: Dynamics of return on investments in fixed assets	95.4	94.3	95.9	92.7	88.5	95.8	109.3	98.6	96.4	97.07	98.4

*Preliminary evaluation.

Source: Federal State Statistics Service.

Labour productivity is quite significantly differentiated by economic activity. With high rates of workforce turnover (hiring and firing) jobs turnover (elimination of old jobs and the creation of new) characterising their update remains rather low. This turnover is supported predominantly by the closing of jobs at existing enterprises rather than job creation.



Source: Federal State Statistics Service.

Fig. 12. Labor productivity and return on capital in manufacturing industries in 2012, as % compared to 2005

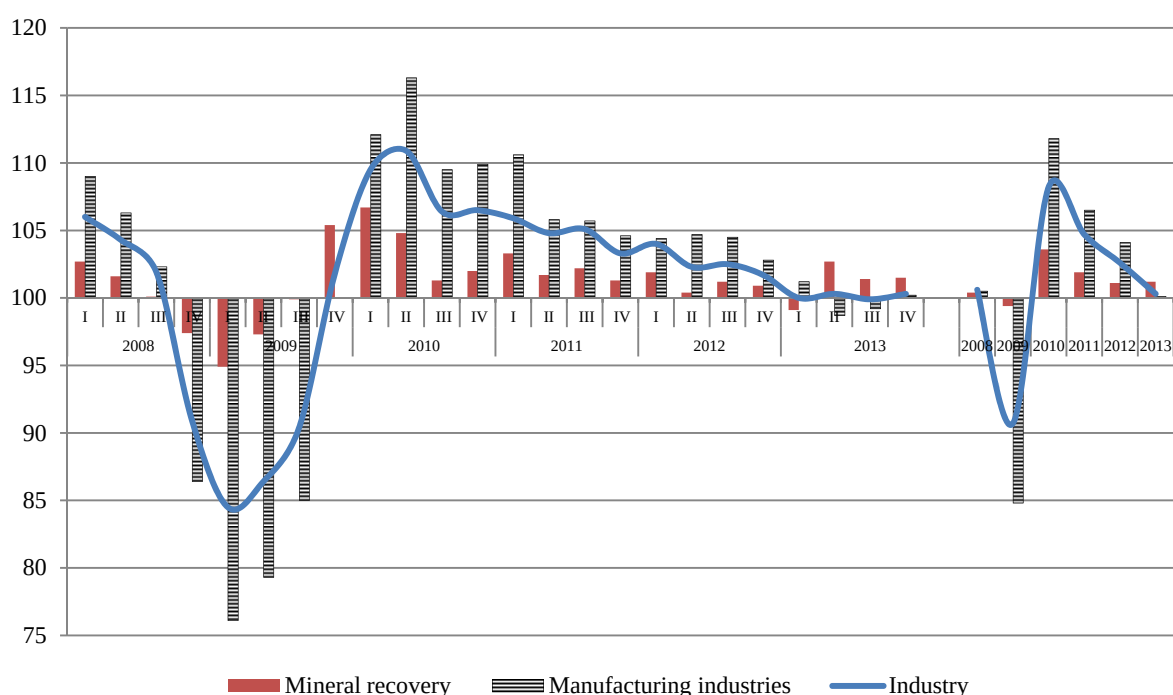
Higher-than-anticipated growth of investment in fixed assets compared with the dynamics of entire output during the period of 2005-2012 and an increase in capital costs per unit of labour did not lead to a corresponding change in labour productivity and, ultimately, increased the tendency to lower the output per unit of capital. Thus, we can assume that irrational investment policy led to a decrease in production efficiency factors and had a negative impact on financial performance.

4.1.5. Dynamics and structure of production by type of economic activity

When analysing the trends and factors in industrial post-crisis recovery several stages can be highlighted:

- Restoration of the positive dynamics of industrial growth in Q1 and Q2 of 2010 versus the corresponding period of the previous year, in the light of a dynamic growth of manufacturing activities until March 2011;

- Weakening of the dynamics of industrial development in the second half of 2010 with a sharp slowdown in mining;
- A slowdown in manufacturing production from Q2 of 2011 until Q4 of 2012;
- Stagnation of industrial production in Q1 of 2013 under the influence of the reduction of mining and slight growth of manufacturing;
- Decline in manufacturing volumes in Q2-Q3 of 2013 and in the production and distribution of electricity, gas and water relative to the same period of the previous year, compensated by positive dynamics in the mining sector;
- Stabilisation of manufacturing activity in Q4 of 2013 with amplification of the downturn in the production and distribution of electricity, gas and water relative to the corresponding period of the previous year.



Source: Federal State Statistics Service.

Fig. 13. Dynamics of industry in 2008–2013, as % of the corresponding period of the previous year

The Russian industry crisis of 2008-2009 was characterised by a deep recession in the manufacturing sector with relatively restrained cuts in the production of fuel and energy mineral extraction. If the slowdown in extractive industries under conditions of the crisis of 2008-2009 can be explained by short-term factors within the international raw materials markets, the sluggish dynamics of domestic production for domestic consumption and the growth of imports can be linked to domestic problems. The nature of the manifestation of the crisis by type of economic activity indicates a lack of domestic business restructuring aimed at creating new competitive markets for domestic products. Once the protection of the domestic markets associated with the undervalued exchange rate began to weaken, it became clear that no positive changes in the competitive environment had occurred. The Russian

economy resumed the proportions of production and imports typical of the period before the financial crisis of 2008-2009.

Furthermore, in 2009-2013 we can observe increasing gaps in the growth of industrial product prices by type of economic activity, as well as in the prices and tariffs for products from the natural monopolies.

The industry output to growth pattern in 2010-2011 was accompanied by an increase in the impact of the extractive industries with only restrained development of the manufacturing industries. It should be noted, that overcoming the crisis was determined by factors within the external economic environment which resulted in advancing growth of the extractive industries compared with manufacturing.

In general, the structure of industrial recovery in 2009-2012 showed a recurrence of patterns from the post-crisis development of 1998-2000, when growth began in the manufacture of food products, mining, and the manufacturing industries associated with the processing of hydrocarbons and other mineral resources, and then spread to other industrial economic activities.

Having achieved pre-crisis levels, starting from the second half of 2012 the Russian economy began to show signs of slowing growth. This situation was greatly influenced by the inherent limitations associated with the fact that the structure of the economy had not change significantly, and that the potential impact of the factors contributing to growth proved to be virtually exhausted. Starting with Q2 of 2013 a drop in output volumes was recorded for the manufacturing industries.

The dynamics of the manufacturing industries are quite significantly differentiated by type of economic activity, with the greatest effect shown by the ratio of rates of production of capital and consumer goods. Slow recovery in investment demand determined the features seen in the operation of the engineering complex.

Table 8

**Indices of production for the main types of manufacturing industries
in 2008–2013, as % of the previous year**

	2008	2009	2010	2011	2012	2013
Manufacturing industries,	100.5	84.8	111.8	106.5	104.1	100.1
Including:						
Production of foods, including beverages and tobacco	101.9	99.4	105.4	101	105.1	102.3
Textile and clothing industry	94.6	83.8	112.1	102.6	98	104.9
Production of leather, leather products and footwear	99.7	99.9	118.7	108.6	89.9	94.7
Processing of wood and of manufacture of wood products	99.9	79.3	111.4	104	103.3	101.4
Pulp and paper industry; publishing and printing	100.3	85.7	105.9	101.8	102.1	94.8
Production of coke and refined petroleum	102.8	99.4	105	102.9	102.2	102.0
Chemical production	95.4	93.1	114.6	105.2	101.3	104.9
Manufacture of rubber and plastic products	122.8	87.4	121.5	113.1	107.4	105.2
Non-metallic mineral products	97.1	72.5	110.7	109.3	105.6	100.3
Metallurgical production and manufacture of finished metal products	97.8	85.3	112.4	102.9	104.5	97.7
Engineering industries	98	66.2	122.3	114.5	107.5	96.8
Machinery and equipment	99.5	68.5	112.2	109.5	100.4	92.4
Manufacture of electrical, electronic and optical equipment	92.6	67.8	122.8	105.1	104.3	97.2
Transport vehicles and equipment	100.4	62.8	132.2	124.6	112.7	100.9
Other industries	98.3	79.3	117.7	104.5	99.1	95.8

Source: Federal State Statistics Service.

In the acute phase of the crisis in 2009, production volumes in the engineering complex amounted to 2/3 of the 2008 level. The features of the post-crisis recovery of the engineering

industry were determined by forward growth in the manufacture of vehicles and equipment as a result of state support and stimulation of demand. Despite the dynamic development of vehicle manufacturing the engineering industry, in general, did not reach the pre-crisis level and in 2012 it was 97.7% against the index of 2008.

For the past five years the dynamics of production engineering has been highly volatile. If, in 2010, the highest growth rates for these activities were determined by the low base of the previous year, then the braking dynamics in 2011-2013 were due to the weakening of domestic demand for capital goods. In 2013, the complex of engineering industries illustrated exceptionally low rates throughout the year; and as a result, recorded a decline in output by 3.2% compared with the previous year. By the end of 2013 the production of machinery and equipment amounted to 92.4% of the previous year's indicator while the production of electrical, electronic and optical equipment was 97.2% and production of vehicles was at 100.9%.

Low investment activity determined the instability in dynamics and the on-going crisis in steel manufacturing and the manufacture of finished metal products (97.7% compared with 2012), as well as in the production of construction materials (100.3%). In addition, a significant impact on the dynamics of output had reduced the demand and prices for key products in non-ferrous metallurgy.

Compared with the pre-crisis period, in 2009-2013 for the consumer complex of manufacturing industries, there were faster growth rates in food production and the production of leather, leather goods and footwear, however in textile and clothing production the crisis remained. In the last four years of the production of consumer goods, stable positive dynamics have been recorded only in the food industry.

In the period 2010-2013, there was steady growth in the intermediate goods sector in the production of rubber and plastic products, chemical production and the production of coke and refined petroleum due to a simultaneous increase in demand in both the domestic and foreign markets for the products of this industry sector.

In general, the Russian economy, in 2013, has overcome the consequences of the crisis; however, the unstable dynamics of the main macroeconomic indicators and the slow recovery of the construction and investment sectors have become the factors limiting the development of the Russian economy in the short term. The dependence on global prices for commodity exports, low domestic demand and the sluggish development of domestic manufacturers in promising consumer markets, investment and in intermediate goods, together with a weak financial system have continued to be the dominating factors.

4.2. Russian industrial enterprises in 2013

The section is prepared using data of monthly business surveys conducted by the Gaidar Institute for Economic Policy (IEP) among managers of industrial enterprises since September 1992. The surveys are based on the European harmonized methodology and encompass the entire territory of the Russian Federation. The size of the panel is about 1000 enterprises that employ over 13% of the total number of employed in industry. The panel is biased towards large enterprises in each of the selected branches. The rate of response to questionnaires ranges from 70% to 75%.

The business survey questionnaire contains quite a small number of questions (not more than 15-20). They are of qualitative rather than quantitative nature. The simple formulation of questions and answers allows the respondents to fill in the forms quickly and without consulting any documentation. It's essential that the respondent at each enterprise is an

executive of the highest level possible who is fully aware of the situation at the enterprise and is directly involved in its management.

When analyzing the results of business surveys a specific derivative indicator is used which is termed “balance”. The balance is calculated as the difference between the percentage of respondents who answered “will grow” (or “above normal”) and the percentage of respondents who answered “will decrease” (or “below normal”). The resulting difference allows to present the distribution of answers to each question by one figure with “+” or “-” sign.

The balance is interpreted as the first derivative or the rate of the process. If the balance of responses to the question about expected change in prices has the “+” sign, it means that in the near future average prices will grow (e.g. the prevailing number of enterprises reported their intention to raise prices). For instance, the increase of balance from +10% to +17% over a month implies that average prices in industry will grow at a higher rate as the prevalence of enterprises anticipating their growth became more convincing. A negative balance is the sign of future reduction of average prices (more enterprises intend to cut their prices). The changing of the balance from -5% to -12% is interpreted as greater intensity (rate) of price decline.

4.2.1. Russian industry: from stagnation to ...?

The official statistical data on the performance of Russian industry in 2013 has been a matter of heated debates about the current situation in and development prospects of this sector of economy. The key point at issue is whether Russian industry is still experiencing stagnation (the fact of which is by now admitted by most experts and officials) or has proceeded into the recession phase. Therefore the IEP’s Industrial Optimism Index (IEP IOI)¹ introduced in 2008 as an indicator of operational monitoring continues to preserve its relevance in the current situation of lingering stagnation in Russian industry and ambiguity of official statistics. It’s the latter circumstance that has revived interest in this aggregate indicator basing upon a representative set of initial indices (estimates of the actual dynamics of demand, finished goods stocks, current sales and output projections of enterprises). It helps to assess the performance and prospects of Russian industry the way enterprise managers see them. The constantly being improved system of IEP’s business survey indicators provides an opportunity to understand what is actually constraining the growth of output and investments at this particular moment rather than in the previous years.

IEP IOI shows that enterprises’ assessments of the last 6 months of 2013 were better than those of the start of the year (*Fig. 14*). The index basically managed to remain in the positive area albeit with a minimal surplus over the zero level. The key positive drivers of situation at enterprises (but not in ministries!) were output projections (after the adjustment for seasonality their values remained positive and at the end of the year were even growing),

¹ The index is calculated as the simple average of balances - differences in responses to four questions from the IEP’s business questionnaire:

1. Actual change of demand, balance = % growth – % decrease;
2. Assessment of demand, balance = % above normal + % normal – % below normal;
3. Assessment of finished goods stocks, balance = % above normal – % below normal;
4. Output projections, balance = % growth – % decrease.

Balances of responses to the 1st and the 4th questions are adjusted for the seasonal and calendar factors.

The index can range from -100 to +100. A positive value of the index implies the prevalence of positive estimates. A negative value of the index means that negative estimates prevail. Lowering of the index value is the sign of deteriorating situation while its growth – the sign of ameliorating situation.

estimates of finished goods stocks (this indicator displayed minimal surplus after surging in June) and the actual change of demand (despite the revealed decrease of sales, the latter was smoother and less intense than in 2012 and early 2013).

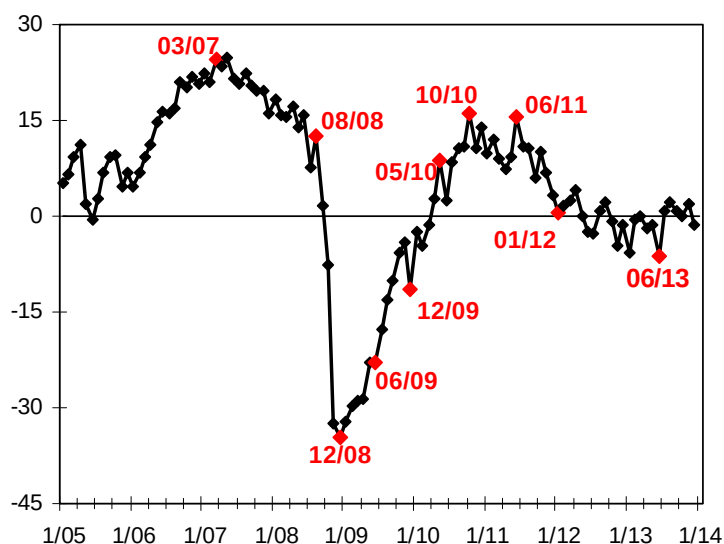


Fig. 14. IEP's Industrial Optimism Index, 2005-2013

But in general the surveyed enterprises found that the situation in 2013 was worse than in 2010-2012. The maximum post-crisis value of IEP IOI annual average was recorded in 2011 when it reached 9.25 points. Then the indicator fell to zero in 2012 and down to -0.97 points in 2013. So, the basic decline of optimism in Russian industry took place in 2012 and more exactly – in its first half. Last year the changes in situation were minimal (according to business estimates) the only noteworthy development being the official admission of the fact of stagnation: first it was attributed to “our partners in the West”, then its domestic origin was also mentioned and official forecasts repeatedly experienced downward corrections. Against this background the projections of enterprises as to the demand, output and employment in early 2014 looked more “patriotic”. The highest optimism continued to be observed in business assessments of the expected growth of output; in November-December the trend was supported by improving projections for the number of employed. The balance of demand projections remained positive but regrettably was not as high and sustainable as that for the projected output.

The start of 2013 was traditional. The actual dynamics of demand for industrial output suffered a traditional sharp drop observed in recent years. Meantime, demand projections (that soared in January similarly following the tradition) showed that industry still cherished hopes for the revival of sales. Output projections also demonstrated high optimism of business expectations the feasibility of which still seemed questionable to enterprises themselves. Doubts of producers about the possibility of demand and output growth were reflected in their estimates of finished goods stocks: the balance of this indicator showed an increase of stocks' surplus up to the 40-month maximum.

The investment outcomes of 2012 and the initial plans for 2013 did not promise the desired growth of investments in production. 56% of enterprises were in general satisfied with their total amount in 2012. It was the best result for the whole 18-year (!) period of monitoring. It looked quite logical taking into account another IEP's survey indicator – the estimate of

“sufficiency/surplus” of investments relative to the expected growth of demand for output. 63% of enterprises estimated the past year investments as “sufficient” (taking into account realistic rather than official forecasts). The latter percentage has also become a record (an absolute maximum) of the multi-year monitoring. Respectively, the share of “non-sufficient” responses fell down to an absolute minimum.

Upon completion of January that was difficult for the economy and statistical recording, the surveys registered a clear growth of sales and output that still failed to reduce high surplus of finished goods stocks and to prevent the decrease of optimism in demand, output and employment projections. Price policies of enterprises were usual for the first months of the year: the most intense rise of prices in January and its slowdown in February. However, price projections of industry were more moderate as compared with the respective months of previous years.

In March the system of indicators of IEP’s business surveys reflected the worsening of situation in Russian industry. Enterprises started to loose confidence in the correctness of their production and marketing policies and attempted to more accurately coordinate their output with the dynamics of demand. The demand for industrial products failed to uphold the high results of February and demonstrated the lowering of growth rates as judged from both the initial data and the data adjusted for seasonality (*Fig. 15*). In March the survey data on the dynamics of output showed that production growth slowed down to zero. The growth of factory prices actually stopped with its rate falling by 10 points.

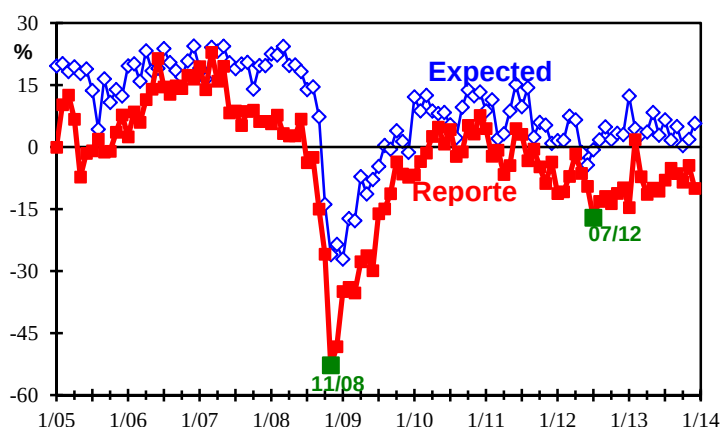


Fig. 15. Change of solvent demand adjusted for seasonality
(balance = % growth - % decrease)

In general the first quarter of 2013 displayed such a high level of correspondence between changes in output and demand that had never been observed in Russian industry either after the IV quarter of 2008 or before that crisis period. However, this correspondence between changes in output and demand was largely attributable to “no change” responses the coincidence of which in the I quarter of 2013 reached almost a historical maximum. Another indicator of the examined quarter also looked abnormal. The share of enterprises where the actual change of output went ahead of the change of demand for their produce fell to the minimum level since 1995 (i.e. to actually the historical bottom). The percentage of such producers in Russian industry became as low as 18% while at the end of 2008 – the beginning of 2009 it reached 20% and 25%, respectively. In other words, in 2013 Russian industry was forced to follow trends in demand for its output almost as strictly as in the crisis period and to

minimize the freedom of action despite the wish to be ahead of demand and produce to stock in the hope that in the following months the demand would grow and enable them to sell the accumulated stocks.

Smaller demand in April increased the share of surplus stocks of finished goods, slowed down production and made enterprises refrain from raising prices both in the current and the following months. In these conditions output projections started to lose optimism after the traditional maximum at the beginning of the year. In 2013 their coincidence with demand projections increased and reached 78% (in the previous year it equaled 69%). Such a high result is not a frequent event for surveys (usually it's registered in the critical periods for Russian industry) – a greater coincidence of output and demand projections was observed only in November–December 2008. So, in the I quarter of 2013 Russian industry was certainly in a difficult situation but planned to mitigate the severity of a possible crisis by at least minimizing the surplus of finished goods stocks.

“Insufficient demand” remained the basic impediment to the growth of output in Russian industry (*Fig. 16*). In the II quarter of 2013 60% of enterprises pointed to its hindering effect. At the peak of the recent crisis (I quarter 2009) demand held back production at 69% of enterprises; the 1998 maximum was 66% and an absolute record over the 20-year period of monitoring was registered in the II quarter of 1994 and amounted to 84%. From the start of 2011 the negative impact of demand on industrial production was gradually increasing. At the end of 2008 the situation developed in quite a different way: then demand grew by 37 points over three quarters. The catastrophic circumstances of 2008 precluded the government from taking preventive measures in order to encourage demand for the domestic produce. In 2012–2013 the situation was different: both demand and output underwent small but clearly negative changes. Potentially this gives the government enough time not only for the working out and implementation of anti-crisis measures but also for the analysis of their impact. So far, the efficiency of these measures can be assessed from the fact that no catastrophic developments under the 2008 scenario have taken place in Russian industry. But the lack of reversal in economic trends, the shifting of blame to “our partners in the West” and the demand that the RF Central Bank should engage in combating the imminent crisis evidences that the set of habitual anti-crisis measures fails to ensure the desired effect and is close to exhaustion while new ideas are formulated and implemented with difficulty.

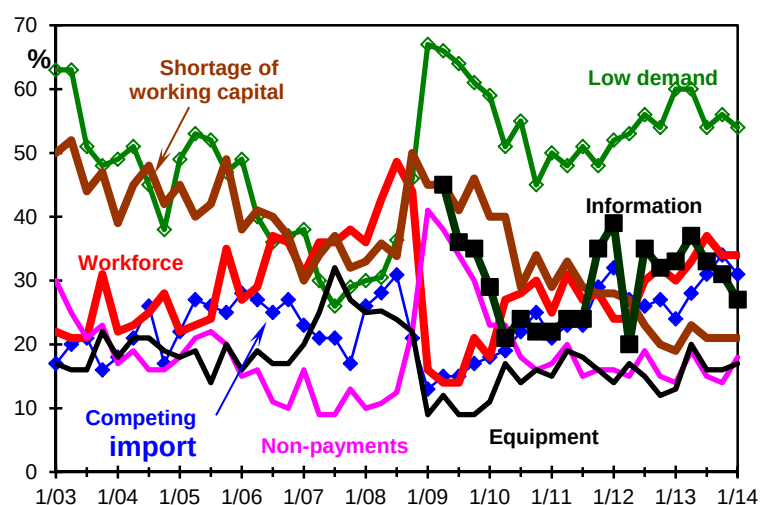


Fig. 16. Impediments to industrial growth, 2003–2013

The latter thesis is directly supported by the upsurge in mentioning the factor of “uncertainty of the current economic situation and its further development” by enterprises. In April 2013 its hindering effect grew up to 37% and had a purely economic background as different from the upsurge in late 2011 – early 2012 when it was triggered by pre-election – election – post-election campaign. As a result this factor has reinforced its second position in the rating of impediments to industrial growth (as assessed by business).

The third and the fourth positions (mentioning in 33% and 28% of responses, respectively) are occupied by the “shortage of skilled labour” and “competing import”. While the former of the above factors has been long and continuously (for the fourth quarter in turn with the same result) hindering growth in Russian industry (but is far from its historical maximum), the latter increased by 4 points over the quarter and approached its absolute maximum. As a result business and authorities seem to have got one more headache. Meantime, positive emotions due to low unemployment even in the situation of stagnation are leveled down by mass workforce problems in industry that will inevitably aggravate in case even a slow economic growth begins.

Next positions in the rating of Russian industry’s problems belong to “low export demand” (22%, the lowering by 9 points over the quarter, the best result over 6 quarters), “shortage of working capital” (23%, almost an absolute minimum) and “shortage of equipment” (20%, an increase by 7 points over the quarter, the worst result from the start of 2008 crisis).

The rating of impediments to industrial growth (let’s point out – as assessed by enterprises) ends with “problems associated with crediting industry”. For already 9 (!) quarters in turn it has been considered a hindrance to production by only 3-4% of enterprises. The interest rate on credits (one of the components of their availability) is mentioned as a hindrance by 7% of respondents.

The drop of sales and growth of finished goods’ surplus stocks that continued in May forced enterprises to further hold back production, lower prices, cut personnel and be very cautious in their investment plans. Meantime, price policies of enterprises demonstrated industry’s attempts to revive sluggish demand for its output.

The growth of output that was registered by surveys in June became a problem for Russian industry in the situation of contracting demand. It resulted in a sharp increase of dissatisfaction with sales and further building of surplus stocks of finished goods (*Fig. 17*), made enterprises revise downwards their demand projections and output and employment plans for July-August.

In July the continuing drop of demand, mass use of price factor for supporting sales, plans for curtailing investments and ongoing dismissals of workers combined with minimal growth of output, sharp positive adjustment of finished goods stocks assessments and strengthening optimism of output projections. Indeed, judging by August data these projections came true supported by positive dynamics of demand and the consequent growth of prices. However, enterprises were not sure of the preservation of these trends in the following months and didn’t plan to increase investments.

The changes of demand and output in September discouraged enterprises, pulled down the indicators of demand sufficiency and increased the surplus of finished goods stocks. At the same time industry continued to raise prices which hardly encouraged demand. The ongoing outflow of workers from enterprises resulted in the deficit of personnel even in the conditions of stagnation.

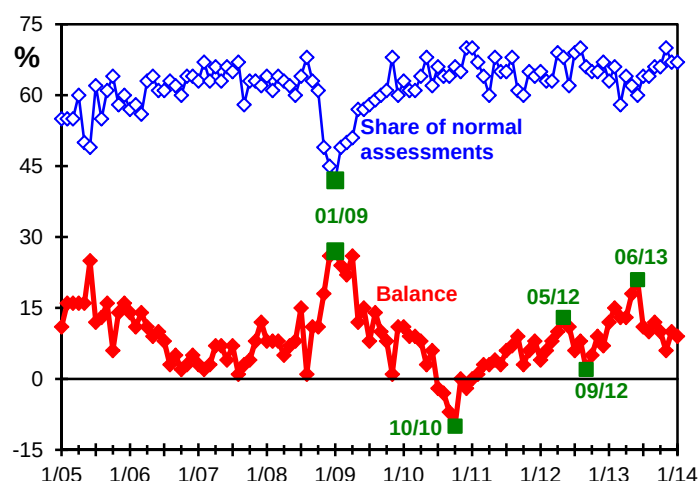


Fig. 17. Assessment of finished goods stocks
(balance = % above normal – % below normal)

October failed to improve trends in either demand or output in Russian industry. This further stirred dissatisfaction with the current volumes of sales and made business refrain from raising prices in the hope to revive sales. The continuing drain of labour from enterprises, the worsening projections for the number of employed and steadily negative investment plans completed the gloomy picture of the start of IV quarter 2013.

According to the survey data in November Russian industry probably attempted to break away from stagnation. However, the acceleration of production growth and the rising optimism of output projections were then supported only by assessments of finished goods stocks. Meantime the dynamics of demand for the industrial produce didn't demonstrate any principal improvements relative to October (as judged from both initial and seasonality-adjusted data).

At the end of 2013 the demand for industrial products underwent dramatic negative changes. The initial data displayed the highest rate of December sales drop over the 5 recent years. After the adjustment for seasonality, the December rate of demand decrease was one of the worst over the last 18 months. However, such dynamics of sales is becoming habitual for the Russian industry. On the contrary, demand projections demonstrated unusual growth by the end of the year. In the previous post-crisis years the balance of December sales projections either continued falling or remained at the worst level registered in November.

In December the industry resolved to scale down factory prices after their growth in August-September and stabilization in October-November. But the rate of this reduction (-5 points) was the lowest as compared with the respective months of 2011-2012. The December balance was also below that of June 2013 when prices fell at the rate of -9 points. Such a "weak" indicator of enterprises' price policies at the end of the year was most likely attributable to the intensive growth of costs that was observed in the same period.

The terms of crediting Russian industry in the IV quarter of 2013 remained stable and were considered acceptable by 72% of enterprises. The value of this indicator (assessment of credit availability) established back in the middle of 2010 and with minimal fluctuations both up and down rests at this level for already 3.5 years coinciding with the respective assessments of the first half of 2008 (Fig. 18).

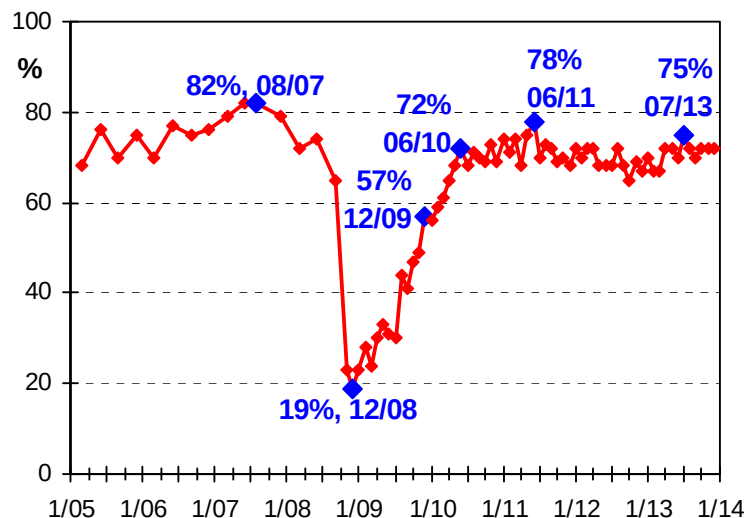


Fig. 18. Share of enterprises assessing credit availability as “above normal” + “normal”

The average minimal interest rate on credits in rubles fell from 13.0% per annum in the I quarter to 12.5% in the IV quarter of 2013. The reduction was observed in all branches but the banking system’s priorities didn’t change. The lowest rates were available for metallurgy and chemical industry, in the second echelon followed machine building and food industry while construction materials and consumer goods industries could borrow only at maximum rates. The quite logical dependence of interest rate on factory size preserved: while credits to enterprises with over 1000 employees were offered at 10.5% per annum, for small- and medium-size businesses the rate was as large as 14.3%.

However, one fourth of Russian industrial enterprises do not use credits preferring to live on their own funds. Last year this indicator was record for the three post-crisis years when enterprises were asked this question. In 2009 18% of them reported having no credits, in 2012 – 23%, in 2013 – 24%. The main direction of credit utilization was the replenishment of working capital as followed from responses of over one half of enterprises in 2012-2013 and 68% of them in 2009. Before the crisis of late 2008 62-70% of industrial enterprises borrowed funds for these purposes. The data was supported by monitoring of impediments to output growth: in 2013 the hindering effect of shortage of working capital fell to the historical minimum (21%). The second most important field of credit utilization was the expansion of production. In the two recent years slightly over one third of enterprises (35%) took credits for these purposes. Earlier this indicator was as high as 46% in 2008 and amounted to 36% in 2005-2007. 23% of enterprises borrowed money for re-equipping production facilities in 2013.

The lack of positive trends in indicators of Russian industry’s performance and a clear growth of pessimism in declarations and forecasts of authorities made us resume at the end of 2013 the monitoring of business assessments as regards the probability of the second wave of the crisis in the sector. In November 31% of enterprises thought that this probability “grew” while 32% found that it “didn’t change”. In January 2013 the proportion between these responses was principally different: 12% – “grew”, 42% – “didn’t change”. So, over the past year the probability of a new crisis (as assessed by top managers of industrial enterprises) increased by 20 points. At the same time the share of “no answer” responses (i.e. the share of

respondents finding it difficult to estimate the dynamics of pre-crisis developments) fell from 43% to 35%. On the one hand, it spoke of the growing concern of industrial enterprises about this problem while on the other hand it showed that one third of them continued to feel “uncertainty about the current economic situation and its further development”. The latter quote is an exact option of response to the question about impediments to industrial growth. In October 2013 31% of enterprises pointed to this factor.

In November 2013 the most notable increase of respondents anticipating the second wave of the crisis was observed in consumer goods and construction materials industries – the respective share there was as high as 41% of enterprises (*Fig. 19*). Taking into account the share of respondents that didn’t see any changes in the probability of the crisis, an ultimate leader was consumer goods industry where only 10% of enterprises didn’t find that the second wave of the crisis was coming closer (in construction materials industry the respective share was 18%). In the second echelon were ferrous metallurgy and machine building (in both of them 34% of respondents estimated the probability of the crisis as growing). But the above shares were opposed by large segments in these industries that did not notice any changes (40% and 34%, respectively). The proportion of growing crisis expectations was even smaller in timber processing (28%), food industry (26%) and chemical industry (23%). These moderate (as compared with other industries) percentages were coupled with a notable share of “no change” responses: 18, 24 and 39%, respectively. Meantime, the most “positive” expectations as regards the second wave of the crisis were demonstrated by non-ferrous metallurgy: 11% - “growth”, 43% - “no change” and 12% - “decrease”.

If examined by positions of responding managers, the biggest growth of crisis moods was registered among enterprise directors (46% - “growth of crisis probability”, 17% - “no change”). On the contrary, their deputies demonstrated an increase of positive (for the current historical moment) assessments (25% - “growth”, 43% - “no change”). Heads of economic divisions displayed almost a zero balance of crisis expectations (35% - “growth”, 33% - “no change”).

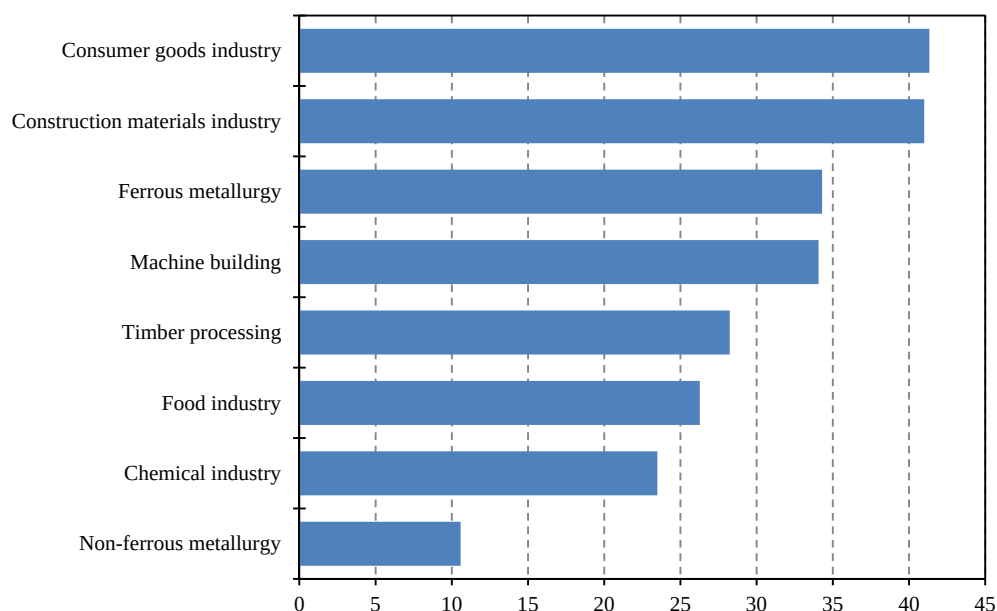


Fig. 19. Rating of industries by the assessed growth of probability of the second wave of the crisis (November 2013, %)

4.2.2. Workforce problems of the Russian industry

In 2013 Russian industry continued to lose workers. According to the data of IEP surveys last year the average annual rate of dismissals there reached -8 balance points – the maximum level since 2010. In the crisis 2009 business let this indicator drop down to -23 points despite the resistance of authorities at all levels. Only in March 2010 surveys registered the first increase of industrial employment after the crisis. This process went on till August 2010 with intensity ranging from +3 to +8 points. Then the recruitment in industry at large stopped but no massive lay-offs were registered either. 2011 began with the most sizable (by post-crisis criteria) hiring of workers – in March its rate reached +15 points. But already in May it stopped and by the end of the year gave way to the reduction of personnel at the rate of -11 points. However, the outcome of 2011 was not so dramatic: enterprises managed to balance the number of hired and dismissed workers with just -1 point result. 2012 turned out to be much worse: the annual balance fell down to -5 points, the rate of recruitment at the beginning of the year increased only up to +8 points while the rate of dismissals at its end reached -12 points. In 2013 industry failed to achieve a positive balance of employment change in any of the months. In February-April when enterprises used to increase the number of employed, the balance was up to only -4 points, i.e. dismissals prevailed over hiring of personnel in industry. In the next months the indicator remained in a narrow interval between -6 and -8 points implying a stable rate of lay-offs as different from previous years when the outflow of workers from enterprises accelerated at the end of the year. So, throughout 2013 industry displayed a flatter dynamics of the number of employed as compared with the previous years (*Fig. 20*).

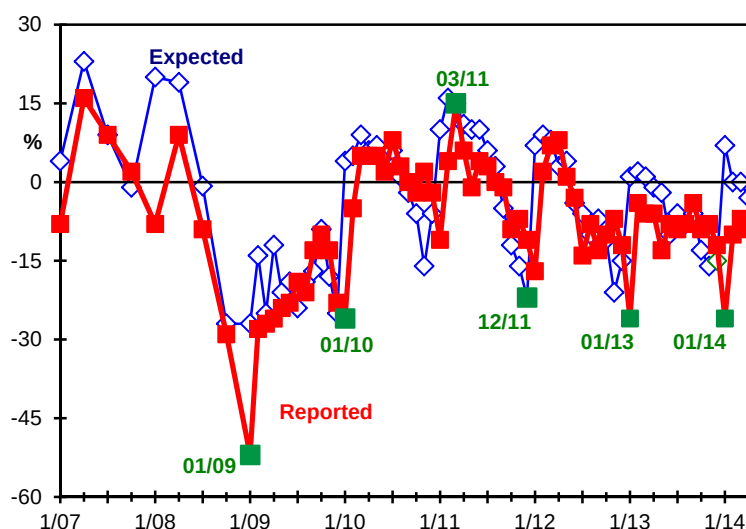


*Fig. 20. Actual and projected changes of employment
(balance = % growth - % reduction)*

Projections for the number of employed in 2013 also demonstrated greater stability as compared with the first post-crisis years. In the first quarters of 2010-2012 industry displayed the most optimistic employment change projections – then the balance rose up to +9 points in 2010 and 2012 and even up to +12 points in 2011. But by the year end it fell down to -22..-16 points. In 2013 this indicator managed to grow to only +2 points in the first quarter, i.e.

didn't differ much from zero, and in November-December was down to only -13 points. Even the latter value was most likely attributable to the declaration of the head of the government who stated that authorities wouldn't fight with lay-offs in case of the second wave of the crisis. Within 4 months before that the balance of employment change projections was relatively stable ranging from -9 to -6 points. So, industry has come to terms with its workforce problems and does not even project to cope with them.

The data about actual dismissals of workers from industrial enterprises and the prevalence of negative employment change projections among their managers could be due to deliberate policies for optimizing the number of employed in the situation of stagnation and the absence of hopes for recovery in the foreseeable future. But three indirect circumstances make one doubt such an explanation.

The first is that the actual employment demonstrates more sizable reductions as compared with those projected (expected) by enterprises. Indeed, the average annual balance of actual employment changes in 2013 reached -8 points while the balance of projections – only -3 points. The statement is supported by the comparison of actual employment changes with the respective projections at micro-level. In 2013 expectations of 15% of enterprises were more optimistic than the actual changes of the number of employed in the same month. The opposite situation (i.e. more pessimistic expectations as compared with actual changes) was registered at 12% of enterprises. So, industry more often hoped for the improvement of employment dynamics than expected its deterioration from the actual level preceding these projections. The maximum prevalence of improvement projections over deterioration projections was registered in 2008. Then positive changes were observed at 19% of enterprises versus negative changes at 10% of them. But in all the surveyed years an absolute majority of enterprises projected preservation of the actual trends. The share of such responses ranged from 70% to 75%.

The second circumstance bases upon the estimates of workforce sufficiency in Russian industry. The question about sufficiency of workers at a particular enterprise (introduced in IEP's business survey questionnaires back in 1996) allows to get direct estimates thereof. Annual averages show that throughout all the years of monitoring the most part of Russian industrial enterprises considered the available number of workers to be sufficient for meeting the expected growth of demand. The historical maximum of this indicator was registered in 2012 when the share of such responses reached 77%. In 2013 it fell down to 73% but remained within the interval habitual for the post-crisis period. Among the rest of enterprises the prevailing estimate throughout the post-crisis period was "below sufficient". In 2013 the share of such responses amounted to 16% – the 5-year maximum. As a result, the balance of estimates of workforce sufficiency (traditionally examined by surveys) was negative albeit not so impressive as in 2006-2008 (*Fig. 21*).

In 2013 the shortage of workforce was most acute in consumer goods industry where as of the end of the year one third of enterprises reported that the number of workers was insufficient relative to the demand projections and the balance of estimates was as low as -24 points. Still, that was not the worst post-crisis result of the sector – in 2010 the share of such responses reached 46%. So, the consumer goods industry managed to reduce the deficit of labour. However, at least initially, it was most likely achieved not by means of recruitment but owing to the revision of demand and output projections. While in 2010 the shortage of personnel was accompanied by hiring of workers (the balance of employment change was positive) and resulted in the decrease of respective indicator from -39 to -28 points, in 2011

there began lay-offs that nevertheless did not reverse the contraction of shortage down to -18 balance points. In 2013 the intensity of labour loss in the sector increased even more (up to -13 points) and its outcome was the deterioration of workforce sufficiency down to -24 points. The extent of labour drain in the past year seems to have surpassed the negative adjustment of demand and output projections and presently the sector experiences shortage of workers even for maintaining the shrinking volumes of output.

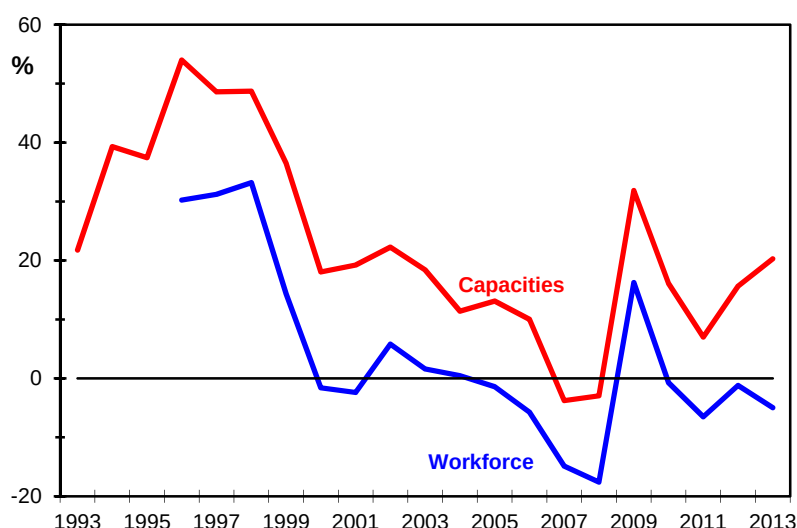


Fig. 21. Average annual balances of capacity and workforce estimates in 1993-2013

Three branches rank second by the shortage of workforce: non-ferrous metallurgy, machine building and food industry where the balance of estimates amounts to -10 points. They also lost workers in 2013 but at different rates: while in metallurgy and machine building the intensity of the process was -6 and -7 points, in food industry – only -2 points. This proportion between estimates of workforce sufficiency and lay-offs can be inter alia due to different prospects of the sectors.

Other branches in 2013 estimated the number of their workers as excessive. The biggest surplus was registered in construction materials industry (+14 points) and ferrous metallurgy (+10 points), the smallest – in chemical industry (+2 points). The workforce situation in these branches was also aggravated by the practice of dismissing workers only at the end of the year. However, the extent of such dismissals (either voluntary or forced) seems to be insufficient as there remained excessive employees.

The third circumstance comes out of the analysis of workforce sufficiency estimates and plans (projections) of enterprises as regards correcting of employment deviations from the “normal” number of employed for this particular enterprise. One should keep in mind that enterprises are free in their estimates of workforce sufficiency, i.e. nothing prevents them from answering that the actual number of workers is excessive (“above sufficient”) or vice versa insufficient (“below sufficient”). Meantime in their employment adjustment plans managers have to take into account the actual situation at the labour market, i.e. the actual ability of enterprises to dismiss excessive workers or hire new ones. Calculations show that in 2013 the ability of industry to correct deviations from the desired level of employment at least

at the level of projections fell to a 15-year minimum. Only 58% of enterprises had plans envisaging lay-offs in case of excessive employment, the preservation of personnel in case of ideal number of workers or their recruitment in case of shortage. The historically greatest ability of industry to provide an adequate response to workforce imbalances was registered in 2010 and amounted to 68%. So, over the 3 recent years the tackling of personnel problems has become a more difficult task for enterprises. And it has turned out that the cause thereof is by no means their inability to dismiss surplus workers due to the pressure of authorities. In 2013 26% of enterprises projected such changes in the number of employed that could result in an increase, preservation or appearance of workforce shortage in industry. This is a historical maximum for this indicator. A similar level of projections implying growing shortage of workers was observed in 2008 when the Russian economy and industry were maximally overheated. At the same period the share of projected changes in employment that could result in an increase, preservation or appearance of workforce surpluses was only 15% – a historical minimum for this indicator. The latter's maximum value (30%) was registered in 1997. At present the share of projections implying growth of workforce surpluses in industry is only 16% and as a result 2013 ranks second among all the 18 years of monitoring this indicator. However, similar results were registered in 2011-2012 proving the minimal pressure of authorities on industry in the 3 recent years with the aim to prevent sizable lay-offs in the situation of stagnation. The latter was proclaimed by the head of the Russian government in autumn 2013.

The detailed (per quarter) analysis of 2013 data shows the weakening of industry's ability to correct the workforce imbalances. While at the beginning of the year 61-62% of enterprises were ready to solve their staff problems, in its second half the respective share fell down to 54% – a minimum for the recent 15 years. At the end of 2013 one third of enterprises had plans (projections) of employment change pointing to the growing shortage of labour in industry. The value of this indicator was most close to an absolute maximum over the whole 18-year period of monitoring employment estimates that was registered in October 2008 (42%). At the beginning of 2008 only 18-19% of industrial enterprises were unable to cope with the deficit of workforce.

On the contrary, the expectation of problems with surplus employment at the end of 2013 reduced and was as small as 13%. This is not the lowest level of this indicator implying that there still exists a potential for lay-offs in industry. In October 2011 the projections for preservation of workforce excessiveness fell down to 7% which was most likely due to the forthcoming federal elections (let's note that already in January 2012, i.e. soon after the elections to the State Duma, the industry's inability to cope with surplus employment returned to 15-20% habitual for that period). In October 2008 this indicator equaled 8% conditioned by the highest point of pre-crisis over-heating of the economy. In 1996-2013 there were no other periods demonstrating a clear inability of industry to cope with excessive employment.

So, industry is rather losing workers than dismissing them on its own initiative. This conclusion is supported by the direct data on the workers' reasons for leaving.

According to the data of 2012 and 2013 surveys workers more often leave industrial enterprises voluntarily than are dismissed by administrations. In 2012 the proportion was 65% versus 27%, in 2013 – 76% versus 30%. So, 3/4 of Russian industrial enterprises are losing workers by no means of their own will and this fact explains quite a natural in such situation insufficiency of labour in industry. Therefore, the thesis about the need to dismiss "extra" workers in case of the possible second wave of the crisis requires a serious revision. Most

likely it shouldn't be applied to the major part of industrial enterprises that as it is do not have extra workers relative "to the expected changes of demand". But the obtained data evidences aggravation of problems faced by employers and authorities rather than their alleviation. These conclusions base upon analysis of the reasons for leaving in 2012 and 2013.

The leader among reasons for leaving is "low wages" (*Fig. 22*). For the second year in turn this factor is mentioned by 47% of enterprises. The composition of branches most intensely losing workers due to this reason hasn't changed: non-ferrous metallurgy, food industry, timber processing and construction materials industry. In machine building the loss of workers due to low wages remains at the level of 55%. The contribution of this factor is the lowest in ferrous metallurgy. Nevertheless, in recent time 63-66% of industrial enterprises find the level of wages paid to be normal. This raises doubts about the alleviation of low wages' negative impact on staff problems of enterprises.

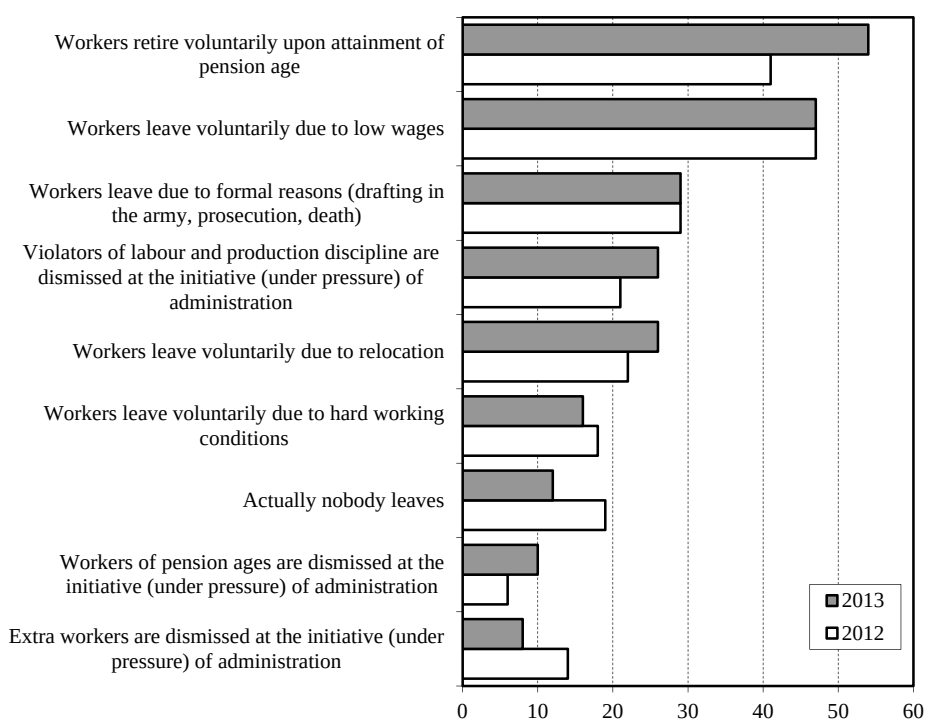


Fig. 22. Actual reasons of workforce drain from industrial enterprises, %

However, in 2013 enterprises faced one more problem that was probably more serious and long-lasting than insufficient wages. The "voluntary retirement of workers of pension ages" has climbed to the first place among reasons for leaving in industry. This fact is the outcome of conjunction of multiple developments in our recent history. The start of economic reforms resulted in the lowering of birth rates in the country and the reduction of the number of graduates from secondary schools in recent years. Drawbacks in the policy of after-school education conditioned creation of such a big number of tertiary institutions that actually any school graduate can find one corresponding to his level of knowledge. On the contrary, the number of vocational secondary institutions shrank as well as the efforts of state to fill them with school graduates. All this resulted in smaller inflow of young people to worker vacancies in industry. Enterprises had to do their best to keep workers of elder ages from retirement. But the objective process of aging that is not responsive to any economic policy tools started to

inconvertibly curtail the number of elderly workers in our industry. In 2013 already 57% of enterprises realized this fact. The growing outflow of pension-age workers was registered in all branches except consumer goods industry (there the share of such quits slightly reduced from 53% to 51%) and food industry (down to 24% from 28%). The biggest growth of voluntary retirements of pensioners was observed in chemical industry (up to 53% from 22%) and ferrous metallurgy (up to 87% from 60%).

The third cause of voluntary quits – “hard working conditions” – retained its importance at the same level both in industry at large and in most branches.

The number of “dismissed at the initiative of administration” grew as well. Similar to the previous year, employers mostly prefer to fire violators of labour and production discipline. At present 26% of enterprises resort to this practice (in 2012 - 21%), most often in ferrous metallurgy (50% of enterprises), consumer materials industry (33%) and machine building (31%). On the contrary, food industry demonstrates steadily low rates of dismissing discipline violators (15%). As compared with 2012, the lay-offs of pension-age workers at the initiative of administration grew as well (from 6% to 10%) but the moderate scale of this practice is obvious. The detailed analysis showed that in 2013 the only contributor to the growth of forced lay-offs of pensioners was ferrous metallurgy. While in 2012 only 8% of enterprises reported such cases (and it was not the highest result as compared with other sectors), in 2013 the respective indicator grew up to 40% – well above other branches where it ranged from 2% to 7%. The persisting low demand for metals makes enterprises of the sector resort to all means of reducing costs that are possible in the current economic situation in Russia. Prioritizing current problems they probably undermine their future development.

The dismissal of “extra” (according to the employers’ opinion) workers remained in the last place among reasons for leaving having lost several percent points over the year. This fact seems quite logical taking into account the shortage of labour in industry that increased in 2013. Currently only 8% of enterprises dismiss workers for that reason. This indicator could be lower if not for ferrous metallurgy and food industry. In the former the share of enterprises laying off extra workers remained at the level of 20% while in the latter the frequency of applying this tool for reducing costs increased (although the growth was not significant – up to 7% from 5%). On the contrary, the scale of such dismissals in other industries diminished.

The performance of Russian industrial enterprises suffering from the shortage of labour and losing it due to demographical reasons is also aggravated by apparent problems with recruiting new, especially skilled workers. The finding of such workers on the market still remains the most difficult task. Only 37% of enterprises state that “there are no special problems with hiring skilled workers, i.e. we find and hire them when it’s necessary”. The probability of finding and hiring other categories of personnel in industry is higher: in 2013 40% of enterprises easily found heads of production and other units, 47% - engineers and office workers, 71% - non-skilled personnel. However, as different from 2012 the situation on the market of skilled labour seems to have changed for the better for employers. First, enterprises got more opportunities to solve their personnel problems by hiring skilled workers (in 2012 only 29% of enterprises could do that). It should be noted, however, that similar improvements took place in respect of other mentioned categories of staff. Second, in 2013 only 5% of enterprises retained the reserve of necessary skilled labour. In 2012 17% of enterprises had such a “reserve”. The lowering of staff reserves was also registered for other categories of workers but it didn’t exceed several percent points. Meantime, the overall capability of relatively problem-less replenishment of workforce in industry (labour market +

own reserve) remained approximately the same: 42% of enterprises in 2013 versus 46% in 2012. So, the re-ranking of potential sources of skilled labour took place in 2013: henceforth employers will search for such workers “out of gate” rather than “in gate”. This can be assessed as a negative circumstance since it implies greater risk for enterprises to face difficulties in hiring workers in case of industrial recovery and feverish demand for labour from businesses already having experience of operation under deficit of skilled personnel. A positive side of the new situation is the lowering of employers’ expenditures on maintaining excessive workforce on the staff.

The problems that industrial enterprises encounter in search for skilled workers remained the same. As assessed by enterprises, in 2013 low wages ranked first in the rating of hindrances to recruitment. The frequency of mentioning this factor remained at the same level – 36%. Nearly similar “popularity” in industry had the problem of general shortage of labour supply in the region – it was named by 34% of enterprises (in 2012 – 37%). To the second place they put the dismantling of the system of vocational secondary education. 26% of enterprises (in 2012 – 22%) found that the number of specialists trained by educational institutions was insufficient and 24% of them complained about the quality of graduates’ training (in 2012 – 22%). At the third place business self-critically preserved hard working conditions. This factor was again mentioned by 14% of enterprises. 9% of respondents (in 2012 – 6%) considered work in industry to be generally non-appealing (“jobseekers do not apply to our enterprise”).

One more direction of IEP’s annual monitoring allows to estimate the impact of staff scarcity that was not an infrequent guest in Russian industry even in the period of 2012-2013 stagnation. The long-standing and informal relations with respondents create conditions for receiving direct answers to direct questions including the ones about possible effects of skilled labour shortage in Russian industry.

The deteriorating quality of manufactured products remains the most important sequence of personnel (and first of all skilled workers’) shortage. In 2013 37% of enterprises (the same percentage as in the previous year) admitted the fact of this most negative outcome of staff scarcity. Also no changes took place in the composition of branches suffering most from the deteriorating quality of output. In the first place remains machine building where 53% of enterprises admitted the fact (in 2012 – 46%), then follow consumer goods industry (in 2013 – 41%, in 2012 – 31%), food industry (in 2013 – 38%, in 2012 – 41%), timber processing (in 2013 – 38%, in 2012 – 39%) and ferrous metallurgy (in 2013 – 31%, in 2012 – 42%). So, direct estimates of producers paint a highly gloomy picture of the vanishing competitiveness of the sector that should have become a locomotive of Russian economy’s modernization. The admission of this fact is hindered by two circumstances: first, by the difficulty of measuring these processes using instruments of traditional statistics and, second, by the utter responsibility for them of authorities the policies of which in the sphere of vocational education have led to such a deplorable result.

The second place among actual aftereffects of staff scarcity continues to belong to the inability to increase output even in case of available orders. About one third of industrial enterprises consistently point to this hindrance to recovery from lingering stagnation. This figure is supported by another indicator of business surveys – the rating of impediments to output growth in industry in which the same share (about one third) of enterprises named shortage of personnel. In 2013 the hindering effect of this factor was the greatest in machine building (46% of enterprises mentioned it against 42% in 2012), consumer goods industry

(43% against 40% in 2012), non-ferrous metallurgy (39% against 18% in 2012) and chemical industry (34% against 23% in 2012). At another pole of this personnel-stagnation rating was ferrous metallurgy where only 10% of enterprises couldn't increase output due to the shortage of labour.

In 2013 an absolute reduction of output due to the insufficiency of workers was registered at 22% of enterprises thus retaining the third place in the general industrial rating of staff scarcity impacts. The leader in decreasing output due this reason was consumer goods industry (49% of enterprises against 51% in 2012). In the second place with a large gap were machine building (32% against 28% in 2012) and timber processing (30% against 23% in 2012).

The "wage response" to the shortage of workers in industry was in the fourth place in 2013. Within two years the application of this tool for fighting deficit of workforce grew from 11% to 19%. Enterprises are forced to increase workers' remuneration even despite stagnation in order not to be left without personnel in the situation of continuous labour drain, the main cause of which according to their own estimates are low wages.

4.2.3. Investment problems of Russian industry

Investment activity that according to the data of official reports has been fading quarter by quarter may eventually spring a very unpleasant surprise in the nearest future. Therefore the analysis of factors hindering growth of investments in Russian industry is of immediate importance.

Usually IEP collects survey data on hindrances to investments in the I quarter when industry is actively developing investment programs for the new year. The set of factors that could be considered hindrances to investments is based on the recommendations of harmonized European survey program and remains unchanged since 1996. It includes: shortage of own funds, high interest rate on credits, difficulties with receiving long-term credits, high prices for construction and installation works and equipment, low profitability of investments and surplus of existing facilities. The latest regular survey was conducted in January 2013. But as the problem of investments' slow down was becoming more and more serious each month, a non-planned survey was made in September 2013. It carried on the traditional multi-year monitoring of hindrances to investments and produced the following results (Fig. 23):

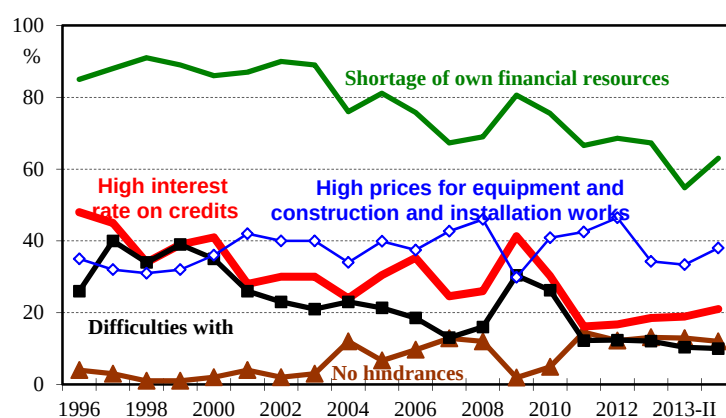


Fig. 23. Hindrances to investments in Russian industry

The results of the second survey in general supported the figures of January survey except for the first (most frequently mentioned) factor in the rating of hindrances – the shortage of own financial resources. The mentioning of this hindrance by enterprises fell by 12 percent points down to 55%. It implies that only slightly over one half of industrial enterprises suffer from the shortage of own funds for investments. The maximum level of this indicator amounted to 90% and was registered at the beginning of 1998, 2002 and 2003. The result of monitoring this deterrent seems to be quite logical taking into account at least two circumstances. First, according to estimates of the Development Center the amount of “surplus” funds on accounts of enterprises continues growing. Second, according to data of IEP surveys the actual (as different from reported) financial and economic performance of Russian industrial enterprises in 2012-2013 was not getting worse – only 13% of enterprises assessed it as unsatisfactory. For reference – in 2009 the share of such assessments was as high as 32%, in the best post-crisis 2007 – 10%. Meantime, enterprises’ projections as regards the change of their performance in 2013 were even several percent points better than in 2012.

In 2013 the highest sufficiency of own funds for investment projects was registered in ferrous metallurgy (where 59% of enterprises did not consider their shortage to be a hindrance for investments), food industry (56%) and electrical power industry (51%). It’s worth noting that the frequency of complaints about high interest rate on credits was the lowest in the same sectors (15%, 14% and 11%, respectively). The deterring effect of insufficient own funds quite predictably diminished with the growth of unit size: while small and medium enterprises mentioned this factor in 72% of responses, very large ones did it in 59% thereof.

The second (albeit, most popular with officials and experts) problem of the sources of finance is high interest rate on credits. But beginning from 2011 it actually worried only 16-19% of industrial enterprises and in 2013 slid down to the 4th place (19%) in the rating of traditional hindrances being monitored since 1996. Complaints about interest rate are mostly heard from enterprises in chemical industry (28%) and construction materials industry (25%). As one could expect, its negative effect on investment activity reduces with the growth of enterprise size.

Difficulties with receiving long-term credits in 2013 were also minimal over the whole period of monitoring. At present they are experienced by only 10% of industrial enterprises. In the 1990’s this hindrance was mentioned by 40% of respondents, in 2009 – by 30%. These difficulties are most often encountered in chemical industry (21%) and electric power industry (15%) which can be due to different understanding of “long term” by enterprises of the named sectors and their creditors.

So, business assessments prove that financial constraints to investments in 2013 and especially at its end were minimal over the whole period of monitoring. The accumulation of own funds by enterprises even in the situation of stagnation and the softening of credit terms by banks even in case of long-term lending extend the financial basis for potential investments in Russian industry. These results and apparent conclusions make one switch attention to other factors hindering investment activities of Russian industrial enterprises.

The negative effect of high prices for construction and installation works in 2013 was also minimal for the period of monitoring: they were mentioned by only 33% of enterprises. It was certainly a consequence of stronger competition between builders and producers of equipment for performing the shrinking volumes of construction works and machinery supplies. This indicator was slightly lower only at the end of 1990’s and in 2009 that was a crisis year for investments. The negative effect of prices reached its peak in the pre-crisis 2008 and at the

beginning of 2012 when the combination of investment plans and investment opportunities permitted service suppliers to raise prices. So, in 2013 the price factor was also at the most comfortable level for investors (certainly relative to other periods and by Russian standards). It can be excluded from the list of potential barriers to investments.

On the contrary, the negative effect of low profitability of investments in 2013 reached its maximum. In the situation of decelerating price growth that got increasingly widespread in industry 20-25% of enterprises could not ensure acceptable rate of return on investments even despite consistent efforts to reduce costs. The most affected were enterprises in ferrous metallurgy (30% of them) and machine building (25%). Meantime enterprises in electrical power industry (even after the announcement about possible freezing of their tariffs) showed the least concern about low profitability of investments (8%).

In 2013 the hindering effect of surplus capacities on investment activity in industry was also record high. At present 10% of enterprises directly admit that they have so many idle machines and equipment that their modernization or increase of fleet makes no sense. Meantime in 2012 the proportion of such statements was only 3% - almost the same as in the favourable for Russian industry 2005-2006 and 2008. So, by this indicator 2013 was the worst year for launching investments. But not in all sectors. The counter-investment surplus of capacities was the biggest in ferrous metallurgy (32% of enterprises in the sector admitted the fact) and food industry (14%). At the same time in chemical industry and timber processing this factor was a hindrance for only 2% of enterprises.

In general the analysis of traditional factors considered to be hindrances to investments has not revealed a principal deterioration of current terms for investing in modernization and expansion of capacities. Rather the opposite is true since the mentioning of most widespread deterrents has become less frequent and the factors whose impact is growing rank last in the rating of hindrances (as assessed by enterprises) and cannot sufficiently explain the increasingly apparent reluctance of industrial enterprises to invest in production. Due to this some additional factors reflecting the specifics of the current period of national economic development were included in the September survey. The results showed that new constraints (some of which had informal nature) well complemented the traditional list of factors and took the third, the fourth and the fifth places in the rating (*Fig. 24*).

It has turned out that the most widespread hindrance among the ones newly included in the IEP's monitoring is the uncertainty about prompt recovery of the Russian economy. 22% of enterprises mentioned this factor thus attaching to it the same importance as to low profitability of investments and high interest rate on credits. Let's note that the survey was conducted in September, i.e. before the public admission of problems in Russian economy by the head of the government and declaration of his intention to take control over their solution. It is logical to suggest that if the survey was done after the proclamation of these estimates and plans, the above hindrance would have gained several more points.

Meantime uncertainty about prompt recovery of the world economy cherished by all Russian officials as the cause of our problems is admitted as such by only 8% of industrial enterprises.

The detailed analysis shows that the strongest dependence of investment intentions on the prospects of Russian economy is currently observed in ferrous metallurgy where 39% of enterprises point to this factor. Moreover, this cause ranks first in the sector by 10 points surpassing the most widespread deterrent to the investment process in Russian industry, i.e. the shortage of own funds. In other branches the impact of uncertainty about prompt recovery

of the Russian economy on investments is much smaller – the place of this factor in their ratings is far from the top. In non-ferrous metallurgy and consumer goods industry it is mentioned by slightly over 1/4 of enterprises, in machine building – by slightly over 1/5 of them, in construction materials industry – by 12%. The lowest dependence of investment plans thereon is registered in food industry. It seems quite natural as the country's population constantly needs feedstuffs and so the industry has to maintain production and investments at a certain (at least minimal) level irrespective of the phase of economic cycle.

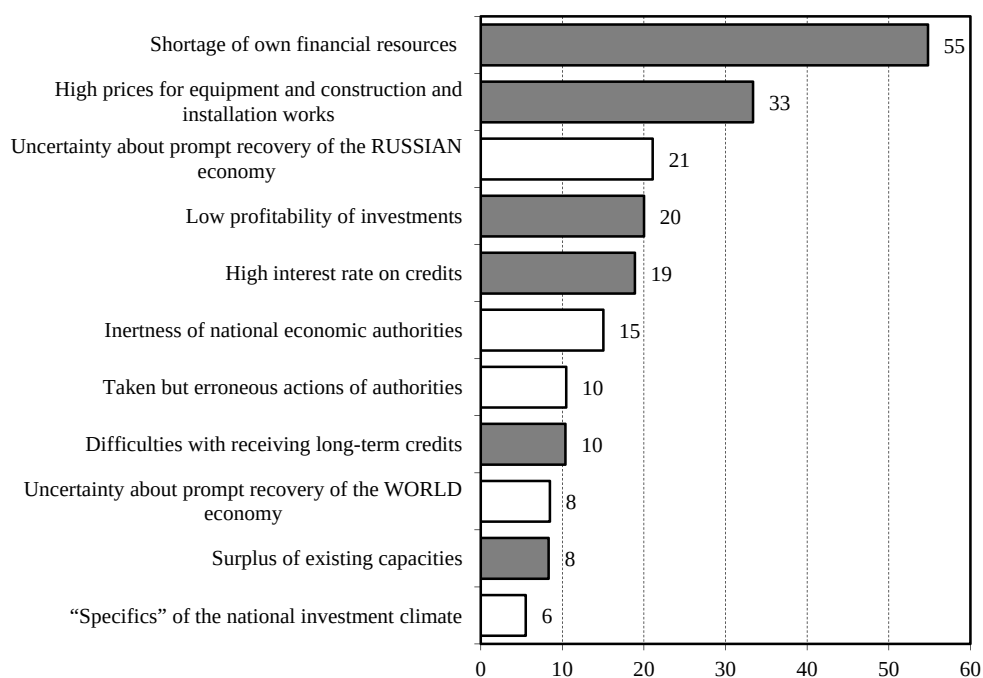


Fig. 24. Structure of hindrances to investments as assessed by Russian industrial enterprises in September 2013 (traditionally monitored factors – grey color, newly monitored factors – white color)

The negative effect of uncertainty about prompt recovery of the world economy on investment processes is also generated primarily in ferrous metallurgy where 27% of enterprises admit this fact (the second place in the sector's rating of hindrances). In other branches this factor is mentioned by 8% or 7% of enterprises at the most (timber processing and machine building, respectively). So, the attributing of problems with investments in Russian industry to the difficult economic situation in partner countries would be amazing for the absolute majority of domestic enterprises.

The fourth place in the current industry's rating of hindrances to investments belongs to inertness of national authorities. It's logical to suggest that these assessments primarily relate to the lack of feasible plans for recovery from the lingering stagnation which is the main cause of investments' slow down. There was enough time from 2011 (i.e. the moment of the first outburst of concerns (expectations) about the second wave of the crisis) to work out such measures. The actions taken by authorities were either inappropriate or the support of Russian industry was not their primary target. It's worth noting that the assessment of authorities' inertness varies greatly by sectors. The most displeased with economic authorities are timber processing (27% of enterprises), consumer goods industry (23%) and construction materials

industry (22%). Meantime in ferrous metallurgy only 1% of enterprises think that authorities are not doing anything in this field. The latter fact can be attributed to strong lobbying capabilities of the largest producers in the sector. This thesis is supported by assessments of authorities' actions depending on the size of enterprise: while small enterprises point to their inertness in 37% of responses, for medium enterprises the respective share is already 18% and for large ones – only 13%.

Erroneous actions taken by authorities in order to overcome the slow down of investments were mentioned by 10% of enterprises participating in the September survey. This result can be interpreted as quite acceptable since 90% of the authorities' endeavors have found support of business. However, in one branch the official anti-crisis (in the part pertaining to investments) actions were assessed as erroneous by a high share of respondents – 27% of enterprises in food industry pointed to this fact. In other sectors the share of such responses was about 10% and in chemical industry and non-ferrous metallurgy even smaller – below 1%.

4.2.4. Precautions of industrial enterprises against the second wave of the crisis

The Rosstat data on dynamics of industrial production in 2013 showed that month by month the crisis was approaching or that at least there were no signs of overcoming stagnation and shifting to sustainable growth. These circumstances made us resume the analysis of anti-crisis measures actually implemented (as opposed to projected) in Russian industry. For the first time enterprises were asked this question in 2012, for the second time – in 2013. The comparison of results of these two successive surveys leads to the following conclusions.

As compared with 2012, in 2013 industry was forced to more widely resort to anti-crisis measures. In some cases the increase ranged from 1 to 3 percent points while in other it actually doubled. And only in two cases enterprises reported a decrease of precautionary preparations by 1 and 4 percent points (*Fig. 25*).

“Accurate” price policies became the leader in 2013. Earlier it ranked second but sluggish demand forced enterprises to use price factor more actively in order to win the competition for consumers and to prevent a crisis drop of sales. As a result the anticipation of the second wave of the crisis currently influences price policies of over one third of industrial enterprises. The most wide-scale anti-crisis adjustments of prices were registered in ferrous metallurgy where 71% of enterprises reported resorting to it (in non-ferrous metallurgy – only 3%), timber processing (45%) and consumer goods industry (43%).

The search for more cost-efficient suppliers (i.e. the reduction of costs) has preserved its popularity with Russian industry at the level of 33%. And here again an absolute leader is ferrous metallurgy (71%). Other industries apply this measure in at least twice smaller proportion of cases and in food industry only 15% of enterprises resort to it.

The minimization of finished goods stocks was the only measure the use of which in industry reduced as compared with the 2012 survey. But it fell by only 4 percent points leaving this tool at the third place (although in company with other measures the popularity of which grew up to 24%). The weakening of importance attached by enterprises to anti-crisis stock management probably became one of the reasons of record high surplus of finished goods stocks in the first half of 2013. And the highest frequency of applying measures for minimization of stocks was again registered in ferrous metallurgy. On the other pole were

non-ferrous metallurgy and food industry that actually did not use this tool in fighting (pre)crisis developments.

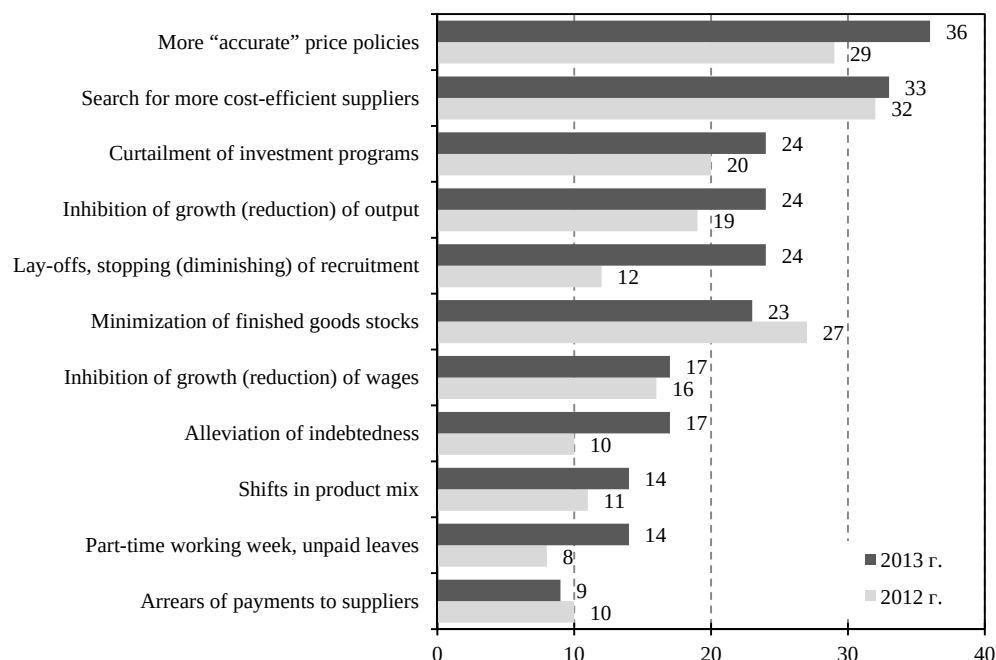


Fig. 25. Actual taking of precautions against the second wave of the crisis in Russian industry, as % of respondents

The extent of use by industry of a whole set of measures expanded from the former 12-20% of enterprises to 24%. The biggest increase was registered in the application of anti-crisis adjustment of the number of employed. While in 2012 only 12% of enterprises resorted to lay-offs, stopping or diminishing of recruitment, a year later such actions were taken twice more frequently. The leader was the same – ferrous metallurgy where 34% of enterprises reported having made pre-crisis adjustment of personnel. However, in this case other industries did not lag far behind the leader: in machine building 32% of enterprises adjusted the number of employed, in non-ferrous metallurgy – 30%. But the initiative here seemed to belong to workers voluntarily leaving enterprises rather than to employers.

The popularity of one more anti-crisis HR measure increased greatly in 2013. The shortening of working week and sending of workers to unpaid leaves was used in industry almost twice as often as a year earlier. An absolute leader here was machine building where this tool was applied by 27% of enterprises, then followed non-ferrous metallurgy (14%) and consumer goods industry (11%). Meantime the incidence of direct inhibition of growth (reduction) of wages in industry remained the same. This measure was most frequently applied in timber processing (24% of enterprises), consumer goods industry (21%) and machine building (21%).

In 2013 one fourth of Russian industrial enterprises curtailed investments as a precaution against resumption (aggravation) of crisis. The impact of crisis expectations on investment activities was the greatest in metallurgy (as followed from reports of 54% of enterprises in ferrous metallurgy and 35% of enterprises in non-ferrous metallurgy), machine building (24%) and timber processing (23%).

The volumes of output also became more affected by possible crisis developments. In 2013 this fact was admitted by 24% of enterprises against 19% in 2012. The strongest impact of crisis anticipations on output was observed in ferrous metallurgy (where it was admitted by 46% of enterprises), timber processing (26%), machine building and consumer goods industry (25% each). The possibility of the crisis had absolutely no effect on production in food industry.

At the beginning of 2013 the alleviation of indebtedness climbed to the fourth place in the general rating of industry's precautions against a possible aggravation of crisis developments. Such actions were taken by 17% of enterprises. They were most popular in ferrous metallurgy (reported by 50% of enterprises in the sector), timber processing, consumer goods industry (18% each) and machine building (15%).

4.2.5. Estimate of industry's demand for anti-crisis measures to be taken by the government

The program of crisis monitoring launched several years ago by the Gaidar Institute for Economic Policy and based on business surveys allows to assess the practical efficiency of anti-crisis measures taken by the government as early as at the design stage. Summarizing the results of three recent years of monitoring, an absolute leadership belongs to three well-known measures of support to the real sector of economy: constraining of increase of tariffs by natural monopolies, alleviation of tax burden and fostering of demand for industry's output (*Fig. 26*).

According to business assessments, the growth of tariffs is the most persistent crisis-provoking measure. In 2011-2013 on the average 65% of respondents pointed to the possibility of industrial recovery in case of constraining their increase. No other anti-crisis measure was so popular with industrial enterprises. In 2013 2/3 of them could have ensured so much needed increase of industrial output if the state listened to appeals to constrain the growth of tariffs.

So, the state that created and nurtured monopolies now has to engage in a severe battle with them in the hope to revive the rest of the economy and industry in particular. The repercussions of this struggle could be traced in speeches of the country's top officials before the decision on freezing tariffs was taken in autumn 2013 and after that – in plans of monopolies to cut investments. But even before the decision was taken business seemed to have made its own attempts to diminish the negative impact of state monopolies on industrial performance. Russian Railways have officially admitted the decrease of carried volumes. Given the lack of data on transportation by trucks, this admission allows to suggest that enterprises are starting to decline services of the monopolist in favour of more competitive and flexible motor transport when it's possible.

In 2011-2013 "alleviation of tax burden" ranked second in the rating of measures most needed for the recovery of industry. The maximum demand and hope for state assistance in this field was registered in 2012 when 73% of enterprises were ready to respond to such a gesture by increasing output. The 2012 result was all the more unique as a year before (in 2011) tax breaks could have helped only 44% of producers. In their anti-crisis policies enterprises focused on lowering costs and expected the same from the state. But these expectations were never to come true while the directions and efficiency of state expenditures probably left business astonished and discontent. In 2013 the industry's demand for revision

of taxes averaged 68% and was the highest in food industry, timber processing (80% each), machine building (78%) and consumer goods industry (76%).

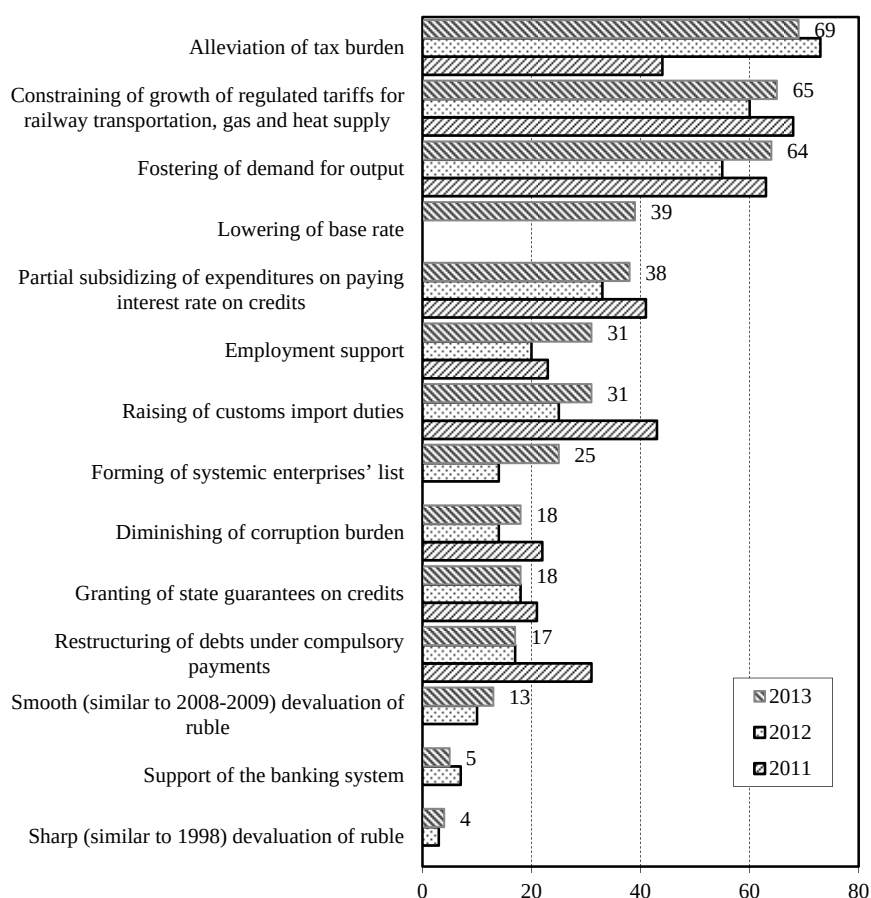


Fig. 26. Rating of desirable anti-crisis measures to be taken by the government (as assessed by Russian industrial enterprises, %)

The fostering of demand for output is regarded as necessary by 63% of enterprises and differs greatly by sectors. While in ferrous metallurgy and machine building it is awaited by 74% of producers, in food industry the respective share is only 37%, in non-ferrous metallurgy – 34%.

Possible government actions in the sphere of lending to the real sector of economy form the second echelon in the rating of anti-crisis measures. The novelty of 2013 is that “the lowering of base rate at which banks receive money from the RF Central Bank for crediting enterprises” has got support of 38% of producers and clearly lags behind the leaders. Although easy to implement, this measure so far gets stuck on an apparent reluctance of the Bank of Russia to assume the responsibility for possible and unpredictable inflationary after-effects of such actions. Besides, between the RF Central Bank and enterprises there are commercial banks supposed to transfer cheaper funds to enterprises. Meantime, the experience of 2008-2009 shows that these institutions may actually ignore the instructions of economic authorities as regards the crediting of real sector. With respect to the current situation this implies low probability of reduction of market rates at which credits will be offered to the most part of industrial enterprises.

Enterprises find that they can get an equal but real benefit from partial subsidizing of expenditures on paying interest rate on credits. The expediency of this measure in the course of 2008-2009 crisis was admitted by 20% of producers. The growth of its popularity in 2011-2013 may be due to the hope that the priority will be given to this form of credit support instead of the then used pumping of cash into the banking system coupled with appeals not to curtail crediting of the real sector. At present the latter actions seem reasonable to only 4% of enterprises.

The third echelon of anti-crisis (growth promoting) measures includes government actions targeted at the support of employment and raising of customs duties on imported products. At the current historical stage mechanisms and directions of possible steps at the labour market can differ from the ones taken in 2009-2010. Then the number of employed in industry was excessive due to the sharp production drop and constraining of lay-offs by authorities. Now the situation is different: there is not enough workforce for a moderate and even zero production growth, workers are leaving industry on a massive scale and enterprises project further reduction of personnel. It's time for authorities to think not about the prevention of lay-offs and aggravation of social tension but about attraction of workers to industry that has got depleted *inter alia* due to the growth of wages in the budgetary sector.

In 2013 the negative impact of imports on Russian industry became rather strong depriving domestic producers of a growing share of the market. The current pre-crisis level of this factor's importance increased the demand for state protection against imports 1.5 fold as compared with previous years.

In 2013 the need for target support of systemic enterprises in Russian industry grew up to 25% from 14% a year before. But these measures have not been so far included in the list of proclaimed actions to be taken by authorities thus undermining hopes for personal treatment by the state that are cherished by about one third of enterprises in machine building and consumer goods industry.

The possible (already underway?) devaluation of ruble considered by economists to be an efficient measure for protecting domestic producers actually rounds out the rating of measures targeted at the stimulation of economy (as assessed by industry). Only 12% of enterprises now speak for a smooth devaluation of national currency. In consumer goods industry that is traditionally most affected by import supplies the devaluation of ruble can help only 7% of enterprises. The cheapening of own output relative to imported commodities seems to be less important than the rise of prices for imported equipment.

Summing up the results of multi-year monitoring of efficiency assessments relating to potential anti-crisis (growth promoting) measures to be taken by the Russian government, the following conclusions can be made:

First, to the opinion of industrial enterprises the currently debated, implemented or earlier applied economic policy measures differ greatly by their efficiency. It would be very irrational to ignore this difference.

Second, the box of most efficient measures is stable, time-proven and largely adopted by authorities. There is little left to do – to ensure their implementation both by overcoming the resistance of monopolies and by suppressing own ambitions.

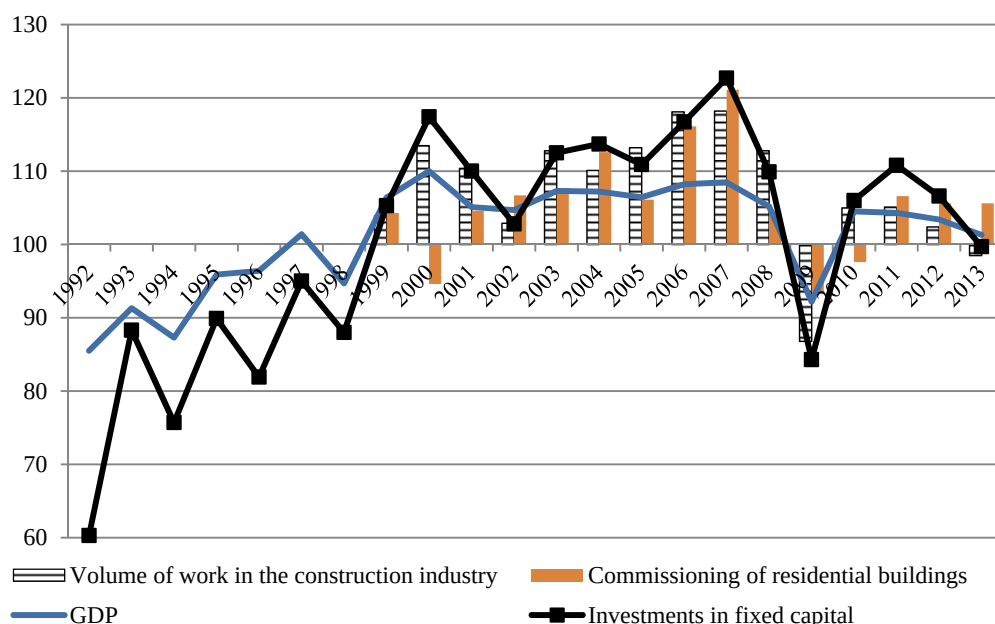
Third, the novelties of 2013 (the lowering of base rate, infrastructural projects) may have unpredictable or remote effects while the GDP growth rates need to be accelerated here and now.

4.3. Investment activity

4.3.1. Internal domestic investments in fixed capital

Conditions and factors activities investment activities in 2009-2013

Transformational changes that have been taking place in the Russian economy over the past 15 years have had a substantial impact on the structural characteristics of the investment process. Comparative analysis of economic development between in 1999 and 2013 allows the identification of common and specific conditions, factors and risks, depending on the investment potential, demand for investment resources and the motivation for investment activities. In 2013, Russia's GDP increased 1.87 times, and investments in fixed capital by 2.89 times compared with 1999. The dynamics of the investment activities during the period under study were not uniform and were determined by the influence of changes in world market conditions, on the one hand, and the level of activity of Russian enterprises in the internal market, on the other (Fig. 27).



Source: Federal State Statistics Service (Rosstat).

Fig. 27. Dynamics of investments in fixed capital in 1992-2013, as % of the previous year,

When the level of potential investment demand in the domestic market was high, stabilisation of the share in the GDP of expenditure for investment purposes reflected the lack of mechanisms to transform savings into investments, which ultimately resulted in restraining of economic development. Development based on extensive use of primary factors, systematic growth of production costs and a high proportion of imports in domestic market resources led to low competitiveness of the Russian economy.

Under the influence of a sharp decline in income from foreign trade the share of gross saving in GDP in 2013 fell to 24.6% and exceeded the 1998 figure, which had been the minimum for the whole 20-year observation period, by less than 1%. It should be noted that, in the period from 2009 to 2013, despite the sharp decline in income, the anti-crisis measures

taken helped to keep the share of investment in fixed capital at an average level of 19.9% of GDP. This was achieved by increasing the average ratio of transforming savings into investments to 73.7% during 2009-2013, in comparison with 53.8% for the previous 8 years. However, due to the undeveloped financial market, inter-industry floating of income and savings was not provided, in particular, between those of exporters, and the sectors serving domestic demand. The savings rate significantly exceeded the accumulation rate and the share of investments in fixed capital in GDP, with the Russian economy acting only as a net lender.

Table 9

Capital transactions account, based on current prices, RUR bn

	2008	2009	2010	2011	2012	2013*
Gross savings — total	12,459.5	7,810.7	12,201.64	16,495.63	17,729.92	18,661.5
Gross accumulation of fixed capital	9,200.8	8,535.7	10,014.4	11,950.5	13,603.7	14,316.4
Changes in inventories	1,325.3	-1,190.9	458.3	2,032.2	1,626.4	1,168
Net lending (+), net borrowing (-)	1,933.4	465.9	1,728.936	2,512.927	2,499.816	3,177.1
For reference: investment in fixed capital	8,781.6	7,976.0	9,152.1	10,776.8	12,568.8	13,255.5

*) preliminary data,

Source: Federal State Statistics Service (Rosstat).

The phenomenon of the Russian economy is that the growth of export earnings and a relative increase in the lending and investment attractiveness of the country has increased the transformation of capital into reserves. In 2004, in order to reduce the risks of adverse international economic conditions, and as an instrument to sterilise excess money supply in circulation, the Stabilization Fund had begun to form, and in 2008 it was transformed into the Reserve Fund and the National Welfare Fund (*Table 10*)

Table 10

**Monetary values of the Reserve Fund and the National Welfare Fund
in 2008-2013, (end of year)**

	Reserve Fund	National Welfare Fund	Reserve Fund	National Welfare Fund
	RUR bn		as % of GDP	
2008	4,027.64	2,584.49	9.8	6.3
2009	1,830.51	2,769.02	4.7	7.1
2010	755.21	2,695.52	1.7	5.8
2011	811.52	2,794.43	1.5	5.0
2012	1,885.68	2,690.63	4.0	4.0
2013	2,859.72	2,900.64	4.3	4.3

Source: Federal State Statistics Service (Rosstat).

Due to the fact that just before the crisis, the aggregate volume of the Reserve Fund and National Welfare Fund had reached 16.1% of GDP, the implementation of an anti-crisis programme in 2009-2010 became possible. Not only did the accumulated volume of funds contribute to reduction of the negative effects of the crisis in the financial and real sectors of the economy, but it also ensured the implementation of state social obligations and stimulated growth of the economy and investment activities. In 2013 active discussions around the problem of the use of the National Welfare Fund to finance major infrastructure investment projects began.

The dynamics of GDP in the short term are more closely associated with such growth factors as inflation, surplus (deficit) of the state budget, the quality of the institutional environment and the restructuring of enterprises and companies in order to reduce costs, excessive labour forces and energy consumption as well as to close down inefficient industries.

In the context of the medium- and long-term development of the Russian Federation the role of investment activities increased dramatically in response to the need to address the problem of deep structural and reproduction imbalances, high energy production, inefficient location of enterprises, insufficient use of material and labour resources and a high proportion of non-competitive goods. At the corporate level, the need for solid investments is associated with a transition to strategic development, including the transition to new products, markets, management techniques and new patterns of corporate control.

Main trends in the financing of investment activities in 2009-2013

The principal aspect of economic development in the period 2009-2012 was the shift toward the increased funding of investments in fixed capital from the own funds of enterprises and organisations, whilst reducing the participation of borrowed funds. The proportion of these own funds in the financing of investments in fixed capital rose to 46.1% in 2013, as compared to 41.0% in 2010. The structure of use of equity funds of enterprises in investment activities closely corresponded with their financial condition. In 2013, the proportion of gross profits in GDP dropped to 28.8% in comparison with 29.6% in 2012, and 32.6% in 2010. The net financial results of enterprises and organisations in 2013 amounted to 87.2% of the same indicator in 2012, while the proportion of profitable enterprises declined by almost 1% compared to the previous year. Furthermore, in 2013, in line with the trend for a reduction in the rate of return existing over the previous decade, the share of profit in investment resources decreased, giving way to other sources.

Table 11

Monetary and financial resources of investment activities in 2008-2012

	2008	2009	2010	2011	2012	2013
Income of consolidated budget, RUR bn	16,003.9	13,599.7	16,031.9	20,853.7	23,435.1	24,082.4
Gross profit in the economy, including gross mixed income, RUR bn	13,498.7	11,921.1	15,093.7	17,172.5	18,255.3	19,142.1
Net financial result, RUR bn	3,801.2	4,431.6	6,330.6	7,252.7	7,716.5	6,650.5
Share of profit-making organisations, in %	71.7	68.0	70.1	71.9	74.1	73.2
Increase in financial assets of the population and real estate acquisition, RUR bn	2323	4,923	6,719	5,785	5,852	6,250.6*
Average per capita income (per month), RUR	14,940.6	16,838.3	18,958	20,780	22,880	25,522
Loans, deposits and other invested assets, provided by organisations, individuals and credit institutions, RUR bn	19,362.5	19,179.6	21,537.3	27,911.6	32,886.9	38,767.9

*) preliminary estimates.

Source: Federal State Statistics Service (Rosstat).

The main reduction of investments in respect of sources of funding was due to the sharp decline in finance for investment provided by parent entities – large holding companies, joint stock companies and financial-industrial groups with state participation. The proportion of investments of such controlling entities in the structure of funding sources had fallen to 12.6% in 2013, compared to 16.8% in 2012 and 19.0% in 2011.

Table 12

**Structure of investments in fixed capital by sources of funding
(excluding small businesses and investments,
which cannot be observed by statistical methods), % of total for 2007-2013**

	2007	2008	2009	2010	2011	2012	2013
1	2	3	4	5	6	7	8
Investments in fixed capital — total	100	100	100	100	100	100	100
including by sources of financing:							

Cont'd

1	2	3	4	5	6	7	8
own funds	40.4	39.5	37.1	41.0	41.9	44.5	46.1
borrowed funds	59.6	60.5	62.9	59.0	58.1	54.6	53.9
of which:							
bank loans	10.4	11.8	10.3	9.0	8.6	8.4	9.3
including loans from foreign banks	1.7	3.0	3.2	2.3	1.8	1.2	0.9
borrowings from other organisations	7.1	6.2	7.4	6.1	5.8	6.1	6.2
budgetary funds	21.5	20.9	21.9	19.5	19.2	17.9	18.8
including:							
federal budgetary funds	8.3	8.0	11.5	10.0	10.1	9.7	9.8
budgetary funds of constituent entities of the Russian Federation	11.7	11.3	9.2	8.2	7.9	7.1	7.7
non-budgetary funds	0.4	0.3	0.3	0.3	0.2	0.4	0.3
funds raised in connection with participation interest in construction (organisations and individuals)	3.7	3.5	2.6	2.2	2.0	2.7	3.0
including: population funds	1.5	1.9	1.3	1.2	1.3	1.3	2.3
other	16.4	17.7	20.4	21.9	22.3	20.0	16.3
including:							
funds of controlling entities	11.3	13.8	15.9	18.0	19.0	16.8	12.6
funds from the issue of corporate bonds	0.1	0.1	0.1	0.01	0.01	0.04	0.1
funds from issue of shares	1.8	0.8	1.0	1.4	1.0	1.0	1.0
Out of the total volume of fixed capital investment from abroad	5.4	4.3	4.3	3.8	3.1	3.0	2.2

Source: Federal State Statistics Service (Rosstat).

The change in volume and proportion of borrowed funds in these sources was accompanied by a change in their structure. The proportion of budgetary sources for financing investments in fixed capital in 2010-2013 was generally at a level of 18.9% and remained below pre-crisis levels, however, the proportions of funds used, according to budget system levels, did change (*Table 13*). The implementation of the programme of anti-crisis measures in 2009-2010 was accompanied by an increase in the financing of investment activities from the federal budget, and this compensated for the reduction of expenditure on investment objectives of subjects of the Russian Federation. State investments from the federal budget were implemented through the Investment Fund, the Federal Targeted Investment Programme (FTIP) and Federal Target Programme (FTP). Over the next three years state participation in financing investment activities was decreasing. In 2013, the share of budgetary funds to finance investments in fixed capital amounted to 2.68% of GDP, including, by means of the federal budget: 1.40% of GDP. In 2013, we noted a decline in spending on the Federal Targeted Investment Programme to 1.06% of GDP in comparison with an average over the previous two years of 1.43%. In absolute terms, the budgetary funds provided in 2013 to finance investments in fixed capital increased by RUR 86.0bn compared with the previous year, and amounted to RUR 1,790.1bn. It should be noted that, unlike 2010-2012, the greatest growth, RUR 62bn, was associated with increased investments of subjects of the Russian Federation in the budget investment programmes.

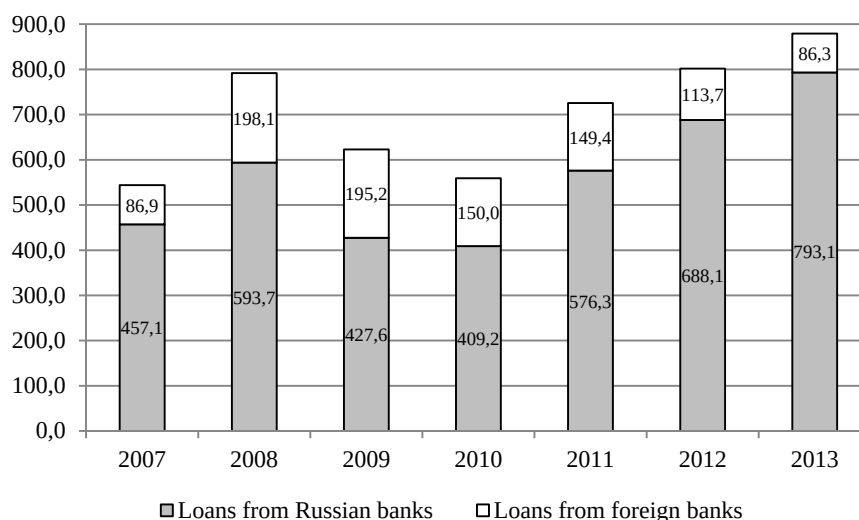
Table 13

The share of expenditure on fixed capital investments in 2007-2013, % of GDP

	2007	2008	2009	2010	2011	2012	2013
Budgetary funds — total	3.37	3.40	3.41	2.80	2.91	2.76	2.68
including:							
from federal budget	1.30	1.30	1.78	1.43	1.54	1.49	1.40
from budgets of the constituent entities of the Russian Federation	1.84	1.84	1.42	1.17	1.20	1.09	1.10
Federal Targeted Investment Programme — total	1.41	1.02	1.28	1.23	1.40	1.45	1.06
including:							
programme part	0.88	0.70	0.77	0.71	0.93	0.97	0.76
non-programme part	0.32	0.38	0.53	0.31	0.51	0.48	0.30

Source: Federal State Statistics Service (Rosstat); <http://faip.economy.gov.ru>.

The general trend is towards a greater participation of the banking sector in financing investment activities during the post-crisis period, but the figure for this is still below the pre-crisis level of 2007-2008. (Table 12). In 2013, the share of bank loans in the structure of funding sources was 9.3% having increased by 0.9% compared with the previous year. Changes in the structure of bank lending in the last three years are defined by the increasing volume and share of loans from Russian banks, which replaced loans from foreign banks. Compared to 2012, the loans from Russian banks increased by RUR 105.0bn, whilst loans from foreign banks decreased by RUR 27.4bn. (Fig. 28).



Source: Federal State Statistics Service.

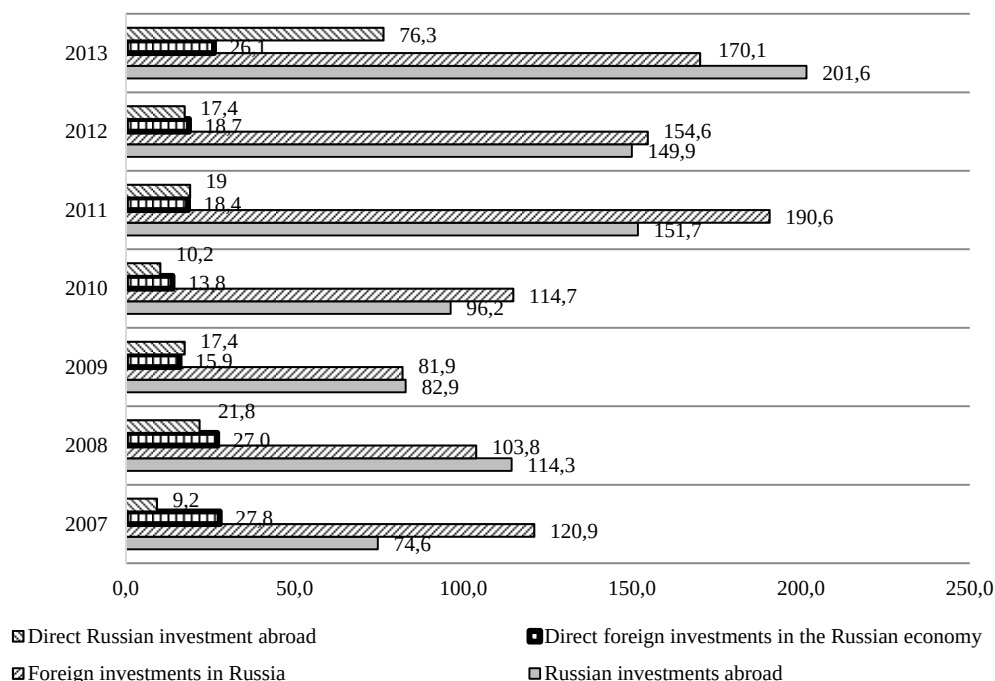
Fig. 28. Bank loans to finance investments in fixed capital in 2007-2013, Rb bn

The crisis of 2008 was characterised by even more rapidly falling rates of foreign investments into the Russian economy compared with the dynamics of domestic investment activities. The decline in foreign loans, while reducing the extent of foreign direct investments, has led to a steady fall in the share of total investments coming from abroad and in the structure of investments in fixed capital to its lowest level for the last 13 years – 2.2% in 2013, even though the volume of direct foreign investments into the Russian economy in 2013 had risen by nearly 40% over the previous year. The change in dynamics of the investment activities of Russian and foreign capital in Russia took place against a background of a sharp increase in net capital outflow. In 2011, the volume of capital exports reached \$81.4bn, which roughly corresponded to the sum of the previous two years. In 2012-2013 net capital outflow was in the range of \$54.6-60bn per year.

In 2013, the total volume of Russian investments abroad exceeded the volume of foreign investments in Russia by \$31.5bn (Fig. 29).

When analysing the sources of financing for investments in fixed assets, it should be noted that, in 2009, there was a turning point in the trend for residential construction. In 2010, after a steady increase in housing construction between 2001 and 2008, the commissioning of residential buildings decreased by 8.9%, moreover, the commissioning of residential buildings paid for by the public and with borrowed funds decreased by 6.9% compared with the pre-crisis level of 2008. The situation changed in the third quarter of 2011, when the commissioning of residential buildings increased. As a result, by the end of 2011 the growth in terms of commissioning of residential buildings was 6.6%, for 2012 and in 2013 was 5.6%

in comparison with the previous year. The proportion of individual house construction to overall residential construction in 2013 reached 43.8%, exceeding the pre-crisis level of 2008 by 1.1%.

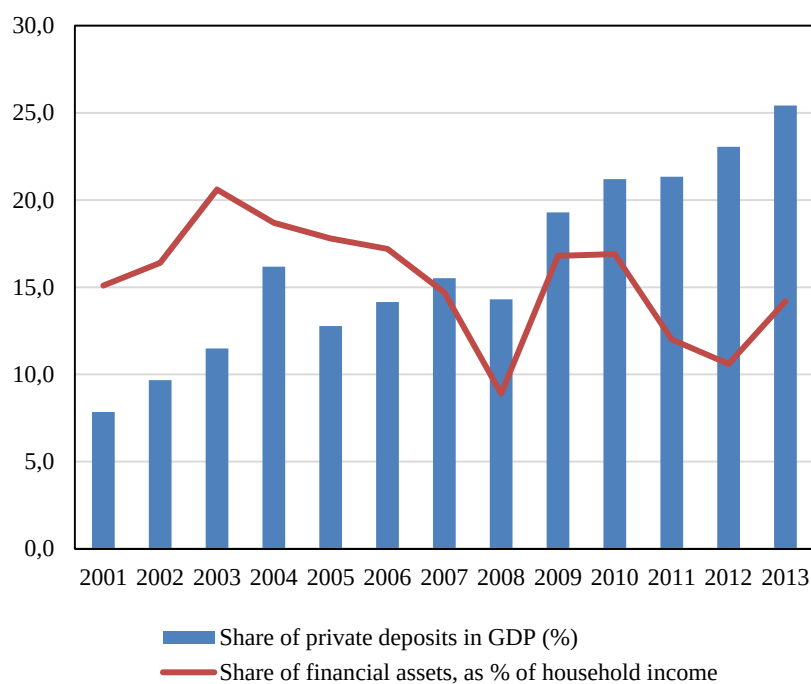


Source: Federal State Statistics Service (Rosstat).

Fig. 29. Volumes of Russian investments abroad and foreign investment into the Russian economy in 2007-2013, in \$ bn

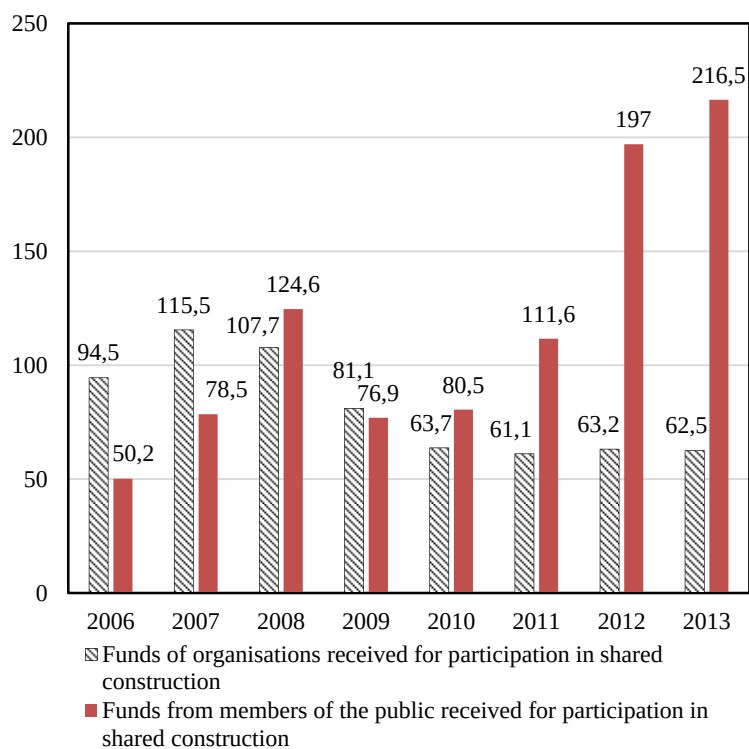
When analysing the dynamics and structure of sources of funding for investment, it is necessary to assess the investment potential of the population. As a result of the population's income growth over the past 10 years, both the volume of investments (deposits) from individuals in financial and credit organisations increased as did the volumes and share of financial asset in the growth of total income. It should be noted, however, that the growth of household savings and the increase in the proportion of savings in income was accompanied by the growth of organised forms of savings, and led to greater participation of households in the formation of investment resources. In 2008, the potential investment resources of households accounted for 14.3%, while in 2012 it was 23.1%, and in 2013, 25.4% of GDP (*Fig. 30*).

The investment activity of the population in 2010-2013 was supported by a growth in demand for loans at lower interest rates. Funds from the public received for use in shared construction have steadily increased over the last three years, and have compensated for the weakening investment activities of organisations (*Fig. 30*). The public remains active in the real estate market. The share of expenditures on the acquisition of real estate in 2013 amounted to 4.4% of household income, while the total amount of funds used to purchase real estate increased by 1.54 times in comparison with 2008.



Source: Federal State Statistics Service (Rosstat).

Fig. 30. Private investments (deposits) in financial and credit organisations and financial assets of the population in the period 2001-2013



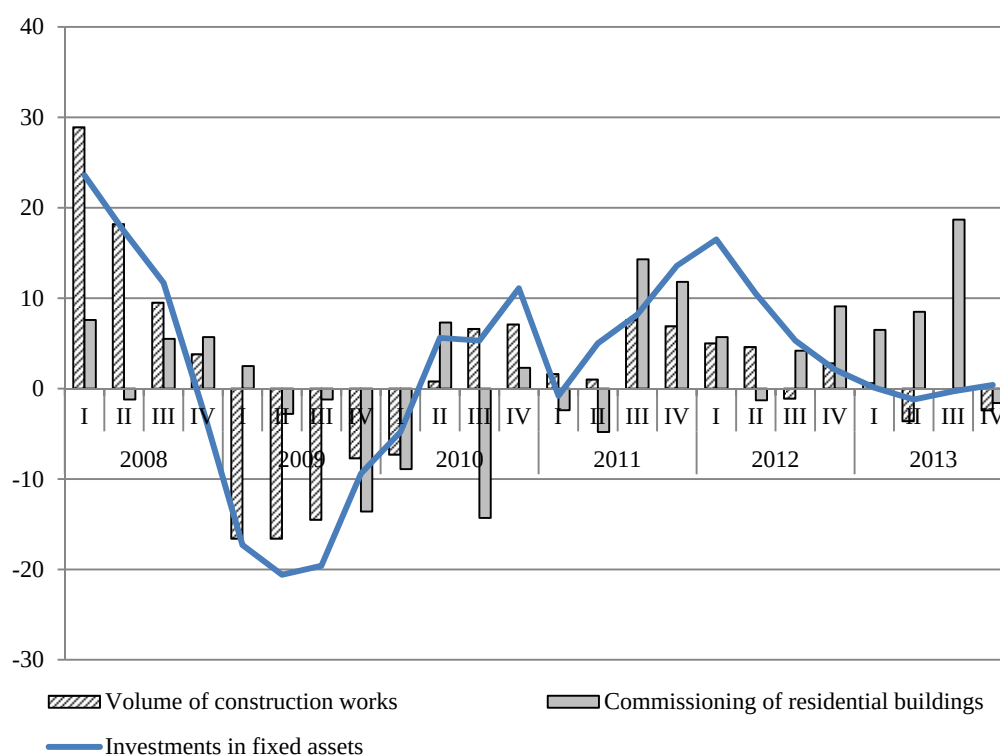
Source: Federal State Statistics Service (Rosstat).

Fig. 31. Funds received for participation in shared construction in 2006-2013, Rb bn

Investments in fixed capital by types of fixed asset and economic activity

The crisis of 2008-2009 radically changed the situation in the investment sphere. In 2009, there was a decrease in the rate of actual volume of investments in fixed assets by 15.7%, which significantly exceeded the decrease in output in basic economic activities (by 9.8%) compared with the previous year. The peak of the investment crisis passed in the first half of 2009, and, since the third quarter, there was a tendency towards a weakening of the decline of investments in fixed assets. However, by 2012, investments in fixed assets exceeded that of 2008 (by 3.2%). The dynamics of business activity in 2012 were extremely diverse, and after the investment growth in the first half of the year, its pace in the third and fourth quarters sharply decreased (*Fig. 32*).

In 2013, the downward trend of investments in fixed assets was quite predictable and was determined by the extremely low level of business activity in the second half of 2012. The stabilisation of investments in fixed capital in the first quarter of 2013, at the level of the previous year, gave way to a decline by 1.2% in the second quarter and by 0.3% in the third quarter (in comparison to the corresponding quarters of 2012). At the end of 2013, investments in fixed assets were at 99.8%, and the volume of works in the construction industry at 98.5% of those of the previous year.



Source: Federal State Statistics Service (Rosstat).

Fig. 32. Dynamics of investments in fixed assets in 2008-2013, as % of the corresponding quarter of the previous year

The dynamics of investment into fixed capital varies between large and small enterprises. While the total volume of investments in fixed assets in 2013 was reduced by 0.2 % in

comparison with the previous year, the investment in fixed capital by the large and medium-sized enterprise sectors decreased by 5.6% (*Table 14*).

Table 14

**Growth in the volume of investments in fixed capital
in 2009-2013, as % of the previous year**

	2009	2010	2011	2012	2013
Investments in fixed capital (for the full range of organisations, including adjustments for investments not observable by direct statistical methods)	84.3	106.0	108.3	106.6	99.8
Large and medium-sized organisations (investments in fixed assets, not including small businesses and investments, not observable by direct statistical methods)	82.56.7	105.1	110.4	100.7	94.4

Source: Federal State Statistics Service (Rosstat).

In 2013, the changes in the structure of investments in fixed assets, by type of economic activity, were determined by the sharp decline in construction and investment activity in the production and transportation sectors, the combined share of which accounted for nearly 70% of investments in the economy. Investments in transportation made up 88.5% of that in 2012, due, on one hand, to the completion of major investment projects in pipeline transport, and, on the other, to a reduction of investment in railway transport with the reduction in volume of freight turnover, and reduced financial performance.

Table 15

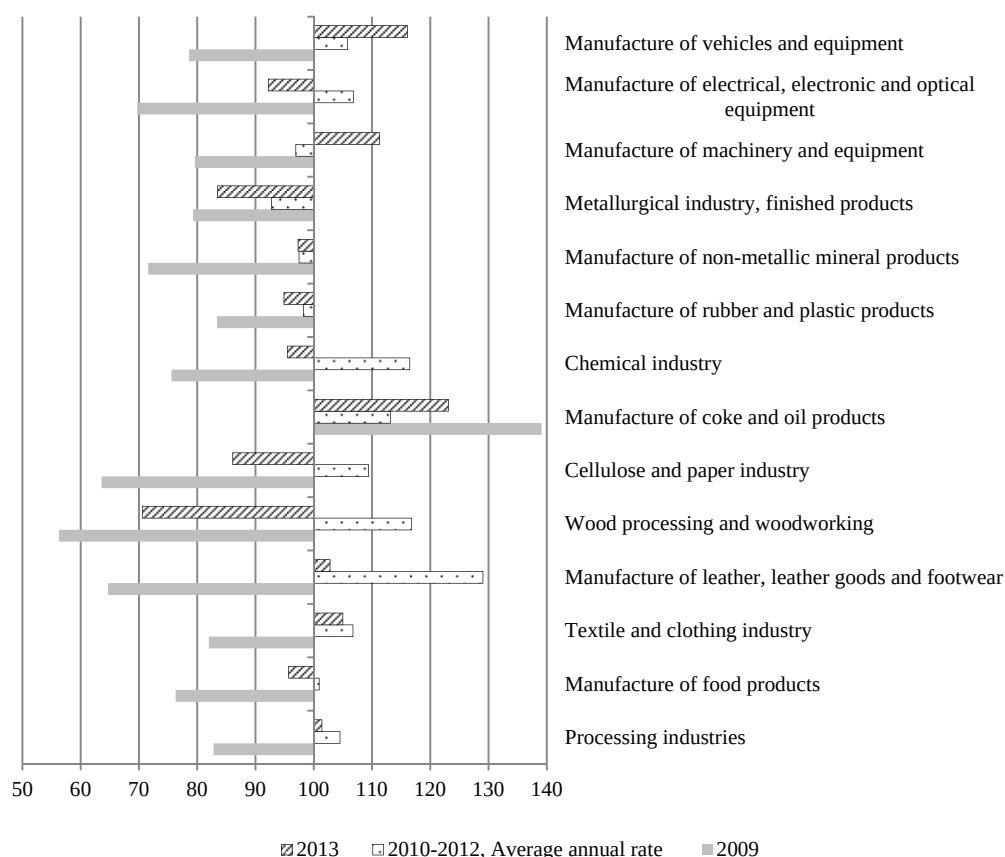
**Investments in fixed capital (excluding small businesses and investments,
not observable by direct statistical methods) in 2008-2013, as % of the previous year**

	2008	2009	2010	2011	2012	2013
Total	109.9	84.3	106.0	108.3	106.6	99.8
agriculture	98.8	78.1	89.1	114.6	92.8	96.0
fishing, fish breeding	88.1	88.1	108.8	137.4	127.4	77.4
production sector	109.9	90.7	106.1	110.9	107.4	96.8
mining	106.5	89.9	106.6	113.8	111.8	93.6
processing industries	112.5	82.8	101.5	105.3	106.7	101.4
production and distribution of electricity, gas and water	111.6	108.9	112.5	114.7	101.7	95.8
construction	126.2	69.9	110.9	90.6	79.9	84.0
wholesale and retail	93.1	79.2	120.2	90.0	107.1	103.1
hotels and restaurants						
transport and communications	116.1	103.5	102.4	118.3	98.4	88.5
financial activity	94.9	99.7	112.9	136.8	111.4	80.8
real estate operations,	109.5	73.7	125.4	91.9	100.8	104.4
public administration	118.3	134.8	115.2	112.4	98.7	93.7
education	108.6	93.0	84.9	122.0	85.2	77.9
health and social services	102.5	79.4	109.7	113.0	93.6	98.8
provision of other services	108.1	83.8	103.6	103.5	111.8	75.0

Source: Federal State Statistics Service (Rosstat).

In the production sector, investment in fixed assets accounted for 96.8% of the 2012 value. One peculiar feature of the investment process in 2013 manifested itself in the maintenance of the positive dynamics of investments in fixed assets in the manufacturing sector (101.4% compared with 2012) while there was a decrease of investment activities in mining (93.6%) and in the production and distribution of electricity, gas and water (95.8%) (*Table 15*). In 2013, growth of investments in the fixed assets for vehicle production (116.1%), the manufacture of machinery and equipment (111.3%) and the manufacture of coke and oil products (123.1%) outstripped the average level for manufacturing. In line with the established model of reproduction of fixed asset investment demand, mining production in

2013 exceeded the pre-crisis level of 2008 by 14.1%. In manufacturing, instability and the reduction of investment in fixed assets over the previous five years (*Fig. 33*) were the consequences of the acute investment crisis of 2008, as well as a lack of motivation to modernise production. In general, in manufacturing, investments in fixed assets in 2013 remained 4.2% below the pre-crisis level, with the exception of oil refining, the chemical industry and production of vehicles that made up almost half of the manufacturing investment demand.



Source: Federal State Statistics Service (Rosstat).

Fig. 33. Growth rate of fixed asset investments in the manufacturing industry in 2009-2013, as % of the previous year

In 2013, the structure of investments by type of fixed assets was transformed by means of increasing the volume and the share of investments in the construction of housing units, as well as machinery, equipment and vehicles whilst reducing the share of investments in non-residential buildings (*Table 16*). In the previous four years, there had been a gradual increase in the share of investment in the acquisition of domestic machines and equipment in the total volume of investments in fixed assets. In 2013, the share of imported machinery, equipment and vehicles in the total volume of investment in machinery, equipment, vehicles amounted to 16.1%. The growth of investment in imports compared to the dynamics of investment in fixed assets continued the trend of recent years and attests to the lack of development of the domestic production of capital goods.

Table 16

**Structure of fixed asset investments by types of assets in 2009-2013
(excluding small businesses and informal activity performance)**

	billion rubles					As % of the total				
	2009	2010	2011	2012	2013	2009	2010	2011	2012	2013
Investments in fixed assets	5,769.8	6,625	8445.2	8,446.2	9,493.4	100	100	100	100	100
including:	346.2	384.3	396.9	439.2	550.6	6	5.8	4.7	5.2	5.8
housing										
buildings (other than residential) and facilities	3,219.5	3,610.6	4,577.3	4,417.4	4,840.8	55.8	54.5	54.2	52.3	51
machinery, equipment, vehicles	1,800.2	2,179.6	2,896.7	3,006.8	3,366.5	31.2	32.9	34.3	35.6	35.5
of which:										
acquisition of domestically produced machinery, equipment and vehicles	1,427.5	1,787.3	2,357.9	2,519.7	2,825.2	24.7	27.0	27.9	29.8	29.8
acquisition of imported machinery, equipment and vehicles	372.6	392.3	538.8	487.1	541.3	6.5	5.9	6.4	5.8	5.7
Other	409.7	450.5	574.3	582.8	735.5	7.1	6.8	6.8	6.9	7.7

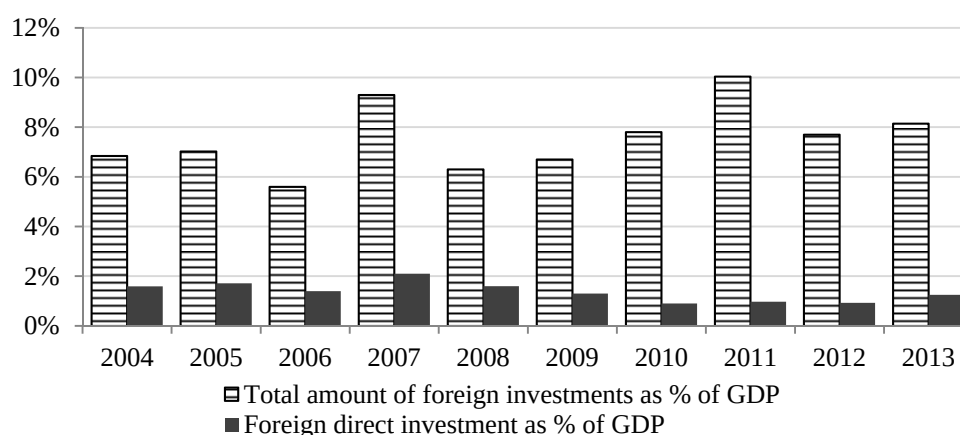
Source: Federal State Statistics Service (Rosstat).

The particular feature of the post-crisis development of the construction and investment complex manifests itself in the faster growth of investments in housing in 2012-2013 compared to the overall dynamics of investments in fixed assets and the construction of non-residential buildings. Positive dynamics of commissioning residential buildings were recorded in the second half of 2011 and evidenced some improvement of the situation with financing. In 2013, organisations of all types of ownership commissioned 69.4m sq m of residential space, which is 5.60% more than in the previous year. It should be noted, however, that the substantial gap which exists between the rates of putting buildings into service and the scope of construction work results from a reduction of required capacity, which will very probably lead to a further decline in the construction industry at the beginning of 2014.

4.3.2. Foreign investments

2013 was characterised by the increased activity of foreign investors in the Russian Federation in comparison with the previous year. Foreign investments into the Russian economy increased in 2013 by 10.1% compared to the \$170.2bn in 2012. In the form of the income of foreign investors transferred abroad, as well as from the payment of interest for using credits and paying off loans, \$127.2bn was withdrawn in 2013, or 74.7% of the volume of foreign investment during this period (in 2012 it was 88.3%). Compared to 2012, capital outflow in these areas decreased by 6.9%. In 2013, Russia's investments abroad reached \$201.6bn, which is 34.5% higher than in 2012 and constitutes 118.5% of the investments in the Russian economy (in 2012 it was 97.0%).

The level of foreign investments in the Russian economy has grown from 7.7% of GDP in 2012, to 8.1% of GDP in 2013 (*Fig. 34*).



Source: Federal State Statistics Service (Rosstat).

*Fig. 34. The level of foreign investment in the Russian economy
in 2004-2013, as % of GDP*

The dynamics of foreign investment in the Russian economy are shown in *Table 17*.

Table 17

Dynamics of foreign investments in the Russian economy¹

	In millions of dollars				As % of the previous year			
	Total	Direct	Portfolio	Other	Total	Direct	Portfolio	Other
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
2011	190,643	18,415	805	171,423	166.1	133.3	74.9	171.7
2012	154,570	18,666	1,816	134,088	81.1	101.4	2.3 times	78.2
2013	170,180	26,118	1,092	142,970	110.1	139.9	60.1	106.6

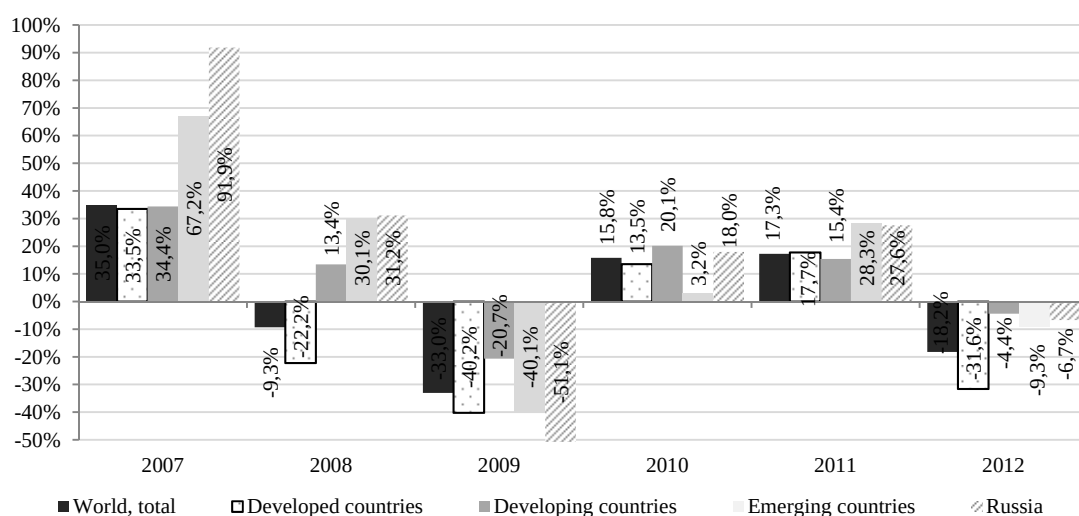
Source: Federal State Statistics Service.

In 2013, the total volume of foreign investments in the Russian economy increased due to the growth of the basic components – direct and other investments.

The main volume of direct investments fell within equity payments and loans from foreign co-owners of organisations. Following the results of 2013 the first grew by 7.9% to \$10.0bn, while the latter increased in 1.9 times to \$14.6bn. Thus, the share of loans from foreign co-owners in the structure of foreign direct investments in Russia rose from 41.1% in 2012 to 55.8% in 2013, and the share of equity payments decreased from 49.5% to 38.2%.

According to the report on investment activities by the UN Conference on Trade and Development (UNCTAD, World Investment Report 2013), published in June, 2013, and based on the volume of foreign direct investments in 2012, the Russian Federation reached ninth place in the world (according to verified data it was ninth in 2011; eighth in 2010 and sixth in 2009-2008). According to this report, in 2012, Russia accounted for 3.8% of world foreign direct investments (2011 – 3.3%, 2010 – 3.1%, 2009 – 3.0%, 2008 – 4.1%) and 6.5% of foreign direct investments into developing countries and countries with economies in transition (2011 – 6.6%, 2010 – 6.1%, 2009 – 6.1%, 2008 – 9.5%).

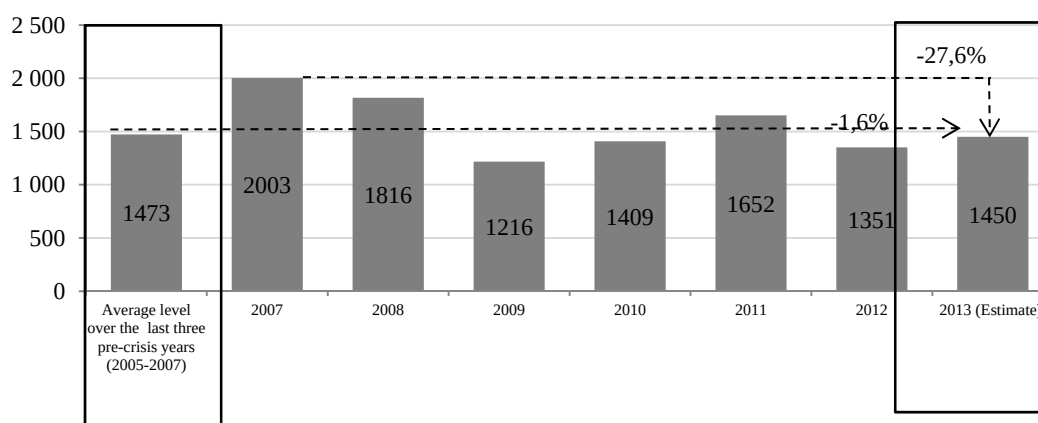
¹ Direct investments – investments in real assets, acquisition of a controlling interest or stock of shares, which gives the right to participate in management; portfolio investments – investments in securities aimed at generating income; other investments – investments made on a return basis (loans from international financial organisations, trade credits, etc.).



Source : UNCTAD, World Investment Report, June 26, 2013.

Fig. 35. Change (increase (+), decrease (-)) of the inflow of direct foreign investments in 2007-2012 compared with the previous year

According to the published UNCTAD report, total global foreign direct investment in 2012 was below the peak level of 2007. (Fig. 35 and 36). According to preliminary estimates, total direct foreign investments could reach \$1.45 trillion, in 2013, and in 2014 this amount will grow to \$1.6 trillion, reach \$1.8 trillion in 2015. This scenario is possible assuming the absence of serious problems in the world economy.



Source : UNCTAD, World Investment Report, June 26, 2013.

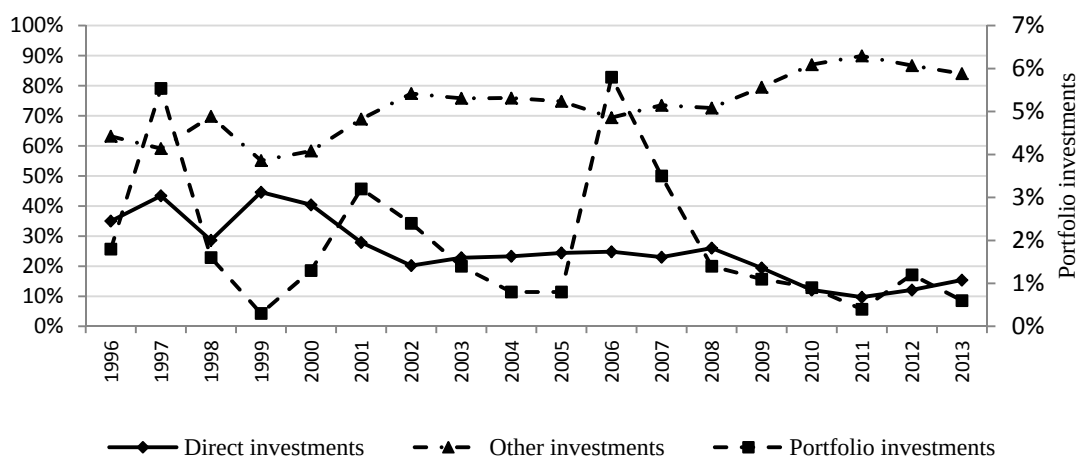
Fig. 36. Inflows of direct foreign investment in the world, billions of dollars

In the segment of portfolio investments in the Russian economy in 2013 there was a reduction in investments compared to 2012, by 39.9%. Moreover, their structure experienced a reduction of component investment in stocks and shares to 41.6% and, consequently, a reduction of its share from 84.4% in 2012 to 82.0% in 2013.

The proportion of trade credits in the structure of other investments fell from 20.9% in 2012 to 19.1% in 2013. According to their terms of attraction of financial resources, the share of loans with maturity more than 6 months increased in 2013 to 64.6% compared to 39.5% in

2012. The share of loans provided for a period of less than 6 months, in 2013, fell to 15.1% (in 2012 it was 33.2%).

Compared with the previous year, in 2013, the structure of foreign investments in the Russian economy changed (*Fig. 37*).



Source: Federal State Statistics Service.

Fig. 37. The structure of foreign investment into the Russian economy, 1996-2013

In 2013, the concentration of foreign investment in industry, commerce and finance remained the same, with these spheres of Russian economy accounting for 90.5% of the total volume of foreign investment into the Russian Federation (in 2012 it was 89.3%). Investor interest in the industrial and trade sectors increased amid the further decline of investments in transport and communications, real estate transactions and investments in financial activity.

The distribution of foreign investments in key sectors of the Russian economy is shown in *Table 18*.

Table 18

Sectoral structure of foreign investment in the Russian economy in 2011-2013

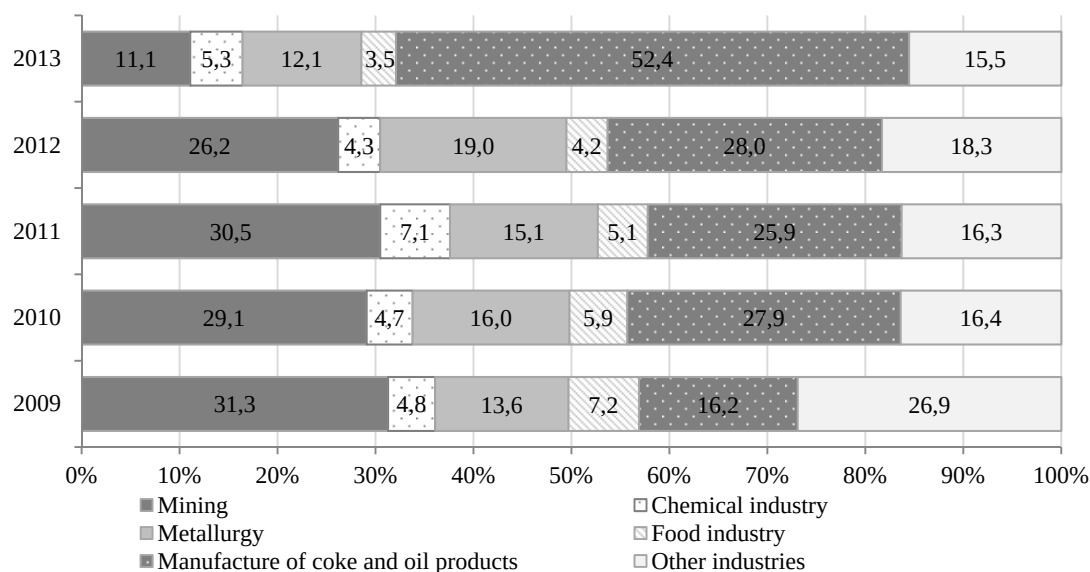
	Millions of dollars			Change as % of the previous year			As % of the total		
	2011	2012	2013	2011	2012	2013	2011	2012	2013
Industry	61,145	69,201	102,849	128.6	113.2	148.6	32.1	44.8	60.4
Transport and communications	5,943	4,622	4,759	90.4	77.8	103.0	3.1	3.0	2.8
Wholesale and retail; repair of motor vehicles, motorcycles, personal and household goods	24,456	25,379	31,030	183.4	103.8	122.3	12.8	16.4	18.2
Real estate transactions, renting and provision of services	9,237	10,035	9,717	125.8	108.6	96.8	4.8	6.5	5.7
Financial activity	86,885	43,395	20,121	229.2	49.9	46.4	45.6	28.1	11.8
Other industries	2,977	1,938	1,704	148.1	65.1	87.9	1.6	1.2	1.0

Source: Federal State Statistics Service (Rosstat).

In 2013, the leading growth sector within the structure of foreign investments in the production sector (*Fig. 38*) was the processing industry when compared with 2012, as investments in the processing industries rose by 82.4% (while in 2012, the growth was

19.8%). Foreign investments in the mining sector fell by 37.1% (in 2012, the reduction amounted to 2.6%).

In manufacturing industry, in 2013, investments in the production of coke and oil products increased by 2.8 times while in the steel industry they decreased by 5.1%, amounting to \$53.9bn and \$12.5bn respectively (in 2012, investments in the manufacture of coke and oil products rose by 22.4%, while in the metallurgical industry they increased by 42.2%). As compared to 2012, foreign investments in the chemical and food industries increased in 2013 by 84.7% and 25.8%, respectively to \$5.5bn and \$3.6bn (in 2012, there was a decline in these industries by 31.8% and 6.6%).



Source: Federal State Statistics Service (Rosstat).

Fig. 38. The structure of foreign investments in industry in 2009-2013

In comparison with 2012, direct and other investments in industry in 2013 grew, by 18.5% and 55.8% respectively (in 2012, direct investments in industry increased by 1.0%, with 'other investments' growing by 14.3%). Portfolio investments in industry fell by 56.0% (in 2012, they had increased 2.2 times). Thus, the share of 'other investments' in industry rose from 84.3% in 2012 to 88.3% in 2013, whilst that of portfolio investments decreased from 1.8% to 0.5% and the share of direct investment over the period decreased from 14.0% to 11.1%.

There were changes in the structure of foreign investments by type of industrial economic activity. In the mining sector, direct investments declined, in 2013, by 5.3% to \$3.3bn. Despite the decline, their share of total investments in this industry grew to 29.3% (in 2012 it was 19.4%). In 2013, the share of other investments in mining, which decreased by 8.1% and amounted to \$44.7bn had dropped to 70.5% (in 2012 it was 80.2%).

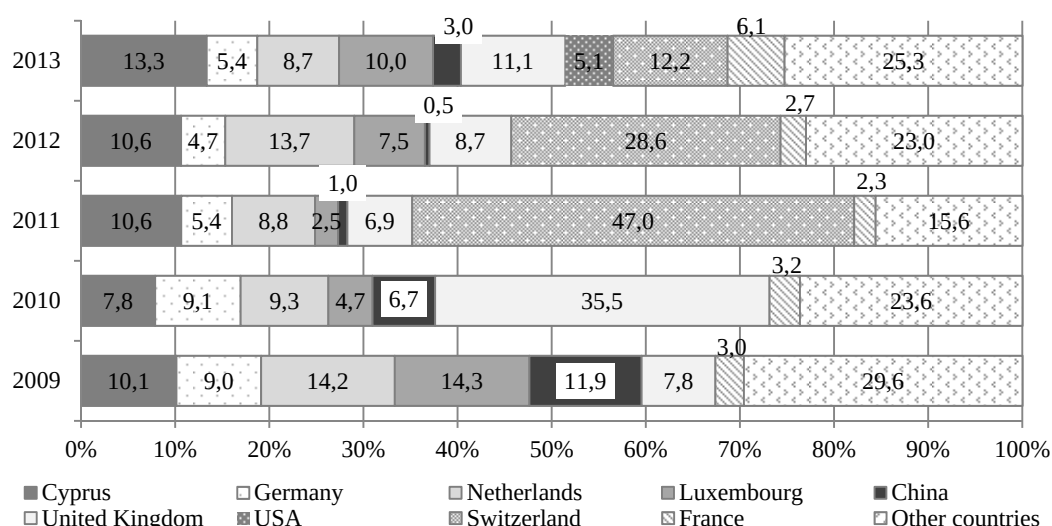
In 2013, the bulk of investment in the processing industry was also attributed to other investments, which, compared with 2012, increased by 91.9%, amounting to a total investment in manufacturing of 90.8% (in 2012 it was 86.3%). Direct foreign investments in the manufacturing sectors increased by 39.4%. In 2013, the share of direct investments in the manufacturing sector amounted to 8.8%, (in 2012, 11.6%). Portfolio investments in

manufacturing decreased 2.9 times, leading to a decrease in their share to 0.4% (in 2012 this was 2.1%).

In the geographical structure of foreign investments in the Russian economy in 2013, we should note the redistribution of countries in the list of major capital exporters to the Russian Federation (*Fig. 39*). In 2013, the largest volume, \$22.7bn, was sent from Cyprus, while Russia received more than \$20.7bn from Switzerland. The United Kingdom was amongst the top three leaders in terms of the supply of capital to Russia during 2013, its investments amounting to \$18.9bn.

According to the 2013 results, for the countries investing in the Russian economy the highest growth in investments are from China, an increase of 6.8 times compared with 2012 (to \$5.0bn), from France, an increase of 2.5 times (to \$9.7bn) and from Luxembourg, by 47.5% to (\$17.0bn).

Compared with 2012, investments from the United Kingdom increased by 39.8%, and from Cyprus and Germany, by 37.8% and 27.1%, respectively. Investments from Switzerland and the Netherlands over the period under review decreased by 53% and 30%, respectively. The differences in the dynamics of investments changed the geographical structure of foreign investments in the Russian economy.



Source: Federal State Statistics Service (Rosstat). Data on investments from the United States in 2009-2012, and from Switzerland in 2009-2010 are included in 'other investments'.

**Fig. 39. Geographical structure of foreign investments
in the Russian economy in 2009-2013**

As of 1 January 2014, the accumulated foreign capital, without taking into account monetary authorities, commercial and savings banks, including ruble-denominated investments converted into US dollars, amounted to \$384.1bn, which is 6.0% higher than the level as of 1 January 2013. The direct accumulated investments since the beginning of the year fell by 7.3% and portfolio investments, by 34.7% , while other investments increased by 16.0%.

According to the results of 2013, in terms of the total accumulated foreign investment, the leaders are Cyprus, the Netherlands, Luxembourg, the United Kingdom and China, the total share of these being 64.2%, (in 2012 it was 65.0%). At the same time, the share of the top five investors in the 'other investments' segment is estimated at 67.2%, (in 2012, 69.1%), and in

the structure of direct and portfolio investments: 58.8% and 50.5% (in 2012: 58.9% and 59.5% respectively).

The structure of foreign investments, accumulated as of the end of September 2013, is dominated by 'other investments', accounting for 65.7% (in 2012 it was 60.1%). The same indicator for direct and portfolio foreign investments amounted to 32.8% and 1.5% respectively (in 2012: 37.5% and 2.4%).

4.4. Oil and gas sector in 2013

Oil and gas comprise the main sector of the Russian economy that continues to play a key role in shaping the state budget revenues and the balance of trade. In 2013, against the background of continuing high global prices for oil and gas, petroleum production in Russia reached its highest level since 1990, and the export of oil and petroleum products reached a historic high. However, there was then a slowdown in petroleum production and a worsening of conditions for its production. In 2013, in order to create appropriate conditions for the further development of the oil and gas sector legislative solutions were adopted involving tax incentives for the development of resources where oil recovery was difficult, the differentiation of gas production taxation and the application of a special tax regime for deposits being developed on the continental shelf, together with a liberalisation of the export of liquefied natural gas (LNG).

4.4.1. Dynamics of global oil and gas prices

The situation in the global oil market in 2013 was characterised by the persistence of high oil prices. The average price of Brent crude in 2013 was 108.8 dollars/barrel, while the price of Russian Urals oil was 107.7 dollars/barrel on the global (European) market. (*Table 19, Fig. 40*). The main factors keeping the prices high were the increased demand for oil (*Table 20*) due to the growth of the world economy, primarily the economies of China and other Asian countries, the conservative policy of the OPEC oil-exporting countries in respect of increasing oil extraction, in addition to geopolitical risks. In 2013 the global demand for oil increased by 1.4%, while demand for oil in North America increased by 1.6% and in China by 3.0%. Global oil production rose by 0.7% in 2013. At the same time there was a noticeable growth of oil extraction by countries other than by those of OPEC (by 2.5%) mainly due to increases in oil extraction in the USA and Canada as a result of the development of unconventional oil reserves. Meanwhile the level of oil recovery by countries from OPEC decreased from 31.1m barrels per day in 2012 to 30.4m barrels per day in 2013, i.e. approaching OPEC's quota for oil recovery (30m barrels per day) established officially by OPEC at the end of 2011. As a result, the global oil market has remained broadly balanced.

Table 19

Global oil prices in 2000–2013 dollars/barrel.

	2000	2005	2006	2007	2008	2009	2010
Price of Brent crude, Great Britain	28.5	54.4	65.2	72.5	97.7	61.9	79.6
Price of Urals oil, Russia	26.6	50.8	61.2	69.4	94.5	61.0	78.3

Cont'd

	2011	2012	2013 I qtr.	2013 II qtr.	2013 III qtr.	2013 IV qtr.	2013
Price of Brent crude, Great Britain	111.0	112.0	112.9	103.0	110.1	109.4	108.8
Price of Ural oil, Russia	109.1	110.3	110.8	102.1	109.7	108.2	107.7

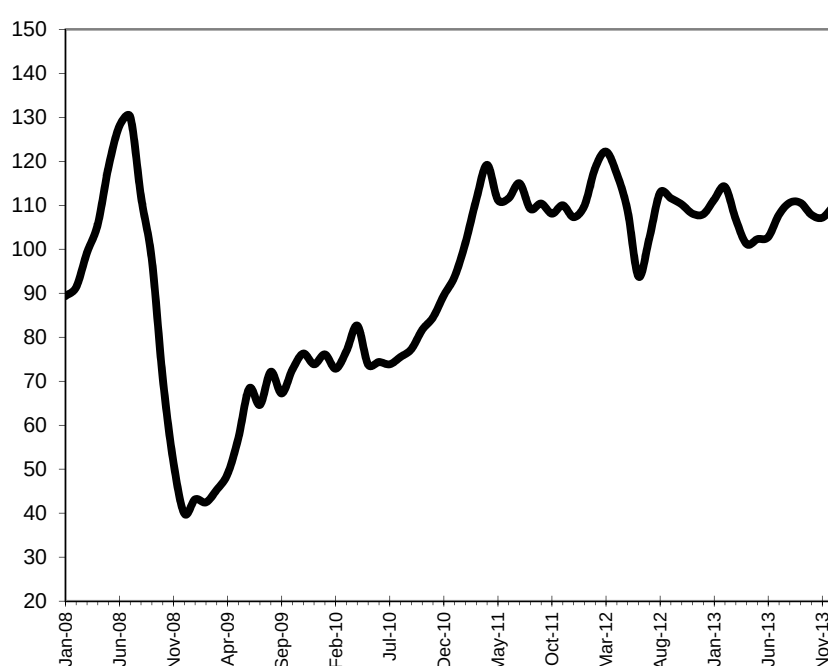
Source: IMF, OECD/IEA.

Table 20

Change in global demand for oil in 2008–2013 as a % of the previous year

	2008	2009	2010	2011	2012	2013
World, total	−0.6	−1.2	3.1	0.9	1.1	1.4
OECD countries	−3.6	−4.2	1.3	−0.8	−1.1	0.2
including:						
North America	−5.2	−3.7	2.0	−0.3	−1.4	1.6
Europe	−0.6	−4.7	−0.3	−2.3	−3.8	−0.7
Non-OECD countries	3.3	2.5	5.2	3.0	3.6	2.6
including:						
Asia (except for counties of the Middle East and former USSR)	1.7	4.4	7.9	3.2	3.9	2.6

Source: OECD/IEA.



Source: Russian Ministry of Economic Development.

Fig. 40. Price of Urals oil in 2008–2013 in dollars/barrel

The prices for Russian liquefied natural gas on the European market were also quite high, although lower than in 2012. The price for gas supplied under long-term contracts, is generally determined on the basis of the prices for energy derived from alternatives such as gasoil/diesel and fuel oil, the prices of which depend on the level of global oil prices. As a result, world gas prices follow global oil prices, although with a lag. Prices for Russian gas on the European market reached their highest level in 2008, while they were at their lowest in 2010. Between 2011–2012, with the growth of global oil prices, Russian gas prices on the European market increased considerably (*Table 21*). At the same time there was a changing situation in the European gas market, in particular the growth in gas supply (especially the considerable growth in supply of liquefied natural gas) from other gas producing countries, and the lower level of spot prices compared with the prices of long-term “Gazprom”

contracts. There was a resulting downward pressure on the price of Russian gas which subsequently forced “Gazprom” to reduce its price of gas on the European market.

Table 21
Global prices of oil and natural gas, 2005–2013

	2005	2006	2007	2008	2009	2010	2011	2012	2013
Average price of oil, dollars/barrel	53.4	64.3	71.1	97.0	61.8	79.0	104.0	105.0	104.1
Price of Russian gas on the European market, dollars/thousand m ³	212.9	295.7	293.1	473.0	318.8	296.0	381.5	431.3	402.0

Source: IMF.

4.4.2. Dynamics and structure of production in the oil and gas sector

In 2013 oil production in Russia reached 523.3 million tonnes, its highest level since 1990 (*Table 22, 23*). There had been a positive impact on the dynamics of petroleum production as a result of changes in the tax system and the coming on stream, in recent years, of several large new oil fields in Eastern Siberia (the Vankorskoye, Talakanskoye, Verkhnechonskoye and Tas-Yuryakhskoye fields) and in the northern European part of the country (the Yuzhno-Khylchuyusskoye field, and the Trebs and Titov fields). Also in 2013 the Prirazlomnoye oil field was put into operation in the Pechorskoye Sea and became the first oil field developed on the Russian arctic continental shelf.

As a result of active geological exploration work, the growth in identified oil reserves currently exceeds production. According to the Ministry of Natural Resources of the RF, in 2013 the increase in identified oil reserves in Russia was 688.8 million tonnes (in 2011 – 744.7 million tonnes and in 2012 – 742.7 million tonnes).

At the same time, there has been a significant decrease in the rate of oil recovery in recent years; which is primarily due to an objective worsening of production conditions. A significant proportion of the currently operating deposits are entering the stage of declining production whilst the new fields, are in most cases, characterised by poorer mining, geological and geographical parameters, requiring greater capital, operational and transport expenditure in their development.

As statistics show, the Russian oil industry is approaching the limit of its production capacity. In order to compensate for the decrease in oil recovery at the producing fields it is necessary both to develop new oil fields in regions either lacking, or with only poor infrastructure, and to exploit the lower quality reserves in the more developed regions.

Table 22
Petroleum production and refining in the Russian Federation in 2000–2013

	2000	2005	2006	2007	2008	2009	2010	2011	2012	2013
Oil recovery including gas condensates, millions of tonnes.	323.2	470.0	480.5	491.3	488.5	494.2	505.1	511.4	518.0	523.3
Primary oil refining, millions of tonnes.	173.0	208.0	220.0	229.0	236.3	236.0	249.3	258.0	270.0	278.0
Ratio of oil refining to its recovery, %	53.5	44.3	45.8	46.6	48.4	47.8	49.4	50.4	52.1	53.1
Oil conversion ratio, %	71.0	71.6	71.9	71.7	72.0	71.9	71.1	70.8	71.5	71.4

Source: Federal Statistics Service, Ministry of Energy of the RF.

At the same time in 2013 the rate of growth of oil refining remained higher than that of oil recovery; in general this was due to a rapid growth in exports of petroleum products,

stimulated by the lower export taxes for these compared with those for crude oil. As a result of this higher rate of growth of primary oil refining, the refining to recovery ratio increased from its 2004 value of 42.4% to 53.1% in 2013. However, during the same period the efficiency of oil refining did not increase, and in 2013 remained at 71.4% which corresponded to its 2005 level. The level of oil refining efficiency is currently close to its pre-reform value (in 1990 the oil refining efficiency in Russia was 67%) and is still much lower than in developed countries where the oil refining efficiency reaches 90-95%. In this respect raising the technological level of the oil refining industry is still one of the most pressing issues for the development of the oil sector of Russia's economy.

Table 23

**Production of oil, petroleum derivatives and natural gas in 2000–2013,
as % of the previous year**

	2000	2005	2006	2007	2008	2009	2010	2011	2012	2013
Oil including gas condensate	106.0	102.2	102.1	102.1	99.3	101.2	102.1	100.8	101.3	100.9
Primary oil refining	102.7	106.2	105.7	103.8	103.2	99.6	105.5	103.3	104.9	102.7
Petrol	103.6	104.8	107.4	102.1	101.8	100.5	100.5	102.0	104.3	101.3
Diesel fuel	104.9	108.5	107.0	103.4	104.1	97.7	104.2	100.3	98.7	103.1
Residual fuel oil	98.3	105.8	104.5	105.2	101.9	100.8	108.5	104.6	101.6	103.3
Natural gas	98.5	100.5	102.4	99.2	101.7	87.9	111.4	102.9	97.7	102.1

Source: Federal Statistics Service, Ministry of Energy of the RF.

In 2013 the largest amounts of oil were produced by “Rosneft”, “Lukoil”, “Surgutneftegas” and “Gazprom”. The share of these four companies reached 74.4% of the total oil recovery in the country. The share of medium-sized companies (“Tatneft”, “Slavneft”, “Bashneft” and “Russneft”) accounted for 13.0% of total oil extraction. In 2013 the operators of production sharing agreements produced 2.7% of Russian oil while the share of other manufacturers, including more than 100 small oil-recovery organisations, was 9.1% (*Table 24*).

In 2013 the state-owned oil company “Rosneft”, completed its acquisition, of the “TNK-VR” oil company from its owners, the AAR consortium and the British company BP. The total cost of this transaction was \$61bn, and was the most significant in the Russian oil and gas sector (previously the most significant one had been the transaction for purchasing 75.5% of “Sibneft” shares by “Gazprom”, at a cost of \$13.1bn, in 2005).

As a result of the acquisition of “TNK-VR” (including its share in “Slavneft”) representing 15.7% of total Russian oil production, “Rosneft” significantly strengthened its position in Russian oil sector and became one of the largest oil companies in the world. In 2013 oil extraction by the company (including its shares in recovery by other organisations) reached 202.4 million tonnes, or 38.7% of Russian oil recovery.

Table 24

Structure of petroleum production in 2008–2013

	Oil recovery, in 2008, m. t.	Share in total recovery, %	Oil recovery, in 2010, m. t.	Share in total recovery, %	Oil recovery, in 2012, m. t.	Share in total recovery, %	Oil recovery, in 2012, m. t.	Share in total recovery, %
1	2	3	4	5	6	7	8	9
Russia, total	488.5	100.0	505.1	100.0	518.0	100.0	523.3	100.0
Rosneft	113.8	23.3	112.4	22.3	117.5	22.7	192.6	36.8
LUKOIL	90.2	18.5	90.1	17.8	84.6	16.3	86.7	16.6
TNK-VR	68.8	14.1	71.7	14.2	72.5	14.0	–	–
Surgutneftegas	61.7	12.6	59.5	11.8	61.4	11.9	61.5	11.8
Gazprom + Gazprom neft	43.4	8.9	43.3	8.6	46.1	8.9	48.5	9.3
including: Gazprom	12.7	2.6	13.5	2.7	14.5	2.8	16.3	3.1

Cont'd

1	2	3	4	5	6	7	8	9
Gazprom нефт	30.7	6.3	29.8	5.9	31.6	6.1	32.2	6.2
Tatneft	26.1	5.3	26.1	5.2	26.3	5.1	26.4	5.0
Slavneft	19.6	4.0	18.4	3.6	17.9	3.5	16.8	3.2
Bashneft	11.7	2.4	14.1	2.8	15.4	3.0	16.1	3.1
Rusneft	14.2	2.9	13.0	2.6	13.9	2.7	8.8	1.7
NOVATEK	2.7	0.6	3.8	0.8	4.2	0.8	4.3	0.8
Operators of PCA	12.0	2.5	14.4	2.9	14.1	2.7	14.0	2.7
Other operators	24.1	4.9	38.2	7.6	44.1	8.5	47.6	9.1

Source: Ministry of Energy of the RF, estimates were made by the author.

“Gazprom” remains the main producer of natural gas. However its share in total Russian production has significantly decreased in recent years, i.e. from 83.2% in 2008 to 71.5% in 2013. (Table 25). At the same time the shares of other manufacturers, i.e. oil companies, “NOVATEK”, the PCA operators and others, increased. In general, the share of the independent producers in gas recovery reached 28.5% in 2013, including 7.7% by “NOVATEK”, the largest independent producer of gas.

Table 25

Structure of gas production in 2008–2013

	Gas recover in 2008, billion m ³	Share in total recovery, %	Gas recover in 2010, billion m ³	Share in total recovery, %	Gas recover in 2012, billion m ³	Share in total recovery, %	Gas recover in 2013, billion m ³	Share in total recovery, %
Russia, total	664.9	100.0	665.5	100.0	671.5	100.0	684.0	100.0
Gazprom + Gazprom нефт	553.1	83.2	513.9	77.2	489.4	72.9	489.1	71.5
including: Gazprom	550.9	82.9	509.0	76.5	478.5	71.3	476.3	69.6
Oil companies	54.8	8.2	66.6	10.0	71.1	10.6	76.8	11.2
NOVATEK	30.8	4.6	37.8	5.7	51.3	7.6	53.0	7.7
Operators of PCA	8.5	1.3	23.3	3.5	26.8	4.0	27.8	4.1
Other manufacturers	17.6	2.6	23.9	3.6	32.9	4.9	37.3	5.5

Source: Ministry of Energy of the RF, estimates were made by the author.

As a result of the acquisition of “TNK-VR” by “Gazprom” the state sector was significantly expanded. The share of state companies in Russian oil production reached 49.0% in 2013 (Table 26). It should be noted that in 2003, prior to the acquisition by “Rosneft” and “Gazprom” of the private oil companies “YUKOS” and “Sibneft” and the entry of “Gazprom” into the “Sakhalin-2” project, the share of state companies in Russian oil production was only 7.3%. In 2013 share of state companies in national gas recovery was 79.1%.

Table 26

Share of state companies in oil and gas recovery in Russia in 2013

	Oil recovery, million tonnes	Share in total oil recovery, %	Gas recovery, billion m ³	Share in total gas recovery, %
Rosneft	192.6	36.8	40.6	5.9
Share of Rosneft in recovery by other organisations (Slavneft, Sakhalin-1)	9.8	1.9	2.5	0.4
Rosneft including the share of Rosneft in recovery by other organisations	202.4	38.7	43.1	6.3
Gazprom including Gazprom нефт	48.5	9.3	489.1	71.5
Share of Gazprom in recovery by other organisations (Sakhalin-2)	2.7	0.5	8.8	1.3
Gazprom including Gazprom нефт and the share of Gazprom in recovery by other organisations	51.2	9.8	497.9	72.8
Zarubezhneft (recovery on Russian territory)	2.8	0.5	0.1	0.0
State companies, total	256.4	49.0	541.1	79.1

Source: Ministry of Energy of the RF, estimates were made by the author.

4.4.3. Dynamics and structure of oil and gas exports

In 2013 a further increase of oil exports together with a growth in oil extraction (*Tables 27, 28*). In 2013 net oil exports reached 383.9 million tonnes (an all-time high). 73.4% of that extracted was exported as crude oil or as petroleum products. The growth of oil exports was achieved due to an increase in the export of petroleum products (by 8.7% compared with 2012), while there was a decrease in the export of crude oil by 1.6% to 45.1% in 2013. Additionally, in 2013 the proportion of residual oil exported was greater than 90%, and of diesel fuel was 59.3%, of their production. In 2013 exports of petrol increased by 33.9% being 11% of production. (This compares with 18.5% in 2005, 8.2% in 2010, 10.6% in 2011; and 8.4% in 2012). At the same time, the import of petroleum products decreased (by 3.6% compared with 2012). The share of imports of petrol from all sources in 2012 was 1.3% (as compared with an average of 1.5% during 2010-2012). In 2013 the proportion of imports in resources of diesel fuel increased to 0.2% (in 2011 it was 1.1%, and in 2012 – 0.3%).

Table 27

Ratio of production, consumption and export of oil and natural gas in 2000-2013

	2000	2005	2006	2007	2008	2009	2010	2011	2012	2013
Oil, million tonnes										
Production	323.2	470.0	480.5	491.3	488.5	494.2	505.1	511.4	518.0	523,3
Export, total	144.5	252.5	248.4	258.4	243.1	247.4	250.4	244.6	239.9	236,6
Export to countries other than members of CIS	127.6	214.4	211.2	221.3	204.9	210.9	223.9	214.4	211.6	208,0
Export to members of CIS	16.9	38.0	37.3	37.1	38.2	36.5	26.5	30.2	28.4	28,7
Net export	138.7	250.1	246.1	255.7	240.6	245.6	249.3	243.5	239.1	235,8
Domestic consumption	123.0	123.1	131.2	124.1	130.4	125.3	125.9	140.7	142.1	137,5
Net export in % to production	42.9	53.2	51.2	52.0	49.3	49.7	49.4	47.6	46.2	45,1
Petroleum products, million tonnes.										
Export, total	61.9	97.0	103.5	111.8	117.9	124.4	132.2	130.6	138.1	151,4
Export to countries other than members of CIS	58.4	93.1	97.7	105.1	107.6	115.4	126.6	120.0	121.2	141,1
Export to members of CIS	3.5	3.9	5.8	6.7	10.3	9.0	5.6	10.6	16.9	10,3
Net export	61.5	96.8	103.2	111.5	117.5	123.3	129.9	127.2	136.8	150,0
Oil and petroleum products, million tonnes										
Net export of oil and petroleum products	200.2	346.9	349.3	367.2	358.1	368.9	379.2	370.7	375.9	385,8
Net export of oil and petroleum products as % of petroleum production	61.9	73.8	72.7	74.7	73.3	74.6	75.1	72.5	72.6	73,7
Natural gas, billion m³										
Production	584.2	636.0	656.2	654.1	664.9	596.4	665.5	687.5	671.5	684,0
Export, total	193.8	207.3	202.8	191.9	195.4	168.4	177.8	184.9	178.7	196,4
Export to countries other than members of CIS	133.8	159.8	161.8	154.4	158.4	120.5	107.4	117.0	112.6	138,
Export to members of CIS	60.0	47.5	41.0	37.5	37.0	47.9	70.4	67.9	66.0	58,4
Net export	189.7	199.6	195.3	184.5	187.5	160.1	173.5	179.2	171.6	189,3
Domestic consumption	394.5	436.4	460.9	469.6	477.4	436.3	492.0	508.3	499.9	494,7
Net export as a % of production	32.5	31.4	29.8	28.2	28.2	26.8	26.1	26.1	25.6	27,7

Source: Federal State Statistics Service, Ministry of Energy of the RF, Federal Customs Service; estimations were made by the author.

In 2013 exports of natural gas improved significantly (by 10.6% in comparison with the previous year). The main factor causing the decrease of gas exports in recent years has been a reduction in its supply to Europe where the market has seen a significantly increased proportion of supply from other gas-producing countries. As a result, in comparison with 2006 when the greatest quantity of Russian gas was supplied to Europe, 2012 saw a reduction

in the export of Russian gas to non CIS countries by 30.4%. At the same time the share of net exports of gas produced fell from 31.4% in 2005 to 25.6% in 2012. In 2013, due to a reduction in both own-gas recovery in Europe and the supply of gas from North America, exports of Russian gas reached the 2006 level, and the share of Russian gas on European market, including Turkey, increased from 26% in 2012 to 30.1% in 2013 (according to estimates by “Gazprom”). At the same time net exports showed an increase to 27.9% of gas production.

In order to expand the opportunities for Russian gas exports in 2013 a liberalisation of the export of liquefied natural gas (LNG) was stipulated by Federal Law № 318-FL as of 30.11.2013: “On amendments to articles 13 and 14 of the Federal Law “On the principles of state regulation of foreign trade activity’ as well as to articles 1 and 3 of the Federal Law ‘On the export of gas”” thus allowing the export of LNG not only by “Gazprom” but also by other Russian producers. There are currently plans for the construction of LNG production facilities by “NOVATEK” (project “Yamal LNG”) and “Rosneft”. There is the prospect of significantly increased LNG production in Russia in the future and its export to global markets.

Table 28

**Dynamics of oil, petroleum products and natural gas export by Russia
in 2005–2013 as a % of previous year**

	2005	2006	2007	2008	2009	2010	2011	2012	2013
Oil, total	98.4	98.0	104.0	94.0	101.8	101.2	97.6	98.2	98,6
including: to countries other than members of CIS	99.1	98.0	104.8	92.6	102.9	106.1	95.7	98.7	98,3
Petroleum products, total	117.9	106.3	108.0	105.0	105.3	106.2	98.5	104.4	109,6
including: to countries other than members of CIS	119.1	104.5	107.6	102.0	107.1	109.6	94.6	100.8	116,4
Gas, total	103.7	97.6	94.6	101.8	86.2	105.6	104.0	96.6	109,9

Source: Federal State Statistic Service.

Crude oil still dominates in the structure of oil exports at 61.2% of the total exports of oil and petroleum products. The main share of petroleum products being exported is of residual fuel oil and diesel fuel. Most of the energy resources (88% of oil, 94% petroleum products and 71% of gas) were exported beyond the borders of the CIS.

An analysis of the dynamics of Russian oil exports over a long period of time shows a considerable strengthening of the export orientation of oil sector in comparison with the pre-reform period. The share of the net export of oil and petroleum products from petroleum production increased from 47.7% in 1990 to 73.4% in 2013. However, one must take into account that this is connected not only with the absolute export volume but also with a significant decrease in the domestic consumption of oil due to the market transformation of the Russian economy and the replacement of residual fuel oil by natural gas. At the same time it should be mentioned that there was an increase in the proportion of petroleum products in oil exports: increasing from 18.2% in 1990 to 38.8% in 2013. (Table 29). Here it is also important to consider that the low efficiency of oil refining in Russia means that the majority of the petroleum products going for export is actually residual fuel oil, which is used in Europe as a raw material for further refining to produce light-petroleum products. In 2013, 55.6% of the total exports of petroleum products was residual fuel oil.

As a result of the physical growth of the export volume of petroleum products and natural gas the proportion of fuel and energy goods in Russian exports reached 70.6% in 2013, the share of crude oil being 33%, and of natural gas – 12.8%. (Table 30).

Table 29

Net export of petroleum products in 2005–2013

	2005	2006	2007	2008	2009	2010	2011	2012	2013
Net export of petroleum products, mln t	96.8	103.2	111.5	117.5	123.3	129.9	127.2	136.8	150,0
Share of petroleum products in net export of oil and petroleum products, %	27.9	29.5	30.4	32.8	33.4	34.3	34.3	36.4	38,9

Source: Federal State Statistics Service, Federal Customs Service; estimations were made by the author.

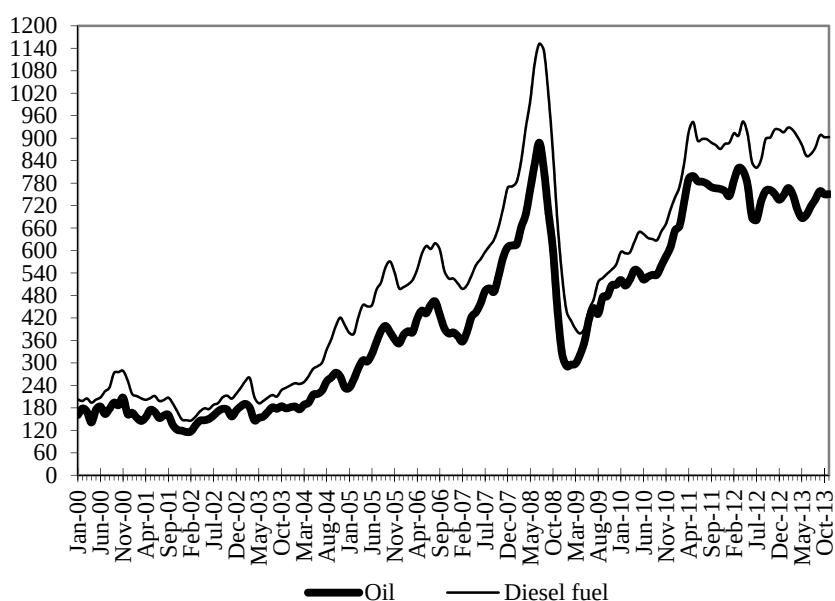
Table 30

**Cost and relative importance of export of fuel and energy goods
2005–2013**

	2005		2010		2012		2013	
	Billion US dollars	%*	Billion US dollars	%*	Billion US dollars	%*	Billion US dollars	%*
Fuel and energy goods, total	154.7	64.1	267.7	67.5	369.4	70.2	371.8	70.6
including:								
oil	83.8	34.7	134.6	34.0	180.9	34.5	173.7	33.0
Natural gas	31.4	13.0	47.6	12.0	63.0	11.8	67.2	12.8

* As % of total volume of Russian exports.

Source: Federal State Statistics Service.



Source: calculated according to data from the Federal State Statistics Service.

Fig. 41. Average prices for exported oil and diesel fuel in 2000–2013 dollars/tonne.

4.4.4. Dynamics of prices for energy products on the domestic market

The prices for oil and petroleum products on the Russian domestic market are basically determined by the corresponding global prices and these equal the yield supplies to the foreign and domestic markets, i.e. because net-back prices equal the global price after the deduction of customs export duty and the expenses for export shipment. In 2012–2013 due to an increase in global prices the prices for oil and light-petroleum products on the domestic

market also increased. These prices, however, are still lower than their highest levels of 2008 when the average domestic price for oil (producer price) reached USD 410.2 per tonne, and the average price for petrol reached USD 810.3 per tonne. (*Table 42, Fig. 43*). In fact the domestic prices for oil in Russia are still significantly lower than global prices. In 2013 the domestic price for oil (producer price) was approximately 45.5 dollars/barrel or 42.2% of the global price (price of Urals oil on the European market).

Table 31

**Domestic prices for oil, petroleum products and natural gas in US dollars
in 2000–2013 (average producer prices, dollars/tonne)**

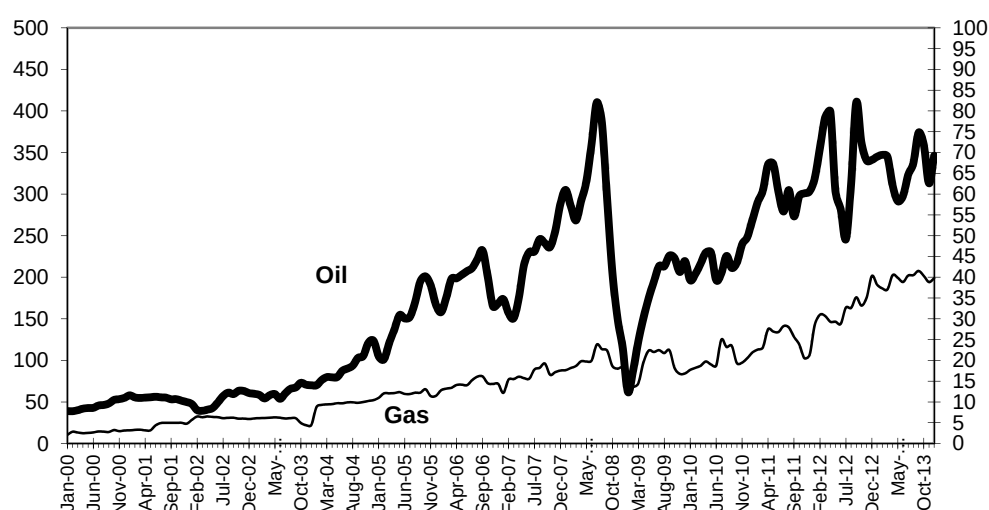
	2000 December	2005 December	2006 December	2007 December	2008 December	2009 December
Oil	54.9	167.2	168.4	288.2	114.9	219.3
Petrol	199.3	318.2	416.5	581.2	305.1	457.4
Diesel fuel	185.0	417.0	426.1	692.5	346.5	394.8
Residual fuel oil	79.7	142.7	148.8	276.5	125.0	250.8
Gas, dollars/thousand cu m	3.1	11.5	14.4	17.6	18.1	16.9

Cont'd

	2010 December	2011 December	2012 December	2013 June	2013 December
Oil	248.2	303.3	341.1	297.9	346.1
Petrol	547.9	576.9	628.7	566.6	614.4
Diesel fuel	536.1	644.9	774.2	596.4	698.0
Residual fuel oil	246.3	274.6	275.3	244.3	235.8
Gas, dollars/thousand cu m	20.5	21.3	40.3	38.9	39.8

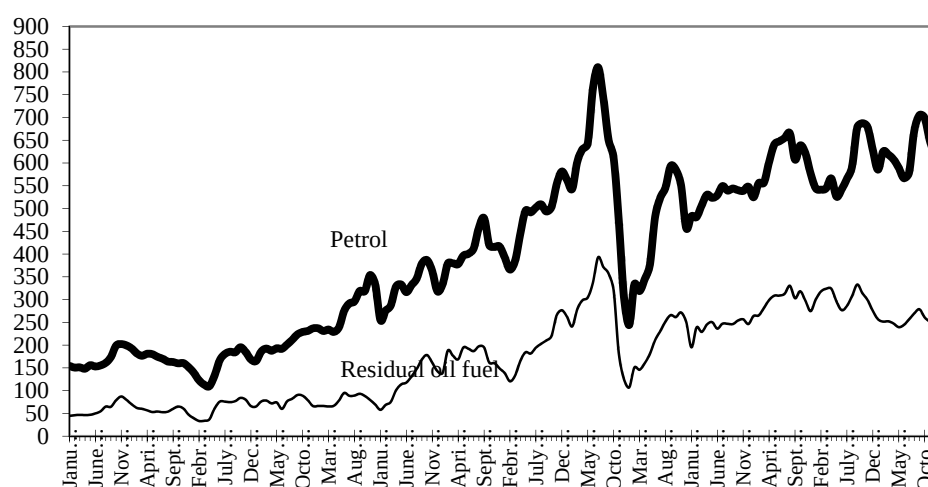
Source: calculations based on data from the Federal State Statistics Service

Domestic prices for gas are still subject to state regulation. In order to ensure the competitiveness of the national economy the government supports a significantly lower level of prices for domestic gas compared with the world price. In 2013 the domestic price (the price for purchasing gas by industrial consumers without indirect taxes) was on average 27.4% of the price for Russian gas on the European market.



Source: calculations based on data from the Federal State Statistics Service.

*Fig. 42. Average prices given by manufacturers for oil and gas in US dollars
in 2000–2013 dollars/tonne, dollars/thousand cu m*



Source: calculations based on data from the Federal State Statistics Service

Fig. 43. Average producer prices for petrol and residual fuel oil in US dollars in 2000-2013, dollars/tonne.

4.4.5. Tax regulation of the oil and gas industry

Alterations to tax regulations have ensured that a reduction of the tax burden and an increase in the flexibility of tax assessment have played key roles in the development of the Russian oil sector during recent years. In order to stimulate the development of new oil and gas fields located in undeveloped regions without any infrastructure, a tax holiday has been applied since 2007 in respect of MET, by using a zero rate of such tax, either for a predetermined period of time or until a specified extraction volume has been achieved. In order to stimulate in-depth development of fields where the reserve depletion is greater than 80%, a special reduction factor (Cd) has been applied to the basic rate of MET since 2007. To encourage the development of small fields a reduction factor Cr (Table 32) has been applied since 2007 in respect of fields with initial recoverable reserves of less than 5 million tonnes. Furthermore, reduced rates of oil export duty have been applied since 2009. At the end of 2011 the total rate of export duty for oil was reduced by applying a coefficient 0.60 instead of 0.65 for calculating the rate of export duty. Such measures, by decreasing the tax burden on the oil and gas industry, have thus positively influenced oil extraction.

Table 32

Rates of MET for oil extraction in 2005–2013

	2005	2006	2007	2008	2009	2010	2011	2012	2013
Basic rate of MET for recovery of oil, rubles/t.	419	419	419	419	419	419	419	446	470
Coefficient of dynamic of global oil prices (Cp)	(P _R – 9) x P/261				(P – 15) x P/261				
Coefficient related to level of reserve depletion of subsurface area (Cd)	–		3.8 – 3.5 x N/V						
Coefficient related to region's subsurface reserves (Cr)	–							0.125xV ₃ + 0.375	

Legends: P_R – average level of Urals oil price for tax period, dollars/barrel; P – average US dollar exchange rate against ruble stipulated by Central Bank of the RF for tax period; N – accumulated oil recovery on the

subsurface area; V – initial recoverable reserves of oil of classes A, B, C1 and C2 in the subsurface area; V_3 – initial recoverable reserves of oil, million tonnes.

Source: Tax Code of the RF (edition 2005-2013), Federal Law № 158-FL as of 22.07.2008, Federal Law № 151-FL as of 27.07.2006.

A significant event in 2013 was the adoption of Federal Law № 213-FL, as of 23.07.2013 “On amendments to part two of Chapters 25 and 26 of the Tax Code of the Russian Federation and article 3.1. of the Law of the Russian Federation ‘On Tax Rates’”. This law includes several measures to stimulate the development of hard-to-recover oil reserves and to establish a differentiation of MET rates depending on indicators representing the permeability of the reservoir, the size of the oil-filled formation and the degree of field depletion.

The law allows for the application of a special reduction coefficient C_r , representing the difficulty of oil recovery, to the MET rate. Depending on the parameters of the particular field (raw hydrocarbon deposit) the following values of the coefficient C_r have been established. (Table 33).

When oil is being recovered from a low-permeability reservoir, the established values of coefficient C_r are applied for 120 tax periods (10 years) starting from 1 January of the year when the extent of reserve depletion of that particular deposit exceeded 1%. Where oil is being recovered from deposits related to the productive sediments of the Tyumen Formation and to the Bazhanov, Abalakskiy, Khadumskiy and Domanikov productive sediments, the established values of coefficient C_r are applied for 180 tax periods (15 years) with effect from 1 January of the year when the extent of reserve depletion of that particular deposit exceeded 1%.

Table 33

Coefficient characterising the difficulty of oil recovery (C_r)

	Value of coefficient C_r
When oil is recovered from a deposit related to the productive sediments of the Tyumen Formation	0.8
When oil is recovered from a deposit with a permeability of not more than $2 \cdot 10^{-3}$ micron ² and efficient thickness of oil-filled layer greater than 10 m	0.4
When oil is recovered from deposit with permeability not more than $2 \cdot 10^{-3}$ micron ² and efficient thickness of the oil-filled layer of less than 10 m	0.2
When oil is recovered from a deposit related to the Bazhanov, Abalakskiy, Khadumskiy and Domanikov productive sediments.	0

Source: Federal Law № 213-FL, as of 23.07.2013.

To determine the values of the coefficient C_r , the applied parameters of permeability and efficient thickness of the oil-filled layer for raw the hydrocarbon deposits are those as indicated in the state balance of mineral reserves.

At the same time, for the purposes of administering the tax, the following special requirements are established for indicating the quantity of oil recovered from deposits where the coefficient C_r is applied:

- A record of the amount of recovered oil must be kept for each well working the deposit;
- Measurement of the quantity of liquid recovered from well together with a determination of its physical and chemical properties must be carried out for each well working the deposit at least 4 times per month.

Federal Law № 213-FL also stipulates a special coefficient C_{dv} , characterising the extent of depletion of the reserves in particular deposits of raw hydrocarbons. In the case of a high level of reserve depletion in a particular deposit (more than 80%) this coefficient is decreased and its value is calculated using a special formula.

Thus, 5 coefficients representing the main rent-forming factors are applied to the basic rate of MET:

- 1) coefficient C_p characterising the dynamics of global oil prices;
- 2) coefficient C_d characterising the extent of reserve depletion of each particular oilfield;
- 3) coefficient C_r characterising the amount of reserves in a particular oilfield;
- 4) coefficient C_r characterising the degree of difficulty of oil recovery;
- 5) coefficient C_{dv} characterising the extent of reserve depletion in a particular deposit of raw hydrocarbons.

The application of coefficient C_p allows the level of taxation to take into account the global oil price which determines the gross income of the producer. This coefficient is applied for all fields. The other coefficients are applied to reduce the tax burden in respect of those fields characterised by high expenses for their development (depleted fields, small fields and hard-to-recover reserves). The higher expenses related to the development of such fields are taken into account by means of the application of a lower tax rate.

It should be mentioned that shale oil currently has a C_r coefficient of zero, the same as that of the productive deposits. Reserves of such oil are actively being developed in the USA at present. However, in Russia they remain undeveloped though there are many such reserves in the country and the bulk of them are located in regions which have already been developed, primarily Western Siberia.

Amendments to Law № 5003-1, as of 21.05.1993, "On tax tariffs" were adopted by Federal Law № 213-FL. In accordance with these, oil recovered from fields in which the initially recovered oil reserves are classed as being similar to the productive deposits of the Tyumen Formation, where the initially recovered oil reserves of the field equal 0.8, are included in the list of oil types to which specific formulas are applied for calculating the relevant export tax duties. In accordance with such formulas, reduced export tax duties are established for oil from such fields.

Currently, special formulas to calculate export tax duty rates are applied to high-viscosity oil as well as to oil recovered from the fields located in Eastern Siberia (within the borders of the Sakha Republic (Yakutia), the Irkutsk Region and Krasnodarskiy Territory), the Nenets Autonomous Area and the Yamalo-Nenets Autonomous Area north of latitude 65 degrees, in the Caspian Sea and on the continental shelf.

There are plans to increase the rate of MET during 2014–2016 and these should compensate for the reduced rate of oil export tax. Federal Law № 263-FL, as of 30.09.2013, "On amendments to Chapter 26 of part two of the Tax Code of the Russian Federation "On tax tariffs" determines an increase in the basic rate of MET for oil recovery (from 470 Rb/tonne in 2013 to 559 Rb/tonne in 2016) with a decrease in the coefficient in the formula to calculate the rate of export tax duty for oil from 0.60 to 0.55. (Table 34).

Table 34

Rates of MET and export duty for oil in 2013-2016

	2013	2014	2015	2016
Basic rate of MET for oil recovery, rubles/tonne	470	493	530	559
Oil export duty coefficient used in the formula for calculating the rate of export duty	0.60	0.59	0.57	0.55

Source: Federal Law as of 30.09.2013 № 263-FL as of 30.09.2013.

There is one further important issue concerning the rates for export duties. In order to ensure the efficiency of oil refining and the export of petroleum products, such rates are set at a lower level than the rate for export duty on oil. This stimulates the growth of oil refining

within the country and the export of petroleum products. However, recent years have shown that such a differentiation of export duties has hardly stimulated growth in the depth of oil refining. In 2013 oil refining efficiency in Russia was 71.4%, i.e. it has not increased within the last 10 years. In fact the Russian export of petroleum products increased during recent years mostly due to an increase in the export of residual oil, which is used in Europe as a raw material for further refining to obtain light petroleum products.

In order to stimulate modernisation of the Russian oil refining industry and to increase oil refining efficiency, the Russian Government adopted several solutions providing successive increases in the rate of duty for residual oil exports from 39% (average level from 2006-2010) to 66% of the rate of export duty for crude oil. (*Table 35*). Such increases in the rate of export duty for residual oil failed, however, significantly to influence the situation; the production and export of residual oil have continued to grow, whilst oil refining efficiency has actually remained unchanged.

Table 35

Rates of export duties for oil and petroleum products in 2011–2016

	From 1 January 2011 until 30 April 2011	From 1 May 2011 until 30 September 2011	From 1 October 2011 until 31 December 2013	2014	2015	2016
Oil*	0.65	0.65	0.60	0.59	0.57	0.55
Commercial petrols, straight-run petrol **	0.67	0.90	0.90	0.90	0.90	0.90
Diesel fuel, light distillates, medium distillates **	0.67	0.67	0.66	0.65	0.63	0.61
Residual oil, lubricating oils and others**	0.467	0.467	0.66	0.66	1	1

* Coefficient in formula for calculating the rate of export oil duty with marginal rate is defined by the formula $29.2 + 0.65 \times (P - 25) \times 7.3$, where P is the price of Urals oil, dollars/barrel, in accordance with the RF Law № 5003-1 “On tax tariffs” and with a price of Urals oil exceeding 25 dollars/barrel.

** Coefficient with respect to the rate of export duty for oil.

Source: Federal Law as of 30.09.2013 № 263-FL, Resolutions of Government of the RF as of 27.12.2010 № 1155, as of 26.08.2011 № 716.

It should also be noted that the Russian government has announced an increase in the rate of export duty for residual oil from 2015 to match the rate of export duty for crude oil and that this has prompted the oil companies to begin modernisation of their oil refining capacity. Currently oil companies have implement special programmes to modernise oil refining capacity which have been agreed with the federal authorities, the execution of which should significantly improve both the level of technology in the oil refining industry in Russia and its efficiency.

A key point in tax regulation has been the significant strengthening of the tax burden on the gas sector as a result of phased increases in the MET rate for natural gas, from 147 Rb/thousand cu m in 2010 to 622 Rb/thousand cu m in the second half of 2013. Such an increase allowed the government to obtain more of the gas rent generated by this sector. An OPGT reduction coefficient (in 2013 the coefficient was 0.455) has been applied to the independent producers which, unlike “Gazprom”, have no income from the shipment and export of gas.

In 2013 Federal Law № 263-FL as of 30.09.2013 “On amendments to Chapter 26 of part two of the Tax Code of the Russian Federation and article 3.1 of the Russian Federation ‘On tax tariffs’” introduced essential alterations to the system of tax assessment for the gas sector. This law defined a new procedure to determine the rate of MET for natural gas and gas

condensate recovery, by means of new formulas and coefficients which take into consideration various factors influencing the production profitability and sale of gas condensate. This order will come into force from 1 July 2014.

In accordance with the new procedure for calculating the MET rates for natural gas and gas condensate, several essential rent-forming factors will be taken into account, including the prices for natural gas on the external and domestic markets, the prices for gas condensate, the price for Urals oil, the level of oil export duty, the US dollar to ruble exchange rate, the proportion of gas in the total amount of product recovered from raw hydrocarbon deposits, the extent of reserve depletion of the subsurface area, the geographical location of the subsurface area, the depth of the raw hydrocarbon deposit and the specifics of the development of the individual oilfield deposits.

The procedures adopted to determine the rate of MET for natural gas will allow a significant increase in the efficiency of the tax system for the gas sector. The current tax system, based on a single undifferentiated rate of MET for natural gas is very inefficient, both in terms of the security of government revenues and from the point of view of creating favorable conditions for investment in developing the fields.

The new procedure for determining the rate of MET for natural gas allows for a consideration of the main factors determining the profitability of production and the sale of gas and for ensuring the required differentiation of the tax burden, depending on the particular conditions for the development of each individual field.

2013 saw the adoption of Federal Law № 268-FL as of 30.09.2013 “On amendments to the first and second parts of the Tax Code of the Russian Federation and particular legislative acts of the Russian Federation to stimulate the recovery of raw hydrocarbons on the continental shelf of the Russian Federation by means of measures taken with respect to tax and custom tariffs”. This law determines the special preferential tax regime for the development of new off-shore fields. This regime is based on an ad valorem reduction in the MET rate, differentiated in accordance with the areas of shelf involved and standard tax on profits. The rates of MET determined for this regime are 30%, 15%, 10% and 5% depending on the shelf areas (categorised by project complexity). No export tax duty will be imposed on exported products and property related to the off-shore projects.

The Russian oil extraction industry is currently nearing its production capacity. Oil recovery in the developed regions, including Western Siberia, the main oil production region of the country, is currently falling due to the depletion of the fields located there. In order to compensate for this reduction in oil recovery it is necessary to develop new fields both in regions with undeveloped infrastructure, including the fields on the continental shelf, and the unexploited, poorer quality reserves in the developed regions.

The development of new fields and the hard-to-recover reserves incurs substantially higher production expenses, and within a common tax assessment would be uneconomic. In this regard, the adoption of the above legislative solutions in respect of the tax assessment of the oil and gas industry is extremely important. This will allow the development of a significant proportion of the raw hydrocarbon reserves which are currently undeveloped, thus maintaining the levels of oil and gas recovery in the country.

4.5. Russian agriculture: the first year within the World Trade Organization

4.5.1. General outline of agricultural performance

On the eve of Russia's accession to WTO the debate held in the country about possible adverse effects of this step grew more fierce. The main hazard for Russian farm producers was considered to be the commitment to reduce import duties: from the moment of accession the average maximum duties on agricultural items were to be cut from 13.2% to 10.8%¹. The system applied in Russia prior to entering WTO envisaged support to agriculture primarily by means of transfers from final consumers who paid higher prices (as compared with the world ones) for most farm products. The lowering of duties and consumer transfers implies an actual curtailment of aggregate support to domestic producers. The reduction of risks and preservation of the existing level of aggregate support to Russian farm producers would require an increase of their budget support. But such policies would be in disaccord with the current budget capabilities and potentially would contradict the terms of the country's accession to WTO restricting amber box² protection measures.

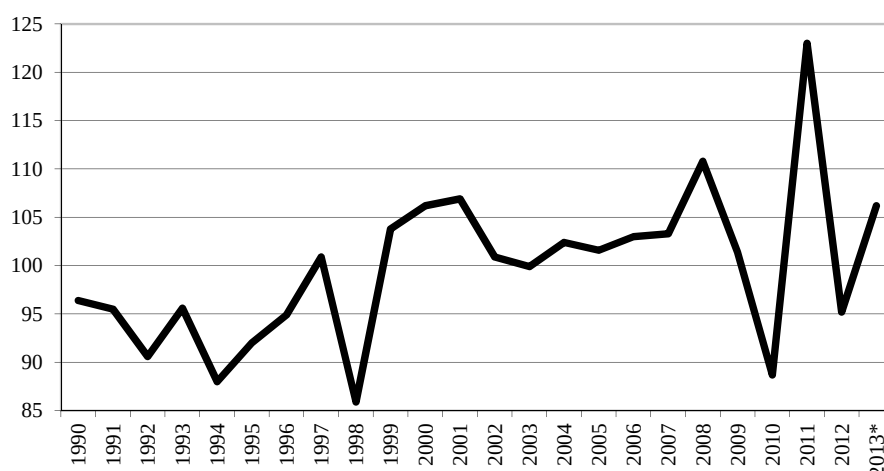
Formally, at the federal level Russia applies long-term mechanisms of state support to farm producers – the financing should comply with the guidelines and amounts envisaged by a regular State program for agricultural development and regulation of agricultural, input and food markets (hereinafter – the State Program) in effect within a particular period (2008-2012, 2013-2020). But in 2013 the mechanisms of support were altered as regards both volumes and directions. In particular, selected sectors still got additional support in excess of the limits stipulated in the State Program³. The allotment of extra budget funds was not directly linked to the WTO accession but was substantiated by the worsening performance of selected sectors following the accession and by the unfavourable conditions of 2012.

Judging by production indicators, 2013 was a better year for agriculture as compared with 2012: its gross output exceeded that of 2012 by 6.2% (*Fig. 44*). But this was due not to a sustainable trend but to poor indicators of the previous year against which the 2013 performance looked better.

¹ Tariff rates for meat products (beef, pork, poultry meat) differ depending on whether the deliveries fall within the quota or are made out of quota. Within the quota the tariff rate for beef is 15%, in excess of it – 55% (for pork – 0% and 65%, respectively). A matter of concern was the abolition of customs duty on import of live pigs. The lowering of specific duties is to be enacted at different dates – some of them come into force at once, others – within the period from 2 to 8 years after the moment of Russia's accession to WTO.

² Traditional measures of support applied in Russia are mostly those regarded as so called amber box tools. See: Shagayda N.I. *Otsenka byudzhetykh raskhodov i byudzhetnoy podderzhki v sel'skom khozyaystve Rossii* [Estimate of budget expenditures and budget support in Russian agriculture] // *APK: ekonomika, upravleniye* [Agro-industrial complex: economy, management]. No. 12, 2012, pp. 14-22.

³ In 2013 the financing envisaged by the State Program was increased by nearly 30%. A part of additional funds was allocated to the reimbursement of expenditures of pig, poultry and egg producers on the purchase of feeds, the prices for which grew due to the unfavourable weather conditions in 2012.



* - 10 months.
Source: Rosstat.

Fig. 44. Index of agricultural production in all types of farms
(in comparable prices, as % of the previous year)

As compared with 2012, the output of grain in 2013 increased by 30%, the output of sunflower seeds – by 11%. The production of sugar beets that used to develop quite dynamically, in 2013 notably fell – by 18% (*Table 36*). The cause of this decrease is to be sought in the change of prices for sugar and the consequent lowering of potential incomes from production of sugar beets resulting in the reorientation of producers towards growing of grains and oilseeds that were more lucrative that year. Grain crops and sunflower seeds compete with sugar beets for areas in the main regions producing this crop.

Table 36

**Gross output of basic farm crops in farms of all types,
1,000 tons (annual average)**

	1990–1995	1996–2000	2001–2005	2006–2010	2011–2013	For reference:	
						2012	2013*
Grains and legumes	92737	65097	78832	85190	85483	70908	91329
Flax fiber	72	38	53	45	64	46	38
Sugar beets	23440	14023	18530	27130	43482	45057	37747
Sunflower seeds	3158	3330	4507	6313	9298	7993	10204
Potatoes	35798	31834	28359	27315	30801	29533	30189

* - preliminary data.

Source: Rosstat.

Table 37 shows the production dynamics for basic livestock products in corporate farms¹.

In 2013 the process of putting in operation large pig and poultry complexes went on resulting in the increase of overall production of meat despite the continuing decline of beef production in corporate farms. The increase of pork output exceeded 15%, that of poultry meat was about 10%. The most part of these products are produced in corporate farms (*Fig. 45*).

¹ The data for all types of farms is not available.

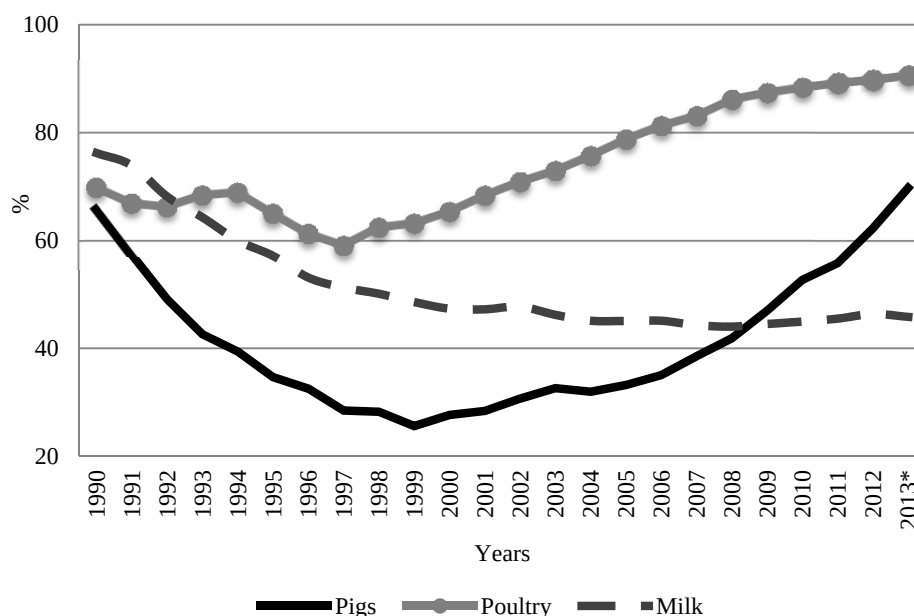
Table 37

**Production of basic livestock products in corporate farms,
1,000 tons (annual average)**

	1990–1995	1996–2000	2001–2005	2006–2010	2011–2013	For reference:	
						2012	2013*
Slaughter livestock and poultry (slaughter weight)	5087	1994	2112	3428	5392	5415	6002
including:							
Cattle	2638	1049	761	592	528	533	538
Pigs	1332	447	510	888	1652	1594	2007
Sheep and goats	143	30	15	15	17	17	17
Poultry	925	440	809	1917	3192	3255	3463
Milk	31758	16825	15051	14270	14398	14752	14048
Eggs (million pieces)	30782	22858	26307	29307	32286	32768	32241

* - preliminary data.

Source: Rosstat.



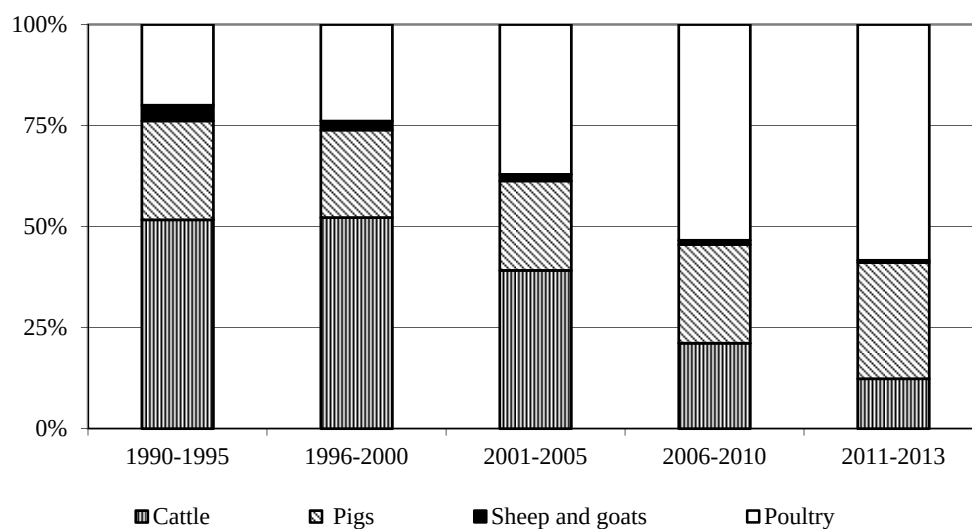
* - preliminary data.

Source: Rosstat.

Fig. 45. Share of corporate farms in production of basic livestock products as % of the aggregate output

In spite of all the efforts of state to stimulate production of milk, in 2013 its output was down 4.7% as compared with 2012. A sharp increase of pork and poultry meat output in corporate farms resulted in a noticeable shift in meat production structure (*Fig. 46*).

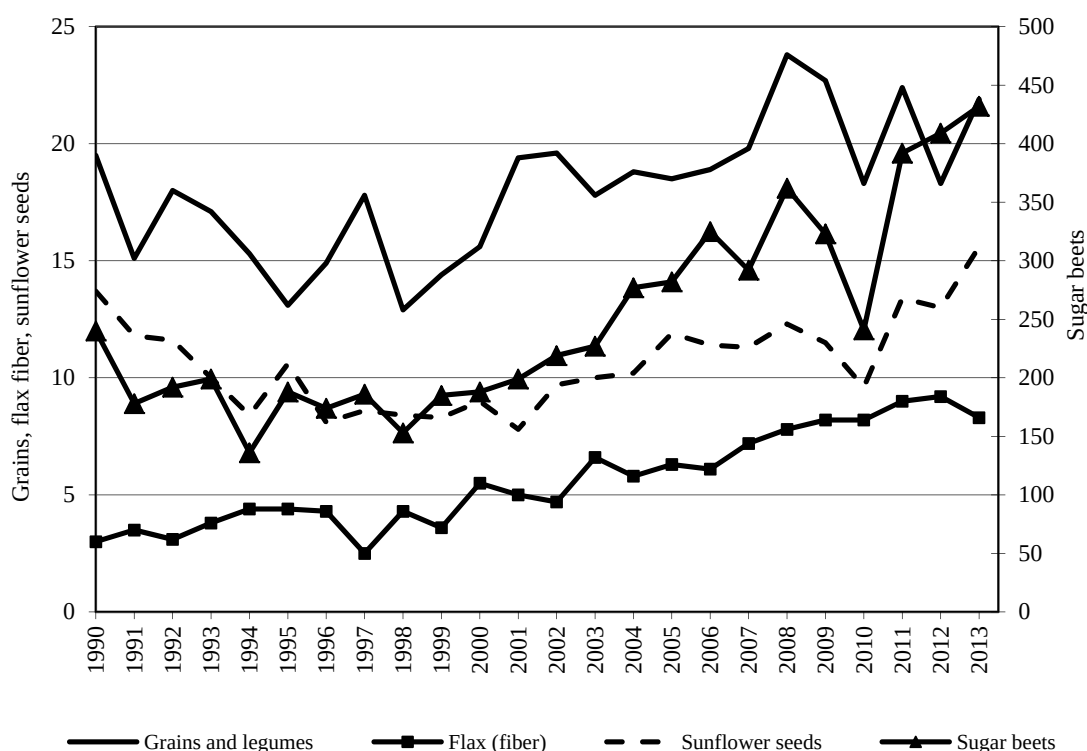
Production of pigs continues to concentrate in corporate farms due to the forced reduction of their population in household farms (attributed to the risk of disease spread in case of home raising of livestock). However, it affects the financial performance of rural households that still keep over 20% of the total pig inventories (in 2006 – over 50%).



Source: Rosstat.

Fig. 46. Structure of meat production by types of livestock, %

In crop production the yields of all basic farm crops continue growing (*Fig. 47*).

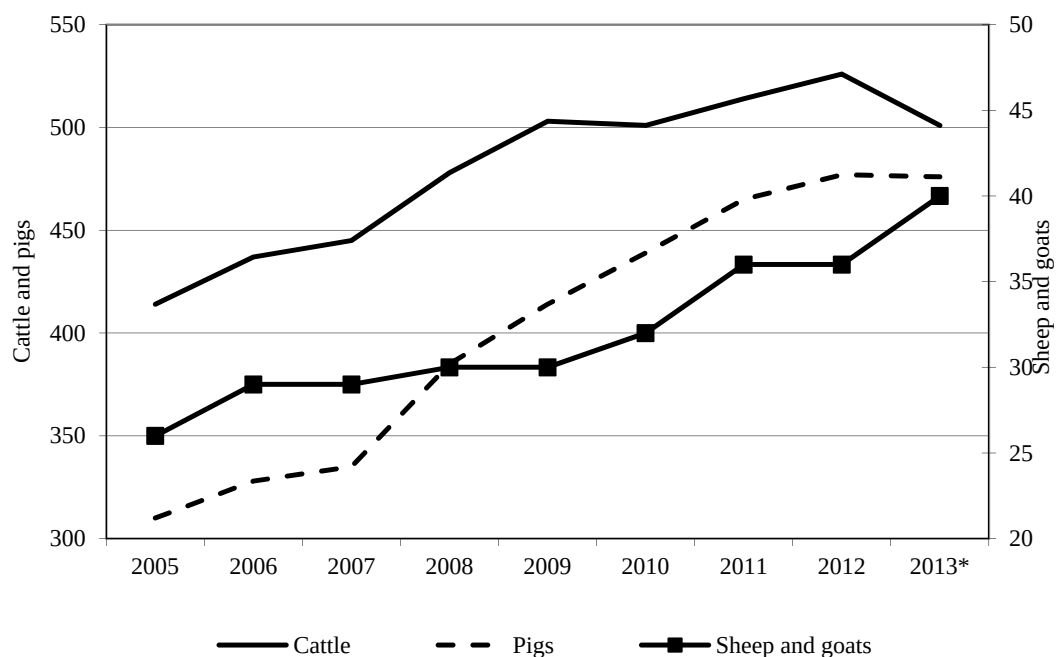


Source: Rosstat.

Fig. 47. Yields of basic farm crops, centners per hectare

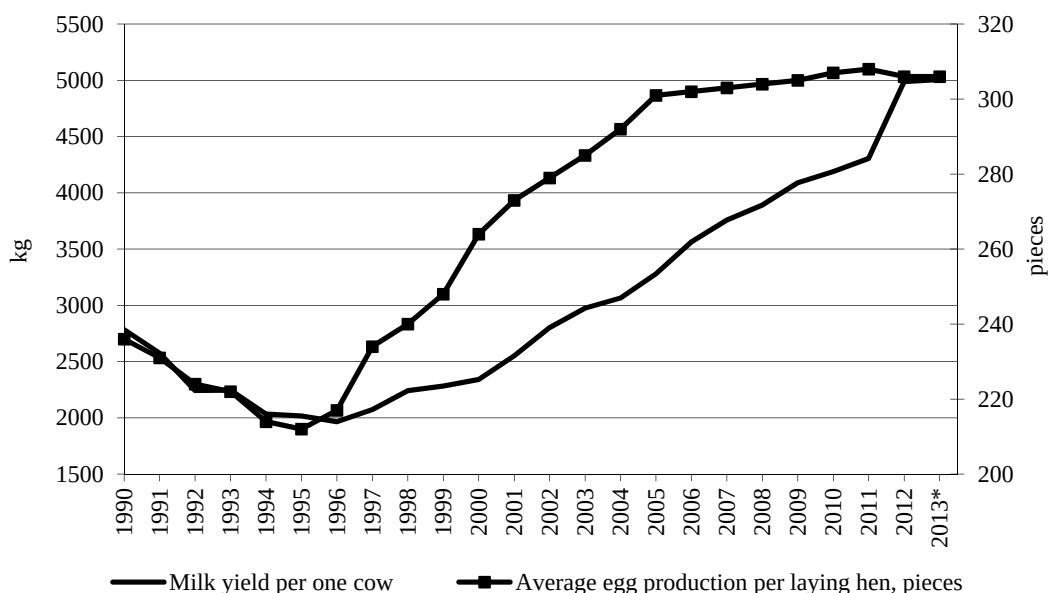
In livestock production higher average daily weight gains in 2013 were recorded only in the raising of sheep while for pigs they remained at the 2012 level and for feeder cattle even

dropped. The productivity of milk cattle raising and production of eggs did not change (Fig. 48 and 49).



* - January-September.

Fig. 48. Annual dynamics of average daily weight gains of livestock in corporate farms (grams)



* - 2013 - estimate.

Fig. 49. Productivity of livestock and poultry in corporate farms

Labour productivity in agriculture continues to demonstrate an upward trend. By the beginning of 2013 in corporate farms it was more than 4 times higher than in 1990¹.

4.5.2. Situation on selected agricultural and food markets

2013 was the first year of Russian agricultural and food markets' operation within WTO. Among the main concerns associated with conditions of joining this world organization were the risks of domestic production decline, growth of imports and the respective weakening of national food security. Indeed, last year the situation in some agricultural sub-sectors was really difficult. But it was not so much due to the fulfillment of Russia's commitments to reduce import tariffs after joining WTO as to a whole range of other conjoint negative factors: the growth of prices for formula feeds in livestock production, the positive world price dynamics on some commodity markets, Russia's accession to the Customs union.

Imports of agricultural and food products after the country's accession to WTO did not change much. According to data of the RF Federal Customs Service, within 10 months 2012 the value of imports fell by 5.3% against the respective period of 2011 and in 2013 it grew by 4.1% against the respective period of 2012².

A matter of concern on the eve of accession to WTO was the probable growth of meat imports. However, imports of red meat fell by 11.7%, imports of poultry meat – by 6.2%. Imports of shellfish increased by 21.3%. Imports of butter and other milk fats grew by 16.1% while imports of dried milk – by more than 48% which is a disturbing rate. Coupled with larger imports of palm oil (up 27.8%) this can be an indirect evidence of softening control over compliance with technical regulations for milk and dairy products or of quite legal increase of foodstuffs' production out of reconstituted milk.

On the contrary, the value of Russia's exports of agricultural and food products in 10 months 2013 fell by 9.4%. It was due to the reduction of export supplies of wheat (by 26.5%), sunflower oil (by 22.7%) and wheat flower (by 44.9%). At the same time the specific trend of the past year was the penetration of Russian meat products to foreign export markets (still, the volumes exported in 2013 remained quite modest – they totaled about 50,000 tons for both meat and sub-products). The major importers of meat from Russia are countries of Middle and South-East Asia (China, Kazakhstan, etc.). The main items exported to foreign markets are poultry meat, pork sub-products and finished meat products.

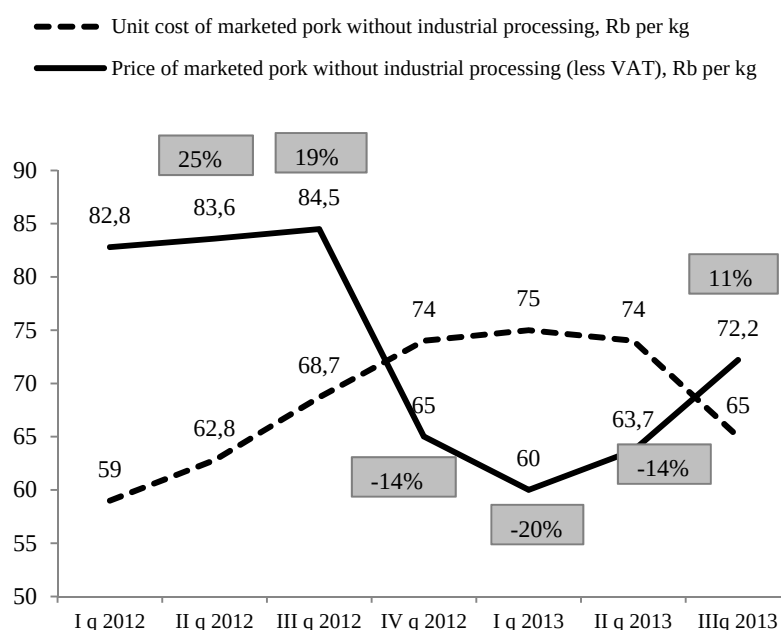
In Russia the excess of domestic food prices over the world ones (that forms primarily due to the application of import duties and quotas) is the basic mechanism of support to farm producers. Producers of meat and milk enjoy the biggest price support. After Russia's accession to WTO import duties on pig sector's produce noticeably fell: the tariff on import of pork within the quota reduced from 15% to zero, on its import above the quota – from 75% to 65%. The tariff on import of live pigs plummeted several fold – from 40 to 5%. Other food items were not subject to such dramatic liberalization of import restrictions in the first year of Russia's membership in WTO. According to commitments undertaken by our country the lowering of import duties is to proceed gradually – within the so called implementation period. For most agricultural and food items this period ends in 2015-2016.

¹ Uzun V.Ya. *Rezultaty yeltsinskoy agrarnoy reformy*. [Results of Yeltsin's agrarian reform] // *Ekonomika sel'skohokhozyaystvennykh i pererabatyvayushchikh predpriyatiy*. [Economics of agricultural and processing enterprises]. No.4, 2013, pp. 19-26.

² Hereinafter the data relates to imports and exports in 10 months 2013 and includes trade with the Republic of Belarus and the Republic of Kazakhstan.

In the first half of 2013 the domestic meat sector was affected by the growth of imports and the combination of record high prices for feeds with low purchase prices for basic types of meat. As a result its profitability fell. In the second half of the year the situation in meat sector improved owing to lower cost of feeds for livestock production.

The fourth quarter of 2012 – the first quarter of 2013 were a period of severe crisis in pig raising. Within this period negative trends in the sector were conditioned by a temporary growth of pork imports due to the lowering of import tariffs in the framework of Russia's commitments to WTO, higher prices for grain and the oversaturation of the market owing to both the increase of domestic output of pork in corporate farms and larger import supplies. As a result prices for live pigs in corporate farms fell by 25-30%¹. All these factors led to the drop of profitability in pig raising (*Fig. 50*). Negative and even zero margins in the period when the sector was undergoing an active phase of investment development can affect the growth prospects of industrial pig production after 2014 if the ratchet effect of increase preserves in 2013-2014. In its turn, the danger of further spreading of ASF² and the above mentioned growth of prices for feeds contributed to the cut of livestock inventories in household farms. As a result, there appeared risks of a sharp production drop in the Russian pig sector and the return to situation observed five years ago when the share of imports on the market reached 40-50%.



Source: National Union of Pig Producers.

Fig. 50. Profitability of pig raising in the Russian Federation in 2012–2013

The risk of disease spread and the detected cases of violation of veterinary and sanitary requirements as to the use of ractopamine (feed supplement for increasing muscle mass of pigs and cattle) and antibiotics forced Russia to introduce restrictions on import of live pigs and pork from the countries of EU, North, South and Latin America and the Republic of Belarus. Together with the removal of pork and poultry meat from the list of goods the import

¹ According to data of the National Union of Pig Producers.

² African swine fever.

of which from developing and least developed countries is eligible for tariff preferences, eased pressure on domestic pork production. Import supplies of pork started to fall already at the beginning of 2013. Coupled with the lowering of domestic prices for grain, this supported the growth of prices for pork in 2013 and helped domestic pig producers to achieve a positive profitability rate of 11% in the third quarter of 2013.

On the whole, despite all the problems faced at the beginning of 2013, the market of pork demonstrated record annual rates of domestic production growth and a shrinkage of imports. For instance, in 2013 the output of pork in corporate farms grew from 1,594 thousand tons to 2,007 thousand tons slaughter weight (up 25% *Table 37*). Meantime, the decrease of livestock population and production in household farms accelerated. In the situation of tougher competition with imported products non-efficient producers quit the market. Despite the positive dynamics in domestic pig raising sector, the share of imports in the total pork market capacity remains relatively high – about 29%¹.

The situation on the market of poultry meat was similar. The lowering of prices for poultry conditioned by high saturation of the domestic market and larger cost of formula feeds affected the profitability of poultry plants – the respective sector's average fell down to 5%². Still, production of poultry meat continues to grow by inertia while imports are slightly shrinking. After a boost in 2010-2012 the sector's growth rates somewhat declined but nevertheless remain rather high. In 2013 the annual output of poultry in corporate farms increased by 6.3% and reached 3,463 thousand tons slaughter weight (*Table 37*).

The domestic market of poultry meat is close to saturation. The share of imports thereon fell down to 13%. But as different from pig raising where the growth of industrial production offsets the decline of output in household farms, in poultry breeding such substitution is impossible – about 90% of poultry meat is produced by the industrial poultry plants. Therefore, further growth of the domestic poultry production is feasible only in case of developing export supplies. Taking into account specifics of pricing different broiler parts, domestic poultry meat has a good export potential.

The production of beef didn't feel any direct effect of accession to WTO as almost all beef in the country is a by-product of milk cattle breeding. The crisis of milk industry fostered a decline of cattle herd. At the same time positive structural shifts are taking shape in the sector inter alia owing to the active state support – the population of meat breeds and mixed bred cattle is increasing. According to the data of IKAR, in 2013 the rate of increase of meat cow number (22%) exceeded that of the cattle herd in general.

In 2013 the output of slaughter cattle meat in corporate farms didn't fall for the first time in many years – 538 thousand tons against 533 thousand tons in 2012 (*Table 37*). It should be noted that the demand for beef is limited by its relatively high price as compared with that for pork and poultry meat. That's why the growing supply of the latter will continue to force beef out of retailing and processing. Consequently, in the medium term the development of domestic cattle meat sector will result in increased production of quality beef rather than in bigger total output of this kind of meat.

As mentioned above, in 2013 the situation in milk sector that in recent years was stagnant became even worse: the output of raw milk fell and imports of dairy products increased. However, this aggravation was not due to the Russia's accession to WTO but was rather conditioned by problems of domestic origin.

¹ According to data of IKAR.

² According to data of IKAR.

The output of milk in corporate farms fell by more than 700 thousand tons and that in all categories of farms – by 1.5 million tons as compared with 2012¹. The reduction of raw milk output in Russia is due to the shrinkage of milk cattle inventories and productivity resulting from poor quality of rough feeds and the rise of prices for formula feeds.

The drop in production of raw milk has toughened competition of processors for this input and led to the increase of purchase prices for milk. According to data of the RF Ministry of Agriculture, the average price received by domestic producers of raw milk grew from Rb 15.6 per kg at the beginning of the year up to Rb 17.9 kg per kg by mid-December 2013 (up 14.4% as compared with the respective date of 2012).

In the situation of continuing deficit of raw milk and high purchase prices for this input one could observe a substitution of some dairy products for other – the production of items requiring much milk (such as cheese and dried milk) was falling while that of whole milk products (kefir, yoghurt, cream) was growing (*Table 38*). High prices for milk inputs on the domestic market coupled with positive dynamics of the world prices for dried milk following the drought in New Zealand fostered the growth of prices for finished dairy products in Russia. During the year average consumer prices for liquid milk rose from Rb 30.8 to Rb 32.5 per litre, those for butter – from Rb 239.8 to Rb 285.3 per kg, for hard rennet cheese – from Rb 255.7 to Rb 288.5 per kg².

Table 38

Production of dairy products in 2012-2013 (1,000 tons)

	2012	2013	Change %
Cheese, cheese products	412.5	389.4	-5.6
Butter	195.3	198.8	+1.8
Whole milk products (in milk equivalent), including	10315.5	10602.1	+2.8
– kefir	780.0	864.1	+10.8
– yoghurt	108.5	114.1	+5.2
– sour cream	525.5	502.0	-4.5
– cottage cheese	366.9	342.0	-6.8
– cream	85.3	93.8	+9.9
Milk in solid forms	117.7	108.6	-7.7
Cream in solid forms	0.3	0.1	-61.1
Dry baby milk (including sour milk) formulas	18.6	17.8	-4.4

Source: Rosstat.

As mentioned above, the reduction of domestic dairy output was compensated by larger import supplies of dried milk and butter.

An essential problem for the Russian market of agricultural and food products is associated with the Customs Union. Transit supplies of “grey” imports come to Russia across the borders of neighboring countries-members of the Customs Union. The major competitor of Russia on the dairy market is Belarus that after the Union’s formation has got an unrestricted access to the Russian market. In 2013 Belarus accounted for 77% of the total imports of dried milk and for 41.3% of the total imports of butter³. Last year the country also became the second (after Brazil) largest supplier of meat to Russia.

The first year of Russia’s membership in WTO showed that natural calamities (drought of the recent years) and the situation on the world markets have a greater impact on the Russian agricultural and food markets than the accession to this organization. Neither essential growth

¹ According to estimates of the National Union of Milk Producers (SouzMoloko).

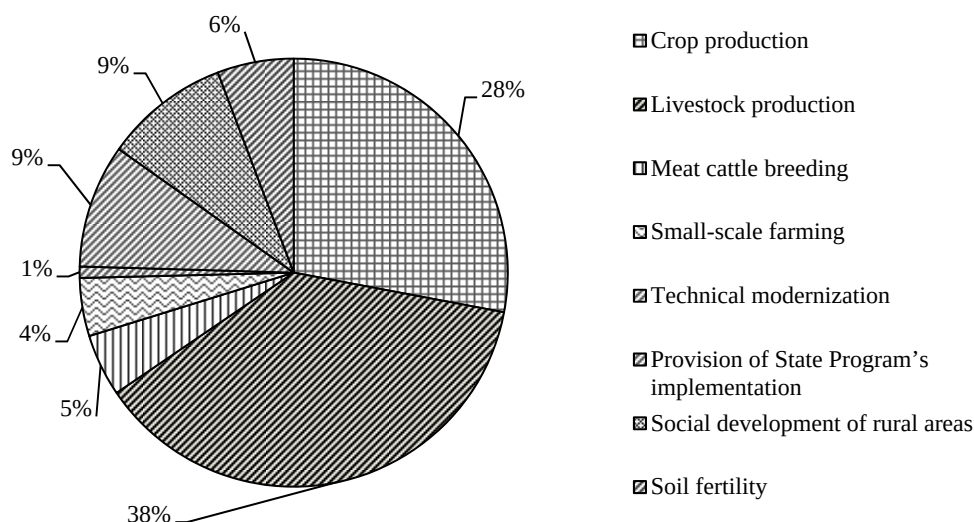
² According to data of FGBU “Spetsstsentruchet v APK” [Federal State Budget Institution “Specialized Center for accounting in the agrifood sector”].

³ According to data of IKAR for 11 months 2013.

of agrifood imports nor expansion of Russian supplies to foreign markets was observed in 2013. Certainly, some sectors of agriculture being at the stage of active investment development require additional measures to adjust to the new conditions of trade. But it's necessary to understand that the accession to WTO determines prospective trends of the farm sector development: improvement of domestic products' competitiveness versus imported items, market exit by non-efficient producers and further consolidation in the sector, measures for the development of export at the state level (efficiency review, granting of quotas, coordination of veterinary certificates) and re-orientation of state policies towards farm support tools permitted within WTO.

4.5.3. Implementation of the State Program in 2013

The eight-year State program for agricultural development and regulation of agricultural, input and food markets for 2013-2020 (hereinafter – the State Program) was adopted as a follow-up of the five-year State Program for 2008-2012. It incorporated actually all basic directions and measures of the first State Program. A few directions (such as “Development of meat cattle breeding” and “Support of small-scale farming”) were detached into separate sub-programs while some other measures were merged based on the respective sector (crop production – livestock production). In 2013 the biggest budget infusions were envisaged for the support of livestock production as the priority direction for domestic farm sector development (*Fig. 51*): together with funds for the support of meat cattle breeding it accounted for 43% of the total allocations. It was presumed that following the increase of production and exports of grain, state support would help livestock sector to grow as well. It's noteworthy that the amount of funds envisaged for the State Program's implementation (including expenditures on bureaucratic apparatus) was the same as that for the social development of rural areas (incorporating measures for gasification, water supply, construction of health care and educational institutions all over the country).



Source: the State Program.

Fig. 51. Structure of financing by basic directions of the State Program in 2013

The global task taken upon by the RF Ministry of Agriculture was the adjustment of the State Program's letter and figure to the commitments assumed by Russia following its accession to WTO. At present 62% of the agricultural budget is allocated to "amber box" measures and 38% - to "green box" measures (*Fig. 52*).

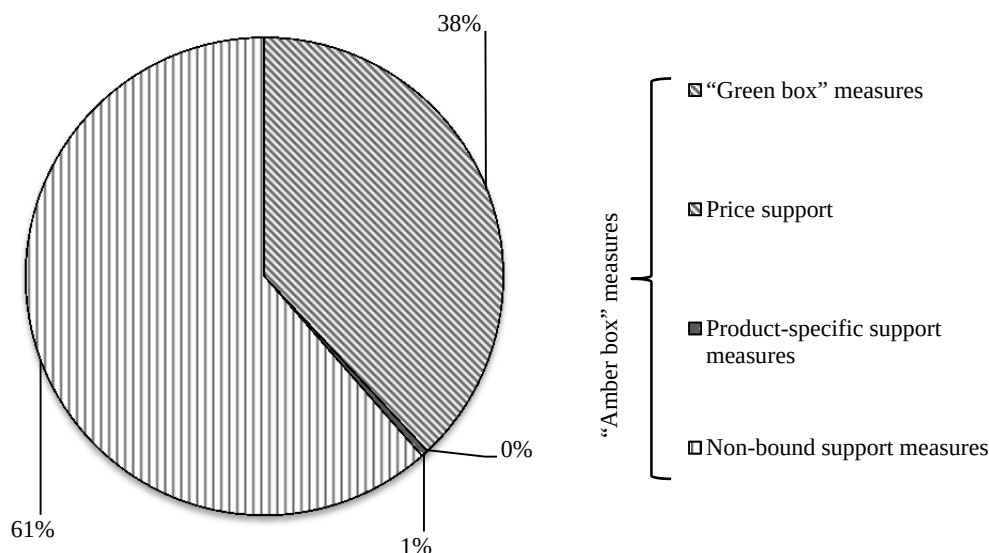


Fig. 52. Structure of farm support in 2013

The reframed support measures are to comply with provisions of Clause 6d Annex 2 of the "Agreement on agriculture", namely: not to be conditioned or determined by types and/or volumes of agricultural output produced by a specific producer in any year after the base period; not to be influenced by the domestic or world prices for agricultural products produced in any year after the base one. In their turn, investments are to be made only in the agreed period and should not be conditioned by requirements to produce a specific kind of produce (which is pretty often the case in the text of the State Program and associated normative acts. For instance, essential economic programs are financed only in the part corresponding to the announced priority directions such as meat cattle breeding, milk cattle breeding, etc.).

One cannot say that the Ministry of Agriculture has so far failed to make successive attempts to adjust measures of state support so that to exclude them from the most market distorting "amber box". Some measures for the development of crop and livestock production were shifted into the category of non-bound support including technical modernization of the sector. It is projected to increase the variety and amount of allocations to general support measures, e.g. product marketing and promotion, construction of logistical centers, support to the development of farm cooperation, information and consulting services, systems of market information, other infrastructural projects. As of January 1, 2014 the state support of farm production and social development of rural areas got Rb 197.8bn from the federal budget which is 44% above the respective indicator of the previous year (*Table 39*).

Table 39

**Actual amounts of federal budget financing under the first State Program
for 2008–2012 by directions, billion rubles**

Directions	2008	2009	2010	2011	2012	2008–2012, % of the projected amounts
Sustainable development of rural areas	8.137	8.963	7.720	7.720	11.000	38.7
Creation of general conditions for farming	17.720	17.737	10.106	11.499	11.800	103.5
Development of priority agricultural sub-sectors	13.144	16.417	10.585	23.129	26.800	116.0
Attaining of financial sustainability of farm sector	78.642	112.270	72.991	74.701	81.000	145.8
Regulation of agricultural, input and food markets	0.639	9.636	5.878	7.934	7.000	Up 4.4 fold
TOTAL	118.3	165.0	107.3	124.9	137.6	118.5
% of GDP	0.28	0.48	0.23	0.22	0.22	

Source: National report on agriculture for 2008-2012. Ministry of Agriculture, 2013; authors' estimates.

In 2013 the actual financing of the State Program was better than in the previous years (Table 40)¹.

Table 40

**Projected and actual financing of the State Program
for agricultural development in 2013**

	Budget item	Envisaged in the State Program, million rubles	Approved budget, million rubles	Actual funding, million rubles	As % of the initial Program projections
1	2	3	4	5	6
1	Partial reimbursement of expenditures on the purchase of elite seeds, on laying out and maintaining of vineyards, perennial fruit and berry plantations, on purchasing and transportation of seeds to the Far North and equated localities, etc.	1960.7	1960.7	1960.6	100
2	Partial reimbursement of interest rate on: - short-term credits (loans) for the development of crop production, processing and marketing	7199.5	19199.5	19175.4	266
	- investment credits (loans) for the development of crop production and processing, development of infrastructure and logistical support of crop produce markets	8785.0	8785.0	13204.7	150
3	Partial reimbursement of farm producers' expenditures on paying insurance fees	5000.0	5000.0	4397.1	87.9
4	Non-bound support to crop producers	15200.0	25200.0	25279.8	166
5	Support of economically viable regional programs in the field of - crop production	3000.0	3000.0	2689.9	89.6

¹ In the 8-year State Program for 2013-2020 the directions of financial support to agriculture were changed as compared with the previous Program and therefore the financing data for 2013 is given separately in Table 40. For more details about the shift in directions of state support under the new State Program see Yanbykh R. *Gosudarstvennaya programma razvitiya sel'skogo khozyaystva na 2013-2020: osnovnye napravleniya i problemy adaptatsii k chlenstvu v WTO*. [State Program for agricultural development in 2013-2020: basic directions and problems of adjustment to the WTO membership] // *Ekonomiko-politicheskaya situatsiya v Rossii*. [Economic and political situation in Russia]. 2012, No.7, pp. 49-52.

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Cont'd

1	2	3	4	5	6
	- livestock production	8000.0	8000.0	7255.5	90.7
	- meat cattle breeding	2000.0	2000.0	2000.0	100
6	Support of pedigree livestock breeding	3500.0	3500.0	3558.6	102
7	Subsidies per 1 litre of marketed milk	10000.0	12758.7	12748.1	127
8	Partial reimbursement of interest rate on: - short-term credits (loans) for the development of livestock production, processing and marketing	4094.6	4094.6	4193.4	102
	- investment credits (loans) for the development of livestock production and processing, development of infrastructure and logistical support of livestock produce markets	28740.6	28740.6	34907.2	121
	- investment credits for the building and reconstruction of meat cattle breeding facilities	4424.0	2503.4	0	0
	- long-term, medium-term and short-term credits taken by smallholder farms	5000.0	5000.0	5000.0	100
9	Total amount for the reimbursement of interest rate (2 + 8)	58243.7	68323.1	76480.7	131
10	Renewal of farm machinery inventories	2000.0	7300.0	2430.0	121
11	Forming of state informational resources for ensuring food security	189.7	180.2	128.6	67.7
12	Support to beginner farmers	2000.0	2000.0	2000.0	100
13	Development of family livestock farms	1500.0	1500.0	1500.0	100
14	Partial reimbursement of expenditures of individual private farms (including individual entrepreneurs) on registering ownership titles to agricultural land plots used by them	120.0	120.0	50.7	42.3
15	Federal Target Program "Social development of rural areas till 2013"	9012.3	9012.3	9012.3	100
16	Federal Target Program "Preservation and restoration of soil fertility of farmlands and of agricultural landscapes as the national endowment of Russia in 2006-2010 and for the period till 2013"	7154.3	6625.5	6537.8	91.3
	Total	158942.9	197671.7	197884.6	124

Source: Calculated by authors using data of the Ministry of Agriculture.

The analysis of preliminary results of the first year of State Program's implementation show that in general measures for supporting livestock production are financed better than those for supporting crop production (*Table 41*). In 2013 the basic subsidies to crop production were for the first time ever granted in the framework of so-called non-bound support per 1 hectare. This measure is less market-distorting and has long been applied in the EU countries. Input support in crop production has been cut to minimum and applies only to specific plantations (vineyards, perennial fruit and berry plantations, purchase of elite seeds, their transportation to the Far North regions, etc.).

The strongest support is rendered in the form of subsidizing credits to farm producers. In 2013 the budget for partial reimbursement of interest rate on all types of credits and loans accounted for 38% of all the allocated funds. This trend could also be tracked in the implementation of the first State Program. Experts have cautioned against a serious problem of accumulating state debts before farm producers on payment of subsidies for the

reimbursement of interest rate on investment credits and loans¹, but the Ministry of Agriculture has so far failed to cope with it. Imbalances in the structure of financing affect other guidelines of the State Program. Year after year such directions as the social infrastructure of rural areas (*Table 39*), smallholder farms and their agricultural cooperation, support of alternative employment in rural areas do not get sufficient funding. In 2013 the most scarcely financed items were the establishment of informational system for ensuring food security and management of agro-industrial complex, the partial reimbursement of expenditures of individual farmers on registering ownership titles to agricultural land plots and the reimbursement of interest rate on credits and loans taken for the development of meat cattle breeding (*Table 40*). There is an impression that due to the extensive commitments for reimbursement of interest rate regional budgets simply get short of funds for other measures. At the same time no funds are allocated from the federal budget unless there is co-financing from the regional budget.

The average share of regional co-financing under all programs is about 26% of the total. However, it differs by directions: for instance under the programs for developing pig production 62.6% of funds were allocated from the regional budgets, under the programs in poultry sector – 36.7%, under the programs of subsidizing investment and short-term credits and loans – 16%, under the Federal Target Program “Social development of rural areas” – 37.7%². In 2013 the total amount of funding from the consolidated budget of the Federation and regions was Rb 267.5bn, or 0.4% of GDP.

The budget of Russia’s State Program is in general comparable to the US agricultural budget (\$155bn, or 0.93% of GDP). First, the difference in percentage of GDP is not so big (in absolute terms the US budget is 25 fold larger). Second, almost ¾ of the US agricultural budget is spent on programs for improving the structure and quality of nutrition and for ensuring access to it for the most vulnerable groups of population (pensioners, women, children and disabled people). In 2013 allocations to the Nutrition Assistance program amounted to \$111.6bn (72%) while the support to farmers and ranchers – to only \$24.8bn (under the Farm and Commodity Programs)³.

Composition of the EU agricultural budget is similar. It amounts to 129.9bn euro or 1.1% of GDP⁴ but the biggest part of it goes to various ecological programs including adjustment to the climatic change, food quality and standardization issues, support to producers of bio-safe products, etc.

According to data of OECD, in 2013 the ratio of aggregate support to farm producers to gross agricultural output⁵ in Russia was lower than in Europe (13% versus 20%) but higher than in the US (7%).

¹ Gataulina E.A. *Programma subsidirovaniya protsentnykh stavok: effect i problemy*. [The program of subsidizing interest rates: effect and problems] // *Ekonomika sel'skohozyaystvennykh i pererabatyvayushchikh predpriyatiy*. [Economics of agricultural and processing enterprises]. No.9, 2010, pp. 54-55.

² The data on regional co-financing relates to 2012. Source: The National Report on Agricultural Development in 2012.

³ The data on US agricultural budget is cited from: Budget Summary and Annual Performance Plan, FY 2013.– USDA.

⁴ EUROSTAT: http://europa.eu/pol/index_en.htm

⁵ Producer Support Estimate (PSE): the annual money equivalent of gross transfers from consumers and taxpayers to farm producers estimated at farm gate and attributable to the state support to agriculture irrespective of their nature, goals and impact on the production or incomes of producers. Source: Agricultural Policy Monitoring and Evaluation 2013: OECD countries and emerging economies. – OECD Publishing, 2013.

The tools of state support to agriculture applied in Russia are mostly those regarded as “amber box” measures. When elaborating the new State Program for 2013-2020 the Ministry of Agriculture made attempts to reduce their share. A new support measure was introduced – the support of incomes in crop production. But even after that about 60% of measures remained in the category of “amber box”. If this approach persists, by 2016 the amount of support will come into conflict with commitments taken by Russia when joining WTO. The potential for increasing the level of support is provided in the WTO Agreement on Agriculture¹ but Russia has so far failed to use these mechanisms to their full extent. Attempts to adjust measures envisaged in the effective State Program to the requirements of WTO were made in the study carried out by the Center of Agrarian Policies of the Institute of Applied Economic Research in the Russian Presidential Academy of National Economy and Public Administration². Owing to the alteration of State Program’s implementation mechanisms, one has succeeded to transfer support measures to the amount of Rb 83.8bn (\$2.7bn) from the “amber box” to the “green box”, of them 65% are those envisaged for livestock production (Rb 55.3bn). The sub-program for technical and technological modernization has been completely re-channelled to the “green box”. As a result the structure of State Program’s budget has radically changed: 24.4% of support still belongs to the “amber box” while 75.6% has been moved to the “green box”. It’s obvious that the RF Ministry of Agriculture should carry out a similar job as at present 90.3% of measures applying to livestock production can be labeled as non-market support. The market gets seriously distorted since a specific product is being supported and according to WTO regulations this is an immediate indication for treating the measure as one from the “amber box”.

So, even in the framework of the existing State program for agricultural development and regulation of agricultural, input and food markets for 2013-2020 there is an opportunity to reduce the amount of most distorting and contradicting WTO rules measures while preserving the basic financial outlays. If all the suggestions for transforming support measures into less market-distorting ones are taken into account, by 2018 the funds for implementing “amber box” support can be cut down to not more than Rb 57,690m (\$1.8bn at the exchange rate effective in early December 2013) which is 2.5 fold below the admissible level declared in the Agreement on Agriculture that Russia signed when joining WTO in 2012.

4.5.4. Recommendations for policymakers

Recommendations as to the adjustment of agricultural policy following Russia’s accession to WTO are formulated on the basis of analyzing its transformation in the recent decade, the requirements of WTO and the practice of their application in Russia in 2012-2013.

1. Using principles of WTO and Common Economic Space (CES) for the improve-ment of domestic agricultural policies

Having joined WTO and CES, Russia has taken commitments to diminish farm support measures distorting the market and to comply with the set limitations on the amount of such support. The domestic agricultural policies do not envisage similar requirements to regions-subjects of the Russian Federation. Any subject of the Federation has the right to render market-distorting support to home farm producers from the regional budget. The amount of

¹ Agreement on Agriculture. www.wto.ru/ru/content/documents/docs/selhozru.doc

² Shagayda N.I. *Otsenka byudgetnykh raskhodov i byudgetnoy podderzhki v sel'skom khozyaystve Rossii* [Evaluation of budget expenditures and budget support in Russian agriculture] // *APK: ekonomika, upravleniye* [Agro-industrial complex: economy, management]. No. 12, 2012, pp. 14-23.

such support is not restricted by either the federal legislation or legislation of the RF constituent members. Moreover, according to the RF Constitution and the effective legislation federal authorities have no competence to introduce such restrictions for subjects of the Federation.

The right of RF regions to support farm producers using “amber box” measures and the active utilization of this right by many subjects leads to the disruption of the national agricultural market. Farm producers from regions with high level of support from the regional budgets enjoy competitive advantages over producers from other regions. As a result the market gets distorted, owing to subsidies the output produced at high cost ousts lower-cost produce from the market.

The priority effort should be the introduction of amendments to Federal Law No.184 of October 6, 1999 “On general principles of organization of legislative (representative) and executive bodies of public authority in subjects of the Russian Federation” that will establish joint responsibility of the Russian Federation and its members for the development of agriculture. It should be envisaged that the federal government is entitled to set mechanisms of control over the level of support to farm producers and to provide for coordination of federal and regional policies of farm support in case international agreements specify restrictions in this field.

2. Abandoning of compulsory co-financing requirement

Federal funds for subsidizing any support measure are allocated only on the condition that it is co-financed from the regional budget¹. In case a subject of the Federation does not have sufficient funds in its budget, regional farm producers lose access to federal funds. This situation infringes the equality of their competitive positions and the integrity of domestic agricultural market, results in the channeling of subsidies to regions with high budget capacities that are often located in areas less fit for farm production. Agricultural producers from regions with lower farm profitability (before subsidies) get more subsidies and credits.

The institute of co-financing extremely complicates the mechanism of State Program’s implementation. Financing of any measure under the latter depends on decisions taken by the Federal Assembly, the RF Government, the RF Ministry of Agriculture, authorities of subjects of the Russian Federation, participants of the State Program. The complicated multi-level system of takings decisions on state support requires a long period for coordination. Farm producers usually learn the rates of subsidies for the current year only in autumn.

In order to eradicate these bottle-necks in financing of the State Program, one needs to abandon the institute of compulsory co-financing. Program measures implemented by the federal government bodies should be financed from the federal budget. Regional policies and the availability of funds in the regional budget should not inhibit the receipt of federal subsidies.

This will enable federal and regional authorities to get rid of endless approvals, delays and obstacles to the implementation of planned measures. Besides, all producers in the country will have equal access to federal funds.

¹ *De jure* according to provisions of the above mentioned Law No. 184 FZ measures of the State Program are considered to be financed by subjects of the Russian Federation while the federal budget just co-finances them. But taking into account the federal status of the State Program, the definition of its measures on the federal level and the fact that most funds are allocated from the federal budget, in this paper the allocation of funds from the regional budgets is called co-financing.

3. Guaranteeing of subsidy receipt, discontinuing of restricted and competition-based distribution of subsidies

According to the Russian legislation a farm producer has the right to apply to the state for subsidies envisaged under the support programs. In case the sum of farm producers' applications exceeds the subsidy limits set for a particular measure in a particular region, the applicant will get a refusal.

Amendments should be made in the law for agricultural development that will guarantee the getting of subsidies. The right to apply for subsidies should be replaced by the right of their guaranteed receipt by all participants complying with the requirements set in laws, the State Program and other regulatory legal acts. In case of subsidy rejection, the farm producer concerned should have the right to turn to the court.

Regulatory acts should clearly specify the state's commitments before farm producers, conditions, rates and guarantees of receiving state support. The terms should be transparent and understandable for farm producers. The access to subsidies should be ensured not by the decisions of bureaucrats but by the law. This will help to cut the number of officials elaborating regulatory acts on law enforcement and taking decisions on the allocation of budget funds as well as to involve more farm producers in measures under the State Program and to lessen corruption in the state support scheme.

The implementation of this approach will require more careful planning of state support measures, the elaboration of mechanisms for rechanneling funds from one measure to another, the forming of a reserve fund that may be needed in case weather conditions are worse than the annual average.

It's obvious that guarantees of granting support to farm producers will work only in case one discontinues the established practice of restricted and competition-based distribution of budget funds that results in the infringement of conditions for fair competition and the creation of preferences for some producers.

4. Transfer from product-specific to non-bound support measures

In Russia a clear preference is given to bound support measures (when the amounts of payments depend on the production volumes or use of inputs, input prices, etc.). In the State Program for 2008-2012 they accounted for 98% of support granted to farm producers. One non-bound support measure appeared in the State Program for 2013-2020 – the subsidizing of incomes in crop production. It accounts for about 10% of the State Program's funds. In the EU non-bound support measures make up two thirds of all subsidies to farm producers.

The transfer to non-bound support measures will liberate such payments from WTO restrictions and help to improve the efficiency of state funds' utilization through:

a) improvement of the transfer efficiency. According to economic theory, non-bound measures are more efficient than the support of specific products or subsidizing of inputs. When money is allocated to the rise of product prices or the reduction of input costs, it gets re-distributed in favour of product buyers and input sellers. In case farm producers receive subsidies for purchasing fertilizers, the sellers of the latter raise prices and according to studies get about 75% of the subsidy amount while only 25% thereof remains in the disposal of farmers¹. The situation is similar when the price for a specific product is supported. Processors reduce purchase prices and farm producers lose the granted subventions;

¹ Melyukhina O.G. *Pochemu podderzhka rossiyskogo APK dostatochna, no ne effektivna*. [Why the support of Russian agro-industrial complex is sufficient but non-efficient]. *Agroinvestor*, No.2, 2013.

b) granting more freedom to business in taking decisions. When the state subsidizes specific products and inputs, it determines the structure of production and input use. Meantime, business is more efficient in performing this mission. For instance, in the process of working out the Priority National Project for 2006-2007 and the State Program for 2008-2012 the decision was taken to subsidize interest rate on credits for agricultural development. The state did not specify for what purposes such credits should be used. Business coped with this task on its own. As a result the major part of subsidized credits was used for the development of poultry and pig production. And these sectors were growing at the rate of 10-15% per annum.

When preparing the State Program for 2013-2020, the government preserved subsidies for the partial reimbursement of interest rate on credits but decided to distribute them by sectors at its own discretion. As a result the bulk of appropriations for subsidized credits is to be channeled to meat and dairy cattle breeding. Since these sectors are loss-making in most farms, business will hardly want to use the provided credit lines for the intended purpose.

5. Incorporation of new “green box” measures in the State Program

Many “green box” measures envisaged in WTO “Agreement on Agriculture” are not used in Russia at all. Their incorporation in the State Program will help to improve its efficiency. The following “green box” measures are vital for Russia and require state support: *food aid to population, support to income insurance, assistance in case of natural calamities, subsidizing of farms that stop commodity production* (for instance, the program for halting commodity production of poultry meat and pork in household farms for the purpose of controlling avian flu and African swine fever that envisages compensation of respective producers’ losses), *subsidizing of input use conservation, subsidizing of structural shifts by encouraging investments, payments under environmental programs, payments under programs of regional assistance.*

In the situation of compulsory cutting of pig population in household farms with a view to reduce the risk of disease spread there arises the need, on the one hand, to develop fair mechanisms for compensating the cost of slaughtered animals and, on the other hand, to improve territorial planning in rural areas. In order to support micro-business in rural households it would be rational to work out a recommended practice of spatial planning specifying zones for location of household and individual private farms of different sizes that would enable them to keep livestock and poultry. The specification of such zones should correspond with the size of smallholder farms; the respective regulations should delimitate the number of animals that a farmer can keep on a plot of a certain size so that to comply with sanitary and veterinary norms. It’s also necessary to inform rural residents beforehand about the requirements to facilities for keeping livestock and the marginal density of livestock population. Besides, the compulsory limitation of livestock inventories in household farms located in built-up areas is to be accompanied by programs supporting restructuring of small family business in order to alleviate the negative effects for rural families.

6. Rigid restriction of “amber box” measures distorting the market

“Green box” measures imply soft options of public support when the state creates favourable environment for farm producers by means of general support or encourages certain structural changes.

When applying “amber box” measures the state intentionally plays against market rules, tries to correct market prices, supply and demand. In this case it has to act rigidly, to take on the responsibility for meeting the assumed commitments, to supervise the transfer of state

support funds to producers and consumers of farm products rather than to middlemen and other market operators. Let's examine it on the example of grain market regulation.

Article 14 of the Law on agricultural development establishes the mechanism of grain market regulation. It's core is as follows. Each year the RF Ministry of Agriculture is to set minimum and maximum prices for 5 types of grain: milling wheat, feed wheat, feed barley, rye and corn. In case the actual market price falls below the minimum threshold, the state has to protect the interests of grain producers by carrying out purchase interventions, i.e. by buying grain at the minimum price. If the actual market price exceeds the maximum threshold, the state has to protect the interests of grain consumers (in fact the buyers of bread) by carrying out commodity interventions, i.e. by selling grain at the market at maximum price in order to prevent the growth of prices above the maximum level.

So, the declaration of maximum and minimum prices is a strong regulator. Grain consumers and producers make efforts themselves to hold prices from falling below the minimum or rising above the maximum. In case authorities adhere to the taken commitments and nothing extraordinary takes place on the market, the state does not need to buy or sell grain in big quantities. Purchase interventions do not require extensive budget funds.

In fact Article 14 of the Law on agricultural development has turned out to be a "green box" measure since the state does not buy grain from producers at the minimum price (as it was the case in other countries applying this mechanism) but makes a purchase declaration at the exchange. Minimum price is declared as the opening one and then usually follows the Dutch auction. OJSC "United Grain Company" that represents the state in grain purchase interventions at the same time buys grain for its own needs, i.e. for resale. It's obvious that the company is interested in maximum reduction of the purchase prices for grain.

For Article 14 of the Law on agricultural development to really foster "stabilization of prices on agricultural, input and food markets and support of farm producers' incomes" (Paragraph 1 of Article 14) and be an "amber box" measure, one should omit from Paragraph 2 of this article the words "including at exchange auctions", to specify the date of publishing maximum prices and the terms of pledge transactions.

7. Increase of support at the account of budget funds and decrease thereof at the account of consumers

As a result of Russian agricultural policies of the recent decade consumers of farm products have become the main source of aggregate support to agriculture. In 2012 they accounted for 54.1% of this support while only 45.9% were provided by the budget. In the US the share of the budget in aggregate support is as high as 97.6%, in the EU – 82.7%.

In 2010-2012 the aggregate annual support to agriculture in Russia averaged Rb 556.1bn. The funds were provided by consumers of agricultural products – Rb 411.2bn and by the budget – Rb 144.8bn (net receipts). In fact budget expenditures totaled Rb 312.5bn but owing to the support measures Rb 167.7bn returned back (import duties, etc.).

Provided that after the accession to WTO the amount of farm support in Russia remains the same but the structure of its sources comes close to the EU pattern, the appropriations from the budget will need to be increased almost 3.3 fold (from Rb 144.8bn up to Rb 472.7bn).

8. Support to small business, setting of limits for support to large business

Measures for the support of agriculture and mechanisms of their implementation are primarily targeted at the support of large business. In spite of declarations about equal rights and equal access to budget subsidies, for small business the latter is actually limited.

In 2010 about 30% of corporate farms and less than 1% of individual farmers and entrepreneurs and consumer cooperatives got subsidies for the partial reimbursement of interest rate on short- and long-term credits of banks and credit cooperatives. The share of smallholder farms in subsidies for mineral fertilizers is somewhat higher: about 3% of individual private farms and entrepreneurs benefitted from them.

The share of small business in the total amount of subsidies is very small: corporate farms and agribusiness companies received about 98% of all subsidies while individual farmers and entrepreneurs and consumer cooperatives accounted for approximately 2% thereof. The only exception were subsidies for fertilizers where the share of smallholder farms reached 12.6%.

The share of 5% of the biggest beneficiaries from budget appropriations was as high as 72.6% of all subsidies on investment credits, 61.6% of subsidies on short-term credits and 47.1% of subsidies on fertilizers.

For the small business to get real state support a whole set of measures need to be taken. The most important of them are listed below:

- a) to specify the categories of farm producers eligible for state support;
- b) to set limits on the minimal size of a farm eligible for state support. Such limits exist in many countries;
- c) to limit the support to large corporate farms and agroholdings. In the EU there is a rule providing that farms with a size of more than 2 thousand hectares are not eligible for support. In the US the upper limit of the total amount of subsidies that can be received from the budget is set at \$300,000.

4.6. Foreign trade

4.6.1. The state of the global economy

In spite of the fact that in 2013 countries were able significantly to reduce two of the most serious risks for economic growth in the short term – the threat of the collapse of the Eurozone and the threat of drastic budget cuts in the US, the world economy is still in a state of uncertainty. The rate of growth of the global economy remains low: in the first part of 2013 it was only 2.5% compared with the first part of 2012. On the whole, according to IMF data, the growth rate in 2013 was 3.0%. Correspondingly, the growth rates of both those countries with developed economies and countries with developing economies have slowed. (*Table 41*).

It is expected that the incentives for economic growth will come, first of all, from the USA. The U.S. GDP in the first quarter of 2013 grew by 1.1% and in the second quarter, by 2.5%. The second evaluation of U.S. GDP growth in the third quarter¹ was rather surprising: the annual growth rate was 3.6% in comparison with the preliminary evaluation of 2.8% and to the predicted figure of 3.1%. The third evaluation of GDP growth turned out to be even higher and was 4.1%², which was the highest growth since 2011. The major factor for such upward adjustment turned out to be the revaluation of growth in private consumption from 1.4% to 2% in annual terms. During conversions the second rate played the major role in the increased investments in stocks.

According to preliminary estimates, in the fourth quarter of 2013 the average annual growth in U.S. GDP was 3.2%³. During 2013 the U.S. GDP rose by 1.9% (in 2012 it rose

¹ <http://www.bea.gov/newsreleases/national/gdp/gdpnewsrelease.htm>

² <http://www.bea.gov/newsreleases/national/gdp/gdpnewsrelease.htm>

³ <http://www.bea.gov/newsreleases/national/gdp/gdpnewsrelease.htm>

2.8%). The major contribution to GDP growth was made by the growth in private consumption, net exports and investment into housing infrastructure which offset the negative impact of the continuing decline in government spending.

In connection with improvements in dynamics of the U.S labour market as well as the medium term prospects from the meeting of the Federal Open Market Committee that took place on the 17 and 18 December 2013, a decision was made to reduce the quantitative easing QE programme. It was decided to reduce the volume of monthly purchases by the U.S of Treasury from \$45bn to \$40bn while the volume of purchased securities backed by mortgage bonds was reduced from \$40bn to 35\$bn per month.

On 29 January 2014 the US Federal Reserve reduced its purchase of assets by an additional \$10bn to \$65bn per month and has kept the key interest rate of federal funding in the range of 0.00–0.25% per annum.

Hopes for economic recovery within the countries of the Eurozone in 2013 do not seem to have been realised. In the second quarter of 2013, in comparison to the previous quarter, the GDP growth rates were 0.3% in the Eurozone and 0.4% in the other countries of the EU. The long-lasting recession in Italy (over nine quarters) and a reduction in the GDP of France caused some decline in growth in the region. According to a preliminary evaluation by Eurostat¹, the GDP of the Eurozone in the third quarter rose by only 0.1%; and the GDP of the 28 countries of the European Union (EU-28) increased by 0.2%. In comparison to the same quarter of the previous year, in the third quarter of 2013 the GDP in the Eurozone fell by 0.4%, whilst that of the EU-28 increased by 0.1%.

The year-end GDP of the integrated group had essentially not risen while a decline was witnessed in the Eurozone, although less than was seen in 2012. According to Eurostat data, in 2013 the Eurozone GDP was reduced by 0.4% while in other EU countries it had increased by 0.1%.

The main contribution was made by Great Britain, which is the largest non-Eurozone country of the European Union. According to Eurostat, the economy of Great Britain increased in 2013 by 0.7% in comparison to the previous quarter, and in comparison to the same period of the previous year, by 2.8%.

In October 2013 the World Trade Organisation (WTO) published the digest 'International Trade Statistics, 2013' which provided the major indicators characterising current trends in the development of international trade in goods and services². In 2012 world merchandise exports rose by 2.5% as did global GDP.

The leaders in world trade are still the United States of America, where foreign trade turnover in 2012 was \$3881.2bn. At the same time a significant deficit in trade balance still remains: in 2012 it had increased by 0.5% in comparison to 2011 and was \$789.8bn (4.9% of the GDP). In 2008 the U.S. balance of trade deficit was \$882bn.

The U.S. is followed by China, which, with an annual foreign trade turnover of \$3867.1bn; it remains the largest exporter of goods. The trade surplus of the People's Republic of China has been positive since 1994, and in 2012 it reached \$230bn (2.8% of GDP), having increased during the year by 48.7%.

¹ http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/2-04122013-BP/EN/2-04122013-BP-EN.PDF

² http://www.wto.org/english/res_e/statis_e/its2013_e/its2013_e.pdf

Table 41

**Dynamics of global GDP and world trade
(Growth rates, as % of the previous year)**

	2010	2011	2012	2013	Prognosis		Difference between the prognosis and the data for October 2013 and January 2014	
					2014	2015	2014	2015
Global GDP	5.1	3.9	3.1	3.0	3.7	3.9	0.1	0.0
Countries with developed economies	3.0	1.7	1.4	1.3	2.2	2.3	0.2	- 0.2
USA	2.4	1.8	2.8	1.9	2.8	3.02.6	0.2	-0.4
The Eurozone	2.0	1.5	-0.7	-0.4	1.0	1.4	0.1	0.1
Germany	4.0	3.4	0.9	0.5	1.6	1.4	0.2	0.1
France	1.7	2.0	0.0	0.2	0.9	1.5	0.0	0.0
Italy	1.8	0.4	-2.5	- 1.8	0.6	1.1	-0.1	0.1
Spain	-0.3	0.1	-1.6	-1.2	0.6	0.8	0.4	0.3
Japan	4.5	-0.6	1.4	1.7	1.7	1.0	0.4	-0.2
UK	1.8	1.1	0.3	1.7	2.4	2.2	0.6	0.2
Canada	3.2	2.5	1.7	1.7	2.2	2.4	0.1	-0.1
Other countries with developed economies	5.9	3.2	1.9	2.2	3.0	3.2	-0.1	-0.1
Countries with emerging markets and countries with developing economies	7.4	6.2	4.9	4.7	5.1	5.4	0.0	0.1
Central and Eastern Europe	4.6	5.4	1.4	2.5	2.8	3.1	0.1	-0.2
Commonwealth of Independent States	4.8	4.8	3.4	2.1	2.6	3.1	-0.8	-0.7
Russia	4.3	4.3	3.4	1.5	2.0	2.5	-1.0	-1.0
Without Russia	6.0	6.1	3.3	3.5	4.0	4.3	-0.1	-0.1
Developing Asian countries	9.5	7.8	6.4	6.5	6.7	6.8	0.2	0.2
China	10.4	9.3	7.7	7.7	7.5	7.3	0.3	0.2
India	10.1	6.3	3.2	4.4	5.4	6.4	0.2	0.1
Latin America and Caribbean countries	6.2	4.6	3.0	2.6	3.0	3.3	-0.1	-0.2
Brazil	7.5	2.7	1.0	2.3	2.3	2.8	-0.2	-0.4
Mexico	5.6	4.0	3.7	1.2	3.0	3.5	0.0	0.0
World trade of goods and services	12.6	6.1	2.7	2.7	4.5	5.2	-0.5	-0.3
Imports								
Countries with developed economies	11.4	4.7	1.0	1.4	3.4	4.1	-0.7	-0.5
Countries with emerging markets and developing countries	14.9	8.8	5.7	5.3	5.9	6.5	0.0	-0.2
Exports								
Countries with developed economies	12.0	5.7	2.0		2.7	4.7	0.3	0.0
Countries with emerging markets and developing countries	13.7	6.8	4.2		3.5	5.8	-0.7	-0.5

Source: <http://www.imf.org/external/russian/pubs/ft/weo/2014/update/01/pdf/0114r.pdf>

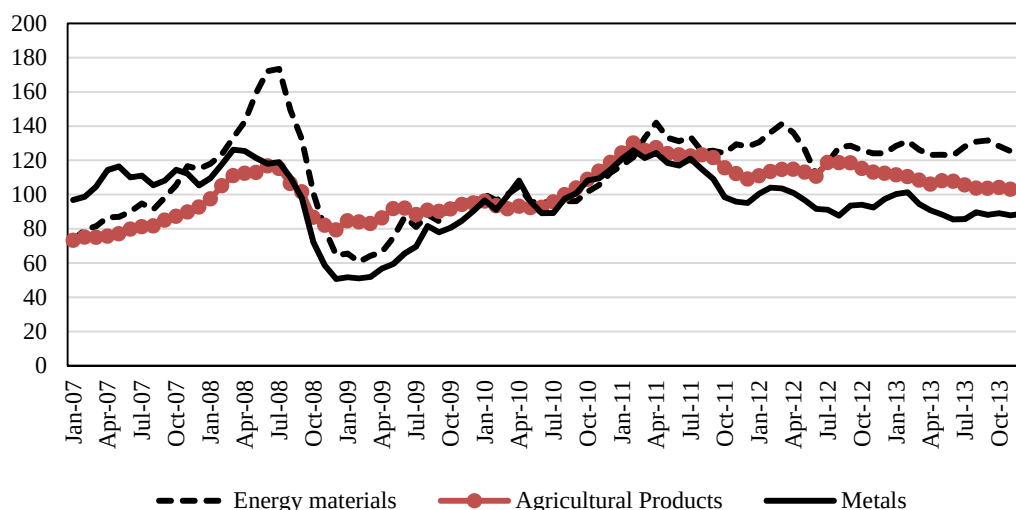
Germany has retained third place in spite of a reduction in foreign trade turnover from \$2728.9bn in 2011 to \$2574.3bn in 2012 (by 5.7%). The trade surplus was \$240bn (7.0% of GDP).

Because of structural problems in the Eurozone, foreign trade turnover of the majority of EU countries diminished in 2012.

In 2012 an export volume of \$529.1bn for the Russian Federation lifted it to eighth place from its previous ninth position where it had been since 2011. Russia's share of global goods export was 2.9%. Russian imports had placed it 17th in 2011 but lifted it to 16th place through its purchase of products totalling \$335.8bn. Russian imports reached 1.8% of the global import volume. Over the last 20 years there has been a trade surplus in Russia. In 2012 it was \$193.3bn.

4.6.2. Conditions of Russian foreign trade: the situation for prices of import and export of basic goods

After significant growth in the middle of 2008 and a sharp decline at the beginning of 2009, the range fluctuations in global commodity prices remained moderate. In 2013 there also were no significant changes in the raw materials market (*Fig. 53*).



Source: <http://econ.worldbank.org/WBSITE/EXTERNAL/EXTDEC/EXTDECPROSPECTS/0>

Fig. 53 Commodity price index of the World Bank (in 2010=100)

The price dynamics for commodities on the global market in 2013 (*Table 42*) were influenced by geopolitical tensions in the oil-producing and adjacent regions of the world. So, in the first quarter the increase in prices for raw materials was explained by the escalation of the Syrian conflict and in the third quarter by aggravation of the situation in Egypt. The soft monetary policies of many countries played a very significant role in supporting global raw material prices on the world market (the policy is implemented in many countries: the USA, the European Union, China, Japan). Weak global economic growth had a negative influence on the dynamics of commodity prices.

The global oil price situation in 2013 remained quite calm, there were no sudden ups or downs: for most of the year prices for 'Brent crude' were higher than \$100 per barrel, but did not rise above \$120 per barrel. On 9 February the price reached its annual maximum of \$118.92 per barrel; but on 17 April the price for 'Brent crude' had reached its lowest level of \$97.67 per barrel. However it did not remain below \$100 for long and by 22 April 'Brent crude' rose to reach \$100.51 per barrel; during the second quarter of 2013 prices remained fairly stable and varied in the range between \$100.15 and \$106.02 per barrel. In the third quarter there was a rise in prices, but by the end of the quarter there had been another decline in prices: in the fourth quarter the price dynamics were better regulated: Brent oil prices fluctuated around a value of \$108.5 per barrel.

During 2013 the price for North American WTI oil remained lower than prices for Brent, although in the third quarter the gap between them narrowed. Whereas during the first quarter one barrel of Brent oil cost \$18.59 more than one barrel of WTI oil, then during the third quarter the difference was only \$4.27.

In 2013 the average price for Brent crude was \$108.7 per barrel, which was 3.1% lower than in 2012. The price for WTI North-American oil during the year rose 3.2% to reach \$98 per barrel.

The price of Urals oil obeyed the dynamics of the world market and at the beginning of 2013 began to grow, reaching its maximum monthly average for the year at a value of \$114.45 per barrel. But during the second quarter those indicators began to fall. In April Urals oil achieved \$101.1 per barrel which was its minimum average monthly rate for 2013. In the third and in the fourth quarters of the year the dynamics improved. But, on the whole, the average price for Urals oil was 2.8% lower than the previous year at only \$107.9 per barrel.

The world natural gas market, in 2013, remained rather heterogeneous – the price dynamics in different countries developing in different directions.

Gas production rates in the U.S. were still growing. According to the US Energy Information Administration, in 2013 the gas production rate in the country had increased in comparison to the previous year by 1% to 690.8 billion cubic metres (bcm)¹. So, taking into consideration that in Russia, during that period, about 652.6bcm of gas were produced², we can conclude that the U.S. still retains the lead in this field.

The United States is reducing its dependence on imported gas. For January-November 2012 in the supply of natural gas to the U.S. had diminished by 9% compared with the corresponding period of 2011, and reached 81.7bcm; then, in January-November, 2013 compared with the similar period of 2012 it diminished by a further 9.9% to only 73.6bcm.

Gas prices in the U.S. still remain the lowest in the world, although in 2013 there was a very marked increase; according to the IMF, in 2013, the spot price for gas at the Henry Hub terminal averaged \$3.73 per one million British thermal units (BTU) which was 35.4% higher than in 2012.

The highest gas price still persist in Southeast Asia despite diminishing by 4.4% in 2013 compared with the figures for 2012. According to the IMF, in 2013, the average price for liquefied natural gas imported by Japan and Indonesia was, on average, \$17.3 per 1m BTU.

In 2013, Russian gas prices at the border with Germany were lower than the year before, which could be explained not only by the oil price dynamics but also by the fact that Gazprom provided the majority of its clients with discounts. According to the IMF, Russian gas prices in Europe in 2013 were \$11.2 per 1m BTU which was 6.7% less than in 2012.

The world market for non-ferrous metals began to worsen in 2011 and in 2013 retained its negative character for Russian exporters. There remained excessive reserves of nonferrous metals which even grew on the London Metal Exchange. The only exception was lead, its stockpiles were reduced by more than ¼ during the year. At the same time copper reserves practically doubled while those of zinc and nickel were also significantly increased. Simultaneously, the growth in metal production in China remained, and, according to Chinese data, the total volume of 10 types of non-ferrous metals produced in the country increased by 10.5% in January-November 2013 compared with the corresponding period of 2012, and reached 36.9m tonnes³. All these factors contributed to the start of a further decrease in world prices for nonferrous metals. According to the London Metal Exchange, prices for aluminum were 8.7% lower than in 2012, while those for copper were 7.9% and for nickel 14.3% lower.

¹ http://www.eia.gov/naturalgas/monthly/pdf/ngm_all.pdf

² <http://minenergo.gov.ru/activity/gas/>

³ http://www.stats.gov.cn/english/PressRelease/201312/t20131211_478510.html

Table 42

Average annual world prices

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2013/ 2012 (%)
Oil (Brent), USD/barrel	37.4	54.38	65.15	72.32	97.64	61.86	79.64	110.9	111.9 7	108.8 6	97.2
Natural gas (U.S.) USD/1m BTU	5.89	8.92	6.72	6.98	8.86	3.95	4.39	4.00	2.75	3.73	135.4
Natural gas, European market, USD/1m BTU	4.28	6.33	8.47	8.56	13.41	8.71	8.29	10.52	11.47	11.79	102.7
Natural gas (Japan), USD/1m BTU	5.13	5.99	7.08	7.68	12.55	8.94	10.85	14.66	16.55	16.02	96.8
Copper, USD/t	2866	3679	6722	7118	6956	5149	7534	8828	7962	7332	92.1
Aluminum, USD/t	1715	1898	2570	2638	2573	1665	2173	2401	2023	1847	91.3
Nickel, USD/t	13823	14744	24254	37230	21111	14655	21809	22910	17557	15032	85,7

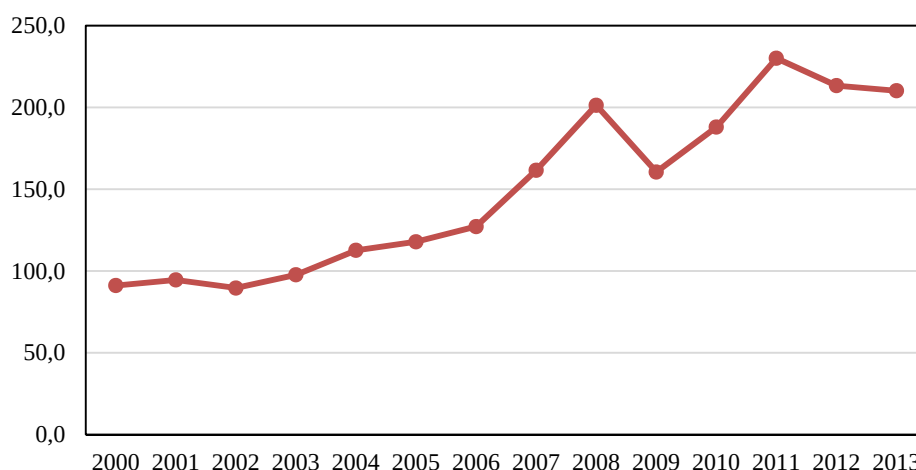
Source: calculations are based on World Bank data, IMF

Fig. 54 shows the change in prices of basic agricultural commodities on the world market according to the UN Food and Agricultural Organisation (FAO) food price index, the main indicator of changes in international prices for a basket of food commodities per month). The index is calculated on the basis of the average values of price indexes for 5 major product groups (meat, dairy products, cereals, vegetable oils and sugar) weighted with the average share of each group in world exports during the period of 2002-2004.

In 2011 the FAO consumer prices index reached its record high of 230.1 points, and although it decreased in 2012 to 213.4 points this was still very high. In spite of some decrease in the prices for food products in 2013 the FAO CPI retained a rather high position (210.2 points). This was possibly because of a significant growth in the price index for dairy products which amounted to 242.7 points, a record maximum for the whole survey period. Prices for meat reached their maximum value at 184.2 points, explained by the growth in demand in China and Japan. The price index for cereals decreased and fell from 236.1 points in 2012 to 219.2 points in 2013. The price index for vegetable oils also turned out to be lower than before: 193 points in 2013 against 223.9 points in 2012. Prices for sugar had fallen in 2013 in comparison to those in 2012, by 18%, which could be explained by an increased rate of supply. The harvest in the country which is the largest producer and exporter – Brazil – turned out to be higher than had been predicted. Record production volumes were also achieved in the second largest exporter of sugar - Thailand.

An upward price trend in the dairy market was caused by a decrease in milk production. Whereas, in 2012 the world milk production rate was increased by 2.32%, then the same indicator in 2013 was only 0.85% or 465.893m tonnes¹. In the first term of 2013, because of a drought in the southern hemisphere, milk production in New Zealand, Australia and Argentina was diminished. The beginning of a new season in Europe was delayed because of a late spring, and this led to a reduction in milk production. In spite of a gradual increase in the supply of dairy products in Europe and the U.S., the growth in prices remained during the second term of 2013. This tendency remained due to growth of demand in the largest world importer and consumer of milk powder – China.

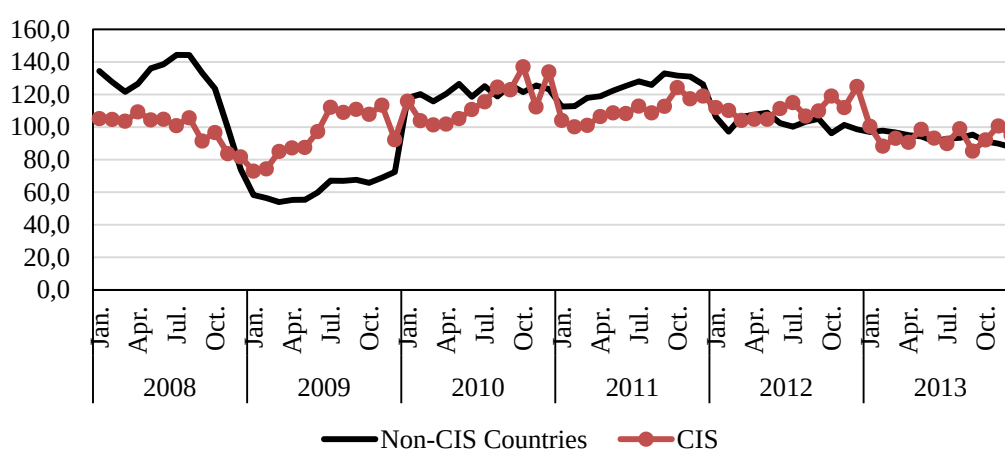
¹ <http://www.eurasiancommission.org/ru/act/trade/catr/monitoring/>



Source: <http://www.fao.org/worldfoodsituation/wfs-home/ru/>

Fig. 54. The FAO food price index

Under current trends in the world market in 2013 Russian trade worsened significantly. In January – September the trade conditions index (*Fig. 55*) was 94.5 points. At the same time trade conditions with non-CIS countries (where the trade conditions index was 94.6 points) and CIS countries (index – 94.2 points) worsened. But trade conditions in 2013 became significantly better than they had been in the crisis period of 2008–2009.



Source: The Ministry of Economic Development

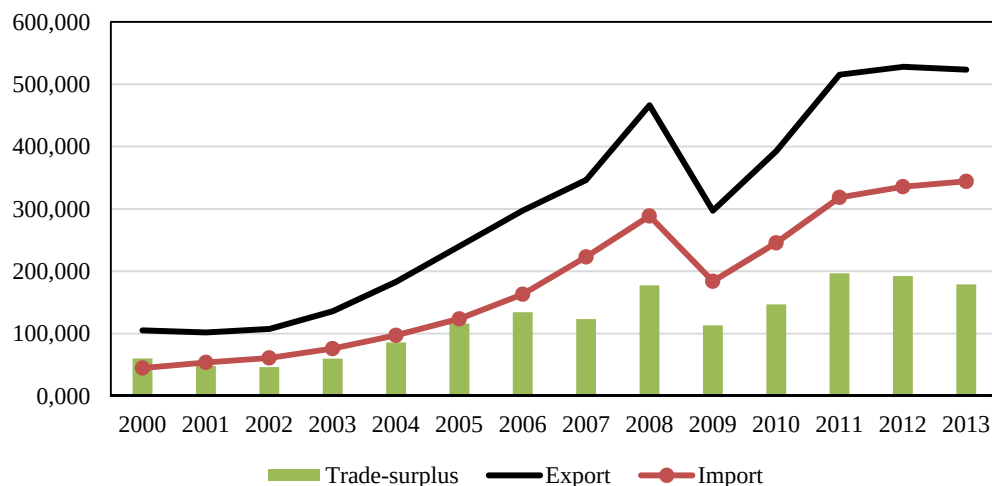
Fig. 55. Index of foreign trade conditions in the Russian Federation

4.6.3. Major indicators of Russian foreign trade

The 2013 Russian foreign trade turnover, calculated on the basis of balance of payments was \$867.6bn, which was 0.5% more than in 2012. At the same time Russian foreign trade turnover with non-CIS countries increased by 0.9% and reached \$739.6bn, while the turnover rate with CIS countries decreased by 2.2% dropping to \$128.0bn.

In 2013 the Russian trend, typical of 2012, of slowing growth in foreign trade indicators remained (*Fig 56*). Import dynamics still remained positive, but export dynamics became negative and, as a result, the trade-surplus was significantly reduced.

Russian exports in 2013 were \$523.3bn, which was 0.9% less than the same indicator for 2012. Russian imports increased by 2.6% and reached \$344.3bn which is the highest value of the whole survey period.



Source: the Central Bank of the Russian Federation

Fig. 56. Major indicators of Russian foreign trade, 2000–2013, billion of dollars.

The negative dynamics in Russian export rates were caused by the price factor in the growth in volume of exported goods. The overall increase in value of imports was caused by an increase in average import prices even though there was a decrease in the physical volume of Russian imports (*Table 43*).

Table 43

Indices of Russian foreign trade, as % of the previous year

	2010		2011		2012		2013	
	Trade volume	Average prices	Trade volume	Average prices	Trade volume	Average prices	Trade volume	Average prices
Export	110	119.8	97.8	132.9	99.9	101.6	104.9	95.7
Import	135.4	101.6	122.2	109.1	105.1	97.3	97.8	102.5

Source: the Ministry of Economic Development

The trade-surplus in 2013 was positive and reached \$179bn (8.5% of GDP) which was 6.9% less than in 2012. The crucial factor in reducing the trade surplus was a deterioration of the terms of trade. The import-export coverage ratio decreased from 157.3% in 2012 to 152% in 2013.

The coefficient of foreign trade imbalance (ratio of positive trade balance to trade turnover) decreased from 22.3% in 2012 to 20.6% in 2013.

Structure and dynamics of exports

In 2013 the Russian export of goods was reduced to \$523.3bn which was 0.9% less than the corresponding figure for 2012. The value of exports to non-CIS countries increased and the total price of exported goods to those was \$444.9bn which was 0.1% more than the level of the previous year (*Table 44*). Meanwhile, the total value of goods sold to CIS countries was \$78.4bn which was 6.3% less than in 2012. The export share of the non-CIS countries increased from 84.2% to 85%.

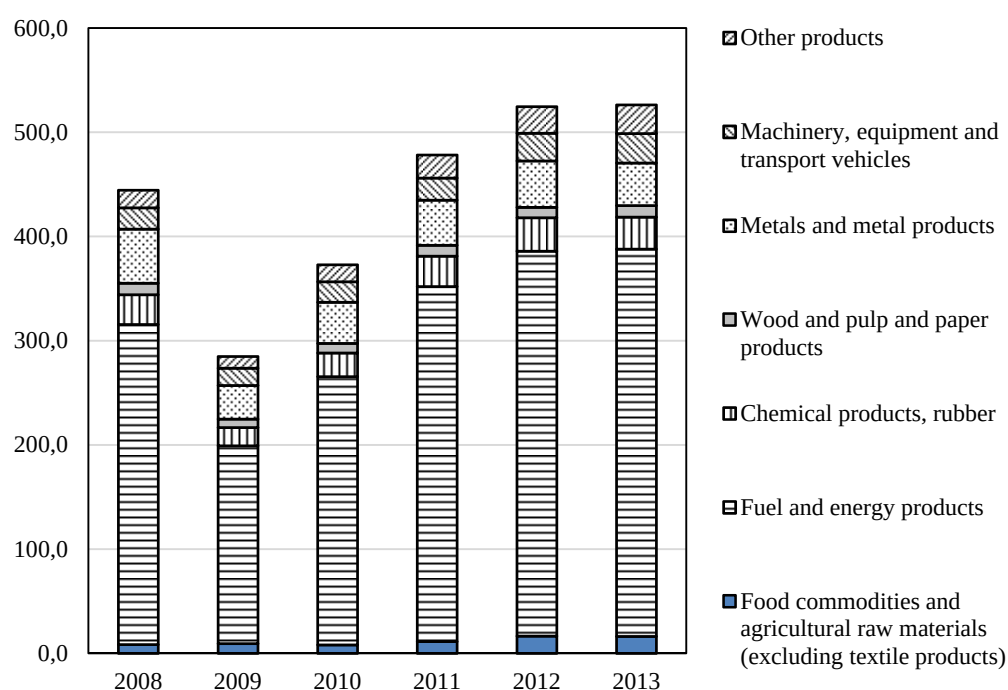
Table 44

Dynamics of Russian export

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Export, billion. dollars	107.3	135.9	183.2	243.8	303.6	354.4	471.6	303.4	400.6	515.4	529.1	523.3
Including:												
Non-CIS countries	90.9	114.6	153.0	210.2	260.2	300.6	400.5	255.3	338.0	436.7	445.2	444.9
Growth Rates, as % of the Previous Year												
Volume Index	115.0	109.5	110.7	104.7	105.8	105.0	96.8	97.0	110.0	97.8	99.9	104.9
Price Index	86.0	113.4	122.7	126.9	119.7	110.9	137.4	76.4	119.8	132.9	101.6	95.7

Source: the Bank of Russia; the Ministry of Economic Development

There is still a very high share of fuel and energy products in the structure of Russian exports (*Fig. 57*) while the proportion of machinery, equipment and transport vehicles is still rather low. At the end of 2013 the value of mineral products in the export structure was 71.6% (including fuel and energy products: 70.6%), in 2012 it was a little lower at 71.4%. In the total volume of Russian exports the share of metals and metal products is continuing to shrink: in 2013 it was just 7.8% in comparison to 2012 when it was 8.5% (in 2011: 9.1%). The proportion of machinery, equipment and transport vehicles in the structure of exports rose to 5.4% in comparison to 5.0% in 2012 (in 2011: 4.4%).



Source: FCS.

Fig. 57. Trade dynamics of Russian exports, billion dollars

A decline in the value of exports in 2013 in comparison to 2012 could be witnessed in three product groups.

The export abroad of foodstuffs and agricultural raw products diminished by 2.4% while the share of this group of products within the total export volume decreased from 3.2% to 3.1%. The decrease in value for this group was caused by a 13.9% reduction in the volumes of wheat and mixtures of cereal grains exported and also by a 10.5% reduction in contract prices.

The volume reduction can be explained both by decreasing purchase by Egypt, which, until recently had been the largest buyer of Russian grain and also by increased competition from Ukraine and Kazakhstan, caused by good harvests. Contract prices declined in line with trends in the world market.

In 2013, for the first time since 2009, a reduction in exports of chemical products could be seen. According to the FCS, exports of Russian chemical products in 2013 decreased 3.9% in comparison to 2012 to \$30.7bn. The situation happened because of a plunge in export prices for fertiliser and synthetic rubber. So, prices for nitrogen fertiliser fell by 10.3% during the year, potash fertilisers by 14.7% while synthetic rubber fell by 18.1%.

The most significant reduction in the value of exports in 2013 was observed within the product group: 'metals and metal products'. Exports of these products were down 8.1% compared with 2012. This happened due to a decrease in contract prices for the whole range of goods within this group and a reduction in the physical volume involved. The reason for this reduction was an overproduction of steel in the world, increased competition and the fall in external demand.

The volume of exports of mineral products increased by 0.6% in 2013 in comparison to 2012. This happened despite a decline in the export price of oil by 4% because of both a reduction in physical volume by 1.4% and because the products were sold at a price which was 2.7% lower than in 2012.

Nevertheless, the reduction in price of the exported oil was compensated by the growth in volumes of exported petroleum products (up by 9.7%) and of natural gas (up by 22.9%). The contract prices for these products actually decreased: for petrol, by 4.6%, for fuel oil not containing biodiesel, by 7.9% and for natural gas, by 2.9%. In spite of this, in 2013, exports of oil products reached 151.4m tonnes thanks to exports to non-CIS countries (which increased by 16.5%). Exports of petroleum products to the CIS countries diminished by 39.3%.

Natural gas exports in 2013 amounted to 196.4bcm which was a record level for the whole observation period (*Table 45*).

'Gazprom' in its report for the fourth quarter of 2013 provided information on the growth of gas sales abroad. Compared with 2012, sales rose from 7.1% to 217.59bcm in 2013. At the same time, exports to non-CIS countries grew by 16.3% and reached 161.49bcm while exports to the CIS and to the Baltic States fell by 12.9% to 56.1bcm. The volume of gas exported to non-CIS countries reached its highest level compared with recent years. The major growth was divided between three countries: Italy increased its purchase of Russian gas in 2013 by 67.9% compared with 2012, the UK, by 54.5% and Germany, by 21.1%. This can be explained by a series of factors. At the beginning of 2013 the demand for gas in Europe was increased because of extremely cold temperatures; at the beginning of March, as supplies from Libya began to be interrupted because of clashes between Libyan militants in the north-western part of the country, in the region where the Mellitah gas distribution system is located. A decrease in exports of liquefied natural gas (LNG) from Qatar to Europe became a significant factor and was connected with the beginning of long-term agreements on gas deliveries to Asia and South America.

Natural gas exports to the CIS and the Baltic States were at their lowest level for several years as a result of decreased demand from such countries as Ukraine, Moldova, Lithuania and Latvia.

Table 45

Natural gas for exports by OAO «Gazprom», billion cubic meters

State	2012	2013	2013 as % of 2012
Germany	33.16	40.15	121.1
Italy	15.08	25.32	167.9
Turkey	27.02	26.69	98.8
France	8.04	8.17	101.6
Finland	3.75	3.54	94.4
Austria	5.22	5.23	100.2
Greece	2.5	2.62	104.8
Netherlands	2.31	2.13	92.2
Switzerland	0.3	0.37	123.3
Denmark	0.33	0.34	103.0
Great Britain	8.11	12.53	154.5
Hungary	5.29	5.97	112.9
Poland	9.94	9.79	98.5
Slovakia	4.19	5.42	129.4
Czech Republic	7.28	7.32	100.5
Romania	2.17	1.19	54.8
Bulgaria	2.53	2.8	110.7
Serbia and Montenegro (Yugoslavia)	0.74	1.14	154.1
Slovenia	0.5	0.53	106.0
Bosnia and Herzegovina	0.26	0.19	73.1
Macedonia	0.08	0.05	62.5
The Ukraine	32.87	25.84	78.6
Belorussia	20.26	20.26	100.0
Moldova	3.08	2.39	77.6
Lithuania	3.32	2.7	81.3
Latvia	1.12	1.13	100.9
Estonia	0.62	0.73	117.7
Kazakhstan	0.93	0.88	94.6
South Ossetia	0.03	0.03	100.0
Armenia	1.94	1.96	101.0
Georgia	0.25	0.18	72.0
In Total	203.22	217.59	107.1

Source: <http://www.gazprom.ru/f/posts/21/499896/qr0312.pdf>, <http://www.gazprom.ru/f/posts/52/479048/gazprom-emitent-report-4q-2013.pdf>

An increase in exports can be observed for product groups with small specific weights. So, although leather, furs and products based on these comprised only 0.1% of total Russian export values in 2013 this was an increase of 21.6%. The export of textile, textile products and footwear (at 0.2%) had also risen in 2013 compared with 2012 (by 22.6%) while exports of precious stones, precious metals and products based on them (at 2.7%) had risen by 4%.

There was a 7% increase in the value of machinery, equipment and transport vehicles exported with an extra 0.8% of this product group going to non-CIS countries while exports to the CIS increased by 16.7%. Sales of Russian cars to the CIS increased by 50.9%.

The structure and dynamics of imports

The slowing of import growth which began in 2012 intensified in 2013. As a result, Russian imports in 2013 increased by only 2.6%, reaching \$344.3bn (*Table 46*). This growth in imports was helped by an increase in deliveries from non-CIS countries, the value of goods transferred from these reaching \$294.7bn, which was 2.1% higher than the corresponding rate for 2012. The value of goods imported from the CIS into Russia reached \$49.6bn, which was 5% more than in 2012. In total, the import share from non-CIS countries diminished from 85.9% to 85.6%. Import growth could be seen in almost all commodity groups except for mineral products, machinery, equipment and transport vehicles (*Fig. 58*).

The imports of precious stones, metals and products based on these materials increased especially significantly, with the increase being estimated at 20.1%; imports of wood, pulp and paper products increased by 9.2% while imports of textiles, textile products and footwear increased by 7.5%.

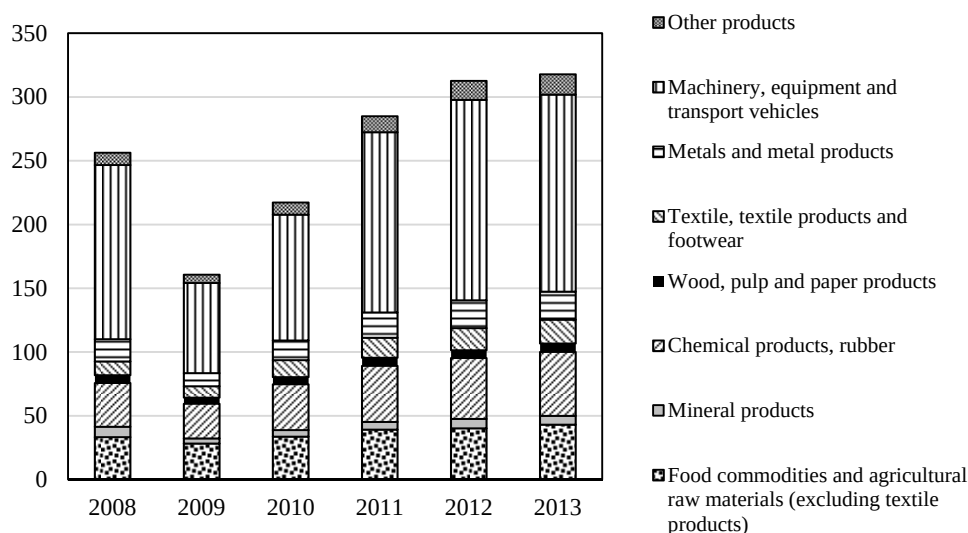
Table 46

Russian Imports, billions of dollars.

	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Imports, billion of dollars	60.9	76.1	97.4	125.4	164.3	223.5	291.9	191.8	248.6	318.6	335.8	344.3
Including:												
Non-CIS Countries	48.2	60.1	76.4	103.5	138.6	191.2	253.1	167.7	213.3	275.5	288.5	294.7
Growth Rates, as % of the Previous Year												
Volume Index	117.6	119.2	124.2	122.4	130.1	127.1	113.5	63.3	135.4	122.2	105.1	97.8
Prices Index	93.4	98.7	106.1	106.5	105.5	107.6	117.8	99.1	101.6	109.1	97.3	102.5

Source: the Bank of Russia; the Ministry of Economic Development

In 2013, according to the FCS, the Russian Federation imported foodstuffs and agricultural raw materials valued at \$43.1bn, an increase of 7.1% on 2012, the total volume of Russian imports for this product group having increased by 0.7 percentage points compared with 2012, reaching 13.6% of total imports.



Source: FCS.

Fig. 58. Trade dynamics of Russian imports in billions of dollars

In comparison with 2012 the volumes of import purchases of wheat and meslin rose by more than 4 times, the import of milk and concentrated cream rose by 46.9%, of butter, by 23.7% and of sugar, by 29.2%. For the same product positions a growth in average contract prices can be noticed. So, the prices for wheat and mixtures of cereal grains increased by 7%, for milk and concentrated cream, by 36.9% and of butter, by 22.9%.

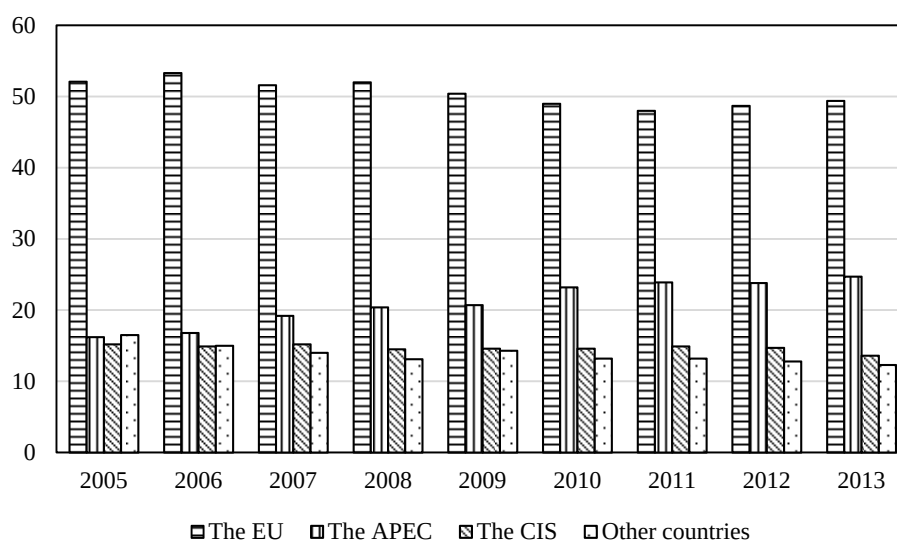
The value of imports of metals and metal products grew by 0.9% and reached \$18.6bn mainly attributable to an increase in the amount of imported steel pipes (by 4.9%) and ferrous metals (by 1.8%). The share of imported metals and metal product volumes had decreased until it reached 6.9% in 2013, compared with 7% in 2012.

Imports of chemical products in 2013 were estimated at \$50.1bn and had increased by 5.1% while their share within total Russian imports had increased from 15.3% in 2012 to 15.8%.

The main Russian import items are still machinery, equipment and transport vehicles. Imports of this category of products diminished by 1.8% in comparison to 2012, falling to \$154.3bn while their share within total Russian imports decreased from 50.3% in the previous year to 48.6%. According to the FCS, imports of cars into Russia in 2013 had diminished by 16.9% in comparison to 2012 with the number of cars estimated at 894.100 pieces; and with the number of HGVs decreasing by 26% and estimated at 88000 pieces.

4.6.4. Geographical structure of Russian foreign trade

The European Union still remains the main foreign trade partner of the Russian Federation. In 2013 the share of the EU in the geographical structure of Russian foreign trade turnover (*Fig. 59*) had increased since 2012 by 0.7 percentage points and was estimated at 49.4%. The Netherlands still remained the major trade partner of Russia within this group, although their share had diminished by 0.8 percent points and was estimated at 9%. Second place was occupied by Germany, and its share in Russian foreign trade turnover had increased from 8.7% in 2012 to 8.9% in 2013. Italy was the third largest partner of Russia within the European Union in foreign trade volume, with its share at 6.4%, having risen by 1 percentage point. On the whole, in 2013, the EU countries had increased their volume of foreign trade with Russia by 1.9% in comparison to 2012 - the volume of Russian exports had increased by 2.2% while the volume of Russian imports had increased by 1.3%.



Source: FCS RF.

Fig. 59. Geographical structure of Russian foreign trade (%), 2009–2013

The share of the Asia-Pacific Economic Cooperation (APEC) in Russian foreign trade turnover increased from 23.8% in 2012 to 24.7% in 2013. The total volume of Russian trade with APEC countries in 2013 increased by 4.2%. At the same time Russian exports to those countries rose by 8.9% and Russian imports, by 0.2%.

The main foreign trade partner of Russia under this group is China, its share in foreign trade turnover remained at the same level as it had been in 2012: 10.5%. Second place belongs to Japan, the share of which increased from 3.7 to 3.9%. The share of trade with the U.S. remained at the same level as it had been in 2012: 3.3%.

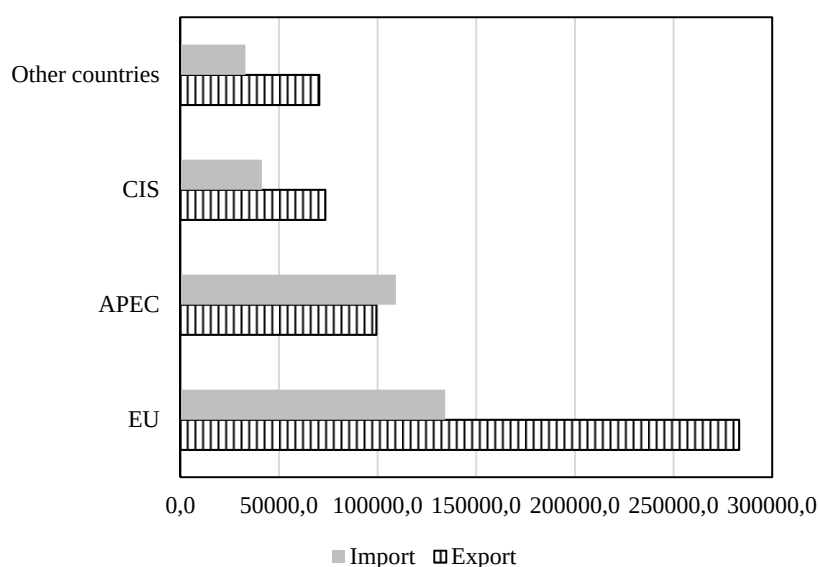
The share of the CIS within the foreign trade turnover of Russia in 2013 was reduced in comparison to 2012, from 14.7% to 13.6%. The major trade partner within this group is Ukraine but it achieved a share of only 4.7% in 2013 in comparison to 5.4% in 2012.

On the whole, in 2013, the trade turnover of Russia with these states diminished relative to 2012 by 2.2%.

Russia's trade balance in 2013 (*Fig. 60*) turned out to be positive for all groups of countries, excluding the member-countries of APEC (- \$9.9bn). The negative balance of Russian trade was formed with 23 countries, with their share in the total trade turnover of the Russian Federation estimated at 30.3%.

The largest deficit in trade of Russia was formed with China (- \$17.6bn), the USA (- \$5.3bn), France (- \$3.8bn) and Austria (- \$2.6bn).

The largest recorded trade surplus of the Russian Federation was with the Netherlands (at \$64.3bn), followed by Italy (\$24,8bn) and Turkey (\$18.2bn).



Source: FCS RF.

Fig. 60. Major indicators of Russian foreign trade by regions in 2013 in billions of dollars

4.6.5. Regulation of Russian foreign trade

Tariff regulation

Export duties

In the first quarter of 2013 the Government of the Russian Federation adopted three resolutions to correct the rates of export customs duties for oil and oil products.

According to the Resolution of the Government of the Russian Federation № 276 of 29 March 2013: on 1 April 2013 a new procedure for the determination of the rates of customs duty came into force. According to the procedure, the Ministry of Economic Development in

Russia monitors the prices of oil and oil products on the world markets and from these determines the export customs duties in respect of those products in accordance with methodology approved by the Government. On a monthly basis, throughout the period from April until December 2013 the Russian Ministry of Economic Development implemented adjustments to the export customs duties on crude oil and for certain categories of goods produced from oil.

Table 47

Export duty rates for oil and oil products in 2012–2013 dollar/tonnes

	Oil	Oil Products
2012		
January 1 st	397.5	262.3
February 1 st	393.7	259.8
March 1 st	411.2	271.4
April 1 st	460.7	304.0
May 1 st	448.6	296.0
June 1 st	419.8	277.0
July 1 st	369.3	243.7
August 1 st	336.6	222.1
September 1 st	393.8	259.9
October 1 st	418.9	276.4
November 1 st	404.5	267.0
December 1 st	396.5	261.7
2013		
January 1 st	395.6	261.1
February 1 st	403.3	266.2
March 1 st	420.6	277.6
April 1 st	401.5	265.0
May 1 st	378.4	249.7
June 1 st	359.3	237.1
July 1 st	369.2	243.6
August 1 st	379.8	250.6
September 1 st	400.7	264.4
October 1 st	416.4	274.8
November 1 st	395.9	261.2
December 1 st	385.7	254.5

Source: Government resolutions of the Russian Federation, data from the Ministry of Economic Development

In order to bring the customs duties in line with the international obligations of the Russian Federation under the WTO the following Resolution of the Government of the Russian Federation №754 was passed: ‘On approving customs export duties for goods exported from the territory of the Russian Federation beyond the borders of the Customs Union-signatories and the repeal of certain legal acts of the Russian Federation’ of 31 August 2013. The resolution implies a partial decrease in customs duties (generally by 1.25 - 2.5 percentage points) for many products which are subject to export duties: in particular, fish (salmon, flatfish, walleye pollock, herring, poutassou), crabs and shrimps, together with magnesium and tungsten ores and concentrates, bituminous mixtures, hides and skins, silver-plated and gold-plated metals etc.

Import duties

During 2013 it was decided to reset the rates of import duties (for some types of forge-stamping hydraulic presses and hydraulic radial-forging machines, some types of self- and non-self-propelled railway wagons, certain types organic chemicals, terephthalic acid and its salts, some types of artificial viscose fibres, some fruit products and silicon).

From 1 April to 30 June 2013 the customs import duties were raised for quark, butter, dairy spreads and some types of cheese in order to protect dairy product producers within the

countries of the Customs Union (CU). Thus, the duty for natural butter was raised to 18.3%, but not less than €0.29 per kilo (previously, 15%, with the same lower limit). The same duties were put in place for recombined oils (whey butter and dairy spreads). Dairy spreads with more than 80% fat are taxed at 18.3%, but not less than €0.16 per kilo (previously, 15%, with the same lower limit). The custom duties for quark that has less than 40% fat were raised to 18.3%, but not less than €0.5 per kilo (previously, 15%, with the same lower limit). The situation is the same for dairy cheese with less than 40% fat. The duties for quark and cottage cheese with more than 40% fat were raised to 18.3%, but not less than €0.4 per kilo (previously, 15%, but not less than €0.3 per kilo).

According to decision №42 of the Council of the Eurasian Economic Commission (EEC) of 2 July 2013 the effect of the premium import customs rates for butter, dairy spreads, other fats and milk butter, cottage cheese and quark was extended up to, and including 31 August 2013.

To stimulate an increase in the production of televisions sets within the Customs Union, according to the decision of the EEC №20 of 14 March 2013, the import duties on LCD and plasma-screen televisions and for TV sets with screens produced using LCD technology was increased to 16%. Previously the rates had been 10% and 15%, respectively.

On 13 September 2013 the Russian Federation joined the WTO multilateral Agreement on information technology directed at the liberalisation of trade in this sector of the world economy. Russia became the 78th party to this Agreement. Upon its accession Russia took a commitment to decrease customs duties for IT products from 5.4% to 0% by 2016.

In total the proportion of participants in the WTO Agreement on information technology accounts for 97% of world exports of information technology. Russia is a net importer of information technology: in 2012 the value of IT exports from the Russian Federation was \$0.99bn, and the value of imports was \$20.21bn.

In order to fulfil its tariff commitments to the WTO on 1 September 2013 new import customs duties came into force in the Russian Federation, those duties being adopted under the Decision of the Eurasian Economic Commission Council №45 of 2 July 2013 (*Table 48*). The decrease in duties concerns about 5100 product lines accounting for almost half of the Common Customs Tariff of the CU. The duties have been slightly decreased for individual items: in the range of 1–3 percentage points. For a small proportion of the product lines the import customs duties have been increased.

On the whole, the decrease in customs duties concerns commodity products including fish, exotic fruits, confectionary products, and raw materials for juice production. However customs duties have also been reduced on some types of equipment (from washing machines to tractors), and also for tropical oils, and certain clothes and fabrics.

So, import customs duties have been diminished from 10% to between 8 and 9% for some product types: 0302, 0303 (fresh fish/chilled and frozen), 0304 (fish fillet). Rates have been reduced from 20–25% to 18.3–22.5% for product type 0402 (milk and cream with added sweeteners), from 15% to 13.3% – for products of type 0407 (birds' eggs). At the same time the customs rates for fats and oils produced from milk and milk spreads (0405) and a range cheeses and quark (0406) have been increased from 15.0%, but not less than €0.5 per kilo to 22.5 %, but not less than 0.45 per kilo, which means that, the ad valorem rate reached its maximum level under the commitment noted above, as, prior to 1 September 2013 the level had been lower.

For a number of product classifications the combined rate has been replaced by the ad valorem rate. For example, knitted garments and other items of clothing previously came under a combined rate of 10.0%, but not less than €3.0 per kilo. Since 1 September 2013 the import duty on these products has been subject to an ad valorem rate of 18.3%.

Table 48

Comparison of the different Unified Customs Tariffs in %

	The UCT of the CU	
	Decision of the EEC Council of 16 July 2012 №54	Decision of the EEC Council of 2 July 2013 №45
The lowest ad valorem rate, other than zero	2	2
The highest ad valorem rate	65	65
Average ad valorem rate for the most protected groups:		
Meat and meat offal	37	37
Carpets and floor coverings	20	16
Arms and ammunition	20	19
Alcoholic and non-alcoholic beverages	18.4	16
Finished textile products	18.4	16
Precious stones and metals	18	17
Arithmetic average rate	10	9.5

Source: <http://www.eurasiancommission.org>

A gradual decrease in customs duties will continue until 2018, provided for by transitional periods for different types of product.

So, according to the Decision of the Eurasian Economic Commission Council №58 of 9 October 2013, import customs duties have been reduced to 13% from the earlier rate of 13.7% for mashed potatoes and plum paste produced from ‘Prunus’ plumbs, in primary packaging with net-weights of not more than 100 kg and intended for industrial processing.

The import duty for ethylene vinyl acetate has been reduced from 8.8% to 6.5%. Import duties for paving and tiles have been reduced from 13% to 12%. Additionally the import duties on turntable units (decks) and sound equipment without a recording function have been cut from 12.3% to 11%. The Decision came into force on 31 December 2013.

Non-tariff regulation

Bans and restrictions

According to the Decision of the Eurasian Economic Commission Council №33 of 5 March 2013 ‘On amendments to section 1.5 of the unified register of goods within the framework of the AurAsEC, where the import or export of which are banned or restricted for the member states of the Customs Union in trade with undeveloped countries’ the register of banned-for-export wood products, regenerated paper, cardboard and wastepaper has been reduced. Wood products made of oak with a thickness greater than 6mm, coniferous species and other species with a thickness of not more than 6mm, timber, shuttering for concreting, carpentry constructions such as beams, roof timbers and roof spacers have been excluded from the register.

According to the Decision of the Eurasian Economic Commission Council №121 of 4 June 2013 ‘On amendments to section 2.12 of the unified register of goods within the framework of the AurAsEC, where the import or export of which are banned or restricted for the member states of the Customs Union in trade with third countries’ the list of narcotic drugs and psychotropic substances which require licences for their import or export has been extended. The following products, in particular, have been added: AMT (*Alpha-Methyltryptamine*) and products based on it, modafinil, nalbuphine, dimethocaine, methoxetamine and its derivatives,

methedrone and ethylphenidate. In all, 69 products were added to the register. Licences for the import of the above substances into Russia and export of those products from the territory of Russia under the terms of trade with undeveloped countries are granted by the Ministry of Industry and Trade of Russia. If a substance is included into the appropriate Russian registers (registers I-IV), then instead of a licence the permission of the Federal Service of the Russian Federation for Control of Narcotics (Federal Narcotics Control Agency of Russia)(FNCA of Russia) is required, and in the case of medicines, a certificate from the Ministry of Healthcare and Social Development is also required for export/import.

Protective measures

Having become a full-fledged member of the WTO, the Russian Federation together with the members of the Customs Union are continuing to develop a range of trade policy instruments to protect their internal markets and in particular the introduction of antidumping duties.

Introduced at the initiative of Russian companies, the antidumping taxes were effective until April 2013 in protecting companies within the Customs Union. Major products, which then came under antidumping scrutiny by the Customs Union, included metals and metal products. However, only one antidumping measure was directed against Ukrainian exports of synthetic yarns. Countries that now come under the current active antidumping measures of the Customs Union are Ukraine and China. In April 2013 two new antidumping taxes directed against Chinese imported products were introduced.

According to the Decision of the Eurasian Economic Commission Council №64 of 9 April 2013 it was decided to introduce antidumping duties at the rate of 51.87% of the customs' value on enamelled pig-iron bathtubs, imported from China. The decision came into force on 26 May 2013 and is effective until 25 January 2018.

Preliminary antidumping duties had been introduced ahead of the completion of the antidumping investigation concerning the Chinese enamelled pig-iron bathtubs on 26 January, 2013. Following the preliminary investigation, the antidumping duties were introduced for a period of 5 years.

Within the period 2009-2011 imports of enamelled pig-iron bathtubs from China to Customs Union countries increased by 48.4%, while the proportion of these Chinese imports represented 82% of the total of this type of product.

Since the consumption of enamelled pig-iron bathtubs in 2011 remained at the 2009 level, the production volume in the Customs Union fell by 16.8% and the volume of their sales, by 26%, while product stockpiles increased by 1.5 times. The share of products produced by enterprises within the Customs Union fell by 15.2% on the domestic market as a result of the increase in imports from China under the dumping prices.

According to the Decision of the Eurasian Economic Commission Council №65 of 9 April 2013 it was decided to introduce antidumping duties of 19.5% for Cold-Deformed seamless stainless steel pipes produced in China and imported to the Customs Union. This antidumping measure was introduced for five years.

This antidumping investigation was started by the Ministry of Industry and Trade of the Russian Federation on 25 November 2011 according to an application filed by the OJSC 'Chelyabinsk Tube Rolling Plant', the OAO 'Pervouralsk New Pipe Works', OAO 'Synar tube plant' and the OOO 'TMK-INOKS'. In connection with the delegation of their authority to the Eurasian Economic Commission the Customs Union countries transferred supranational

powers for implementing special protective antidumping measures and compensation investigations to the EEC.

The investigation showed that the share of imports from China in the total imports of seamless stainless steel pipes to the Customs Union between 2008 and 2010 increased steadily so that, by 2010 the share was already 78.8%. In the second half of 2010 the indicator grew further, reaching 81.3%, but during the first half of 2011 it fell back to 63.2%.

In 2010 the weighted average price for such tubes from China had diminished by 15.2% in comparison with 2008. The unified dumping margin for all exporters and/or producers of seamless stainless steel pipes from China was 19.15%.

Within the period between 2008 and 2010 despite the growth in consumption of stainless steel tubes within the Customs Union by 48.2% the production volume by Customs Union companies fell by 9.1%. The rapid increase in imports of the Chinese tubes was accompanied by a decrease in the share of the Customs Union of domestically-produced tubes by 12 percentage points while the share of Chinese imports increased by 31.6 percentage points.

In the face of intense price competition from the increased Chinese imports, the economic enterprise sector of the Customs Union reduced their prices which resulted in a decrease in sales profitability by 5.8 percentage points and in a reduction of 38.3% in profits, so it was decided to introduce antidumping taxes.

According to the Decision of the Eurasian Economic Commission Council № 133 of 14 May 2013 antidumping taxes on light commercial vehicles (LCV) from Germany, Turkey and Italy imported into the Customs Union were introduced for a term of 5 years. The Decision came into force 30 calendar days after it had been officially published on 16 June 2013.

The antidumping investigation was initiated by OOO ‘Sollers-Elabuga’. Analysis of the Russian market for LCVs during the period from 2008 until 2011 indicated that, while there was a reduction in the total volume of imported light commercial vehicles into the Customs Union by 29.1%, their imports from Germany, Italy and Turkey had increased by more than 23%. At the same time the proportion of dumped imports increased steadily. According to the Eurasian Economic Commission Council, the proportion of dumping was 95.4% of the total import volume, having increased by 40.5% compared with the figures from 2008. The weighted average price for the products from Germany, Italy and Turkey in 2011 had decreased by 9.5% in comparison to 2008.

The demand for LCVs within the member-states of the Customs Union in 2011 had increased by 3.7 times in comparison to 2009, but the share of vehicles produced by the Customs Union in the consumption volume had decreased during the period of 2009–2011 by 20.1 percentage points; the profits of the corresponding sectors of the Customs Union economy having decreased by 17% in 2010 compared with 2009; in 2011 the vehicle production sector of the economy suffered losses, with the profitability of production becoming negative. Thus, while production costs had increased by 42.7%, in an effort to remain competitive against the increased dumping imports the wholesale prices rose by only 6.4 %. To sum up, the investigation showed the existence of dumping imports from Germany, Italy and Turkey which had caused material damage to the economies of the members of the Customs Union.

The antidumping duty for all German manufacturers was set at 29.6% of the customs value; for the Italian Sevel S.P.A. factory (owned by PSA Peugeot Citroen) and others Italian manufacturers the duty was 23%, and for all the Turkish manufacturers, including Ford,

Otosan Sanayi Anonim Sirketi the duty was 11.1%. The antidumping duty is in addition to a current duty of 10%.

According to the Association of European Businesses, in 2012 LCV sales in Russia had increased by 7% compared with 2011, reaching 188,095 units. At that time the market leader was the 'GAZ Group' – 90247 units. Among foreign brands the leading positions were taken by light commercial vehicles from Volkswagen (16161 units), Ford (12962 units) and Peugeot (9933 units).

The introduction of antidumping duties for the import of LCVs is likely to lead to a reduction in the volume of imports. To maintain leading positions in the Russian market, the foreign automotive concerns will have to localise their production of LCVs within the Russian Federation. So, Ford together with the 'Sollers-Elabuga' company has already started producing some LCV models in Tatarstan. Fiat, Peugeot-Citroen and Renault are looking at the possibility of starting production of LCVs in ZiL. Since 2013 Mercedes has been manufacturing its Sprinter LCV at the GAZ Group production line in Nizhny Novgorod.

It should be noted that German manufacturers do not approve of the introduction of antidumping duties for LCVs and they intend to appeal the decision in accordance with established procedures. The French producers are also studying the possibility of sending a request either to amend or to revoke the duties. The companies have the right to ask for arbitration by the WTO or to challenge the decision through the EurAsEC Court. They can send a request to the ECE after one year to ask for another investigation on the basis of which they can ask for the measures to be reviewed or cancelled. However, for that to occur the companies will have to demonstrate that the markets for that industry have improved.

In April 2013 the ECE completed its reinvestigation in connection with caramel imports from Ukraine, which was undertaken as a result of a request from the Ukrainian companies DO 'Confectionary Corporation ROSHEN', PJSC 'Kharkov biscuit makers' and PJSC Confectionary Plant 'Kharkovchanka'.

A special protective measure in connection with caramel was introduced under the Resolution of the Government of the Russian Federation №445 of 3 June 2011, for a 3 year period and imposed a special duty of \$294.1 per tonne. This has been in place since 8 July 2011. According to the Agreement on the Application of Special Protective, Antidumping and Countervailing Measures, during the transitional period from 19 November 2010, this Russian measure was also extended into the territory of the Customs Union.

During the investigation it was found that, in the first half of 2012, compared with the first half of 2011, against a backdrop of a 4.1% fall in caramel consumption in the Customs Union, the production rate remained almost level, yet the sales volume increased. At the same time, a reduction in the volume of caramel imported, by 30.7%, made possible an increase of 5.1% in its share of goods in the Customs Union.

During the same period the sale weighted average selling price fell by 1.3% against a backdrop of a reduction in the cost of production by 11.4%. This provided companies with the opportunity to increase their levels of profitability to 4.4% while, during the first term of 2011, they had suffered losses. So, the effect of the special protective measure against caramel imports had a positive impact on that sector of the economy. As a result the College of the Eurasian Economic Commission made a decision to diminish the effective rate of the special duty for caramel. The reduction was implemented in two stages: from 15 June until it reached \$283.8 per tonne, and from 15 December, 2013 until it reached \$273.5 per tonne.

During the investigation it was found that the share of caramel imports from Brazil exceeded the 3% threshold for total caramel imports so it will now also be subject to the effect of special protective measures.

Under the Decision of the ECE №181 of 27 August 2013 a special protective duty was introduced for china dinnerware. The duty is effective from 28 September 2013 until 28 September 2016 (inclusive).

On 3 September 2012 an investigation was initiated in relation to an application by OOO DO 'Promisly Verbilok', OAO 'Imperial Porcelain Plant', ZAO «Dobrushsky Porcelain Plant» and the PK «Dulevsky Porcelain Plant» and this confirmed the presence of grounds for the use of special protective measures. Between 2009 and 2011 the volume of imports increased by more than 70% and during the first half of 2012 compared with the first half of 2011, by additional 15.9%. The porcelain dinnerware was being imported into the Customs Union and sold at prices which were well below those of the Customs Union members. This caused a reduction in the ratio of the production volume to the import volume of the china dinnerware by 1.7 times and led to a reduction in manufacture and sales, and a fall in the market share of the manufacturers within the Customs Union and to unprofitability of production.

From 29 September 2013 until 28 September 2014 (inclusive) the duty will amount to \$1479 per tonne. From then on, until 28 September 2015(inclusive) the special duty will be reduced to \$1035.3 per tonne. From 28 September 2016 the duty will be \$591.6 per tonne.

This measure is directed, initially, against manufacturers in China and Ukraine which are the major suppliers of this kind of dinnerware to the Customs Union. During the period under examination 83% of the total volume of imports was from China.

At the meeting of the College of the Eurasian Economic Commission which took place on 25 June 2013 it was decided to introduce a final special protective duty for combine-harvesters and their modules until 7 March 2016.

During the period of investigation by the College of the Eurasian Economic Commission a preliminary special protective duty was introduced on 25 December, 2012 to cover combine-harvesters and their modules, with its level set at 27.5% of the customs value. Based analysis of the results of the investigation, it was concluded that there was a basis for the use of a special protective measure.

So, during the period between 2009 and 2011 the volume of import of combine-harvesters to the Customs Union in absolute numbers increased by 19.9% and in the second half of 2012 by an additional 92.3%¹ compared with the first half of 2011. This led to a reduction in the production of combine-harvesters by 14.4%, to a fall in volume of their sales by 43.4% and to an increase in stockpile by 67.4%. As a result the share of national producers of combine harvesters on the Customs Union market was reduced by 14.6 percentage points, and their profits by 3.6 times. In 2012 those trends intensified.

According to the conclusions of the investigation, the ECE decided to introduce duty at rate of 26.7% until March 2016 with a phased reduction to 25.7%. Nevertheless, Kazakhstan blocked the decision of the College of the Eurasian Economic Commission. After conducting several consultations with the Customs Union member-countries the ECE decided to introduce import quotas for combine-harvesters and their modules in place of the antidumping duties as a protective measure. The quota came into force on 1 January 2014 and lasts until 21 August 2016. The size of the quota in 2014 for Russia will be 424 units, in 2015 –

¹ http://www.eurasiancommission.org/ru/act/trade/podm/eec_investigations/Documents/report_final_harvesters.pdf

437 units, in 2016 – 288 units; for Kazakhstan – 300 units, 309 units and 204 units respectively; for Belarus – 50 units, 52 units and 34 units respectively. The import of combine-harvesters to the Customs Union member-states in excess of the quota during the effective period of the protective measure will be forbidden.

In total nowadays there are 14 effective measures for the protection of the domestic markets of the Customs Union (*Table 49*).

Table 49

Internal market protective measures within the Customs Union

Product	Product Position CN FEA CU	Exporting country	Type of Measure
China dinnerware	6911	Worldwide	Special protective
Light commercial vehicles	8704	Germany, Italy, Turkey	Anti-dumping
Enamelled pig-iron baths	7324	The PRC	Anti-dumping
Cold-deformed seamless stainless steel tubes	7304	The PRC	Anti-dumping
Graphite electrodes	8545	India	Anti-dumping
Activated charcoal	3802	Worldwide	Special protective
Stainless steel tubes	7304, 7306	Worldwide	Special protective
Polymer coated metals	7210, 7212, 7225	The PRC, Taiwan, Hong-Kong, Macau	Anti-dumping
Forged steel rolls for rolling mills	8455	Ukraine	Anti-dumping
Caramel	1704, 1806	Worldwide	Special protective
Roller-bearings	8482	The PRC	Anti-dumping
Some types of steel pipes	7304, 7305, 7306	Ukraine	Anti-dumping
Fasteners	7318	Worldwide	Special protective
Combine-harvesters and modules	8433	Worldwide	Import quota

Source: <http://www.eurasiancommission.org/ru/act/trade/podm/mery/Pages/default.aspx>

Proceedings by the WTO

On 9 July 2013 the European Union lodged the first legal complaint against the Russian Federation with the Court of the WTO in connection with the implementation of scrappage taxes on cars. In Europe it is believed that in spite of all imports from the EU being subject to the fees, while vehicles produced within Russia, Kazakhstan and Belarus are exempt from the tax. According to this the duty creates preferences for automotive manufacturers in the Customs Union, which is in contravention of the WTO agreements. In the EU it was hoped that the conflict over the scrappage taxes would have been settled by 1 July, 2013, with the adoption of amendments to Federal Law №89-FZ of 24 July 1998 'On Production and Consumption of Wastes' which levelled the conditions levy on national and foreign producers, but the amendments had not been passed by this time, and the State Duma was dissolved for the summer holidays.

According to the Federal Treasury data on performance, from the day of introduction of the scrappage taxes in September 2012 until 1 December 2013 the federal budget a profit from them was RUR64.3bn.

According to the WTO rules, the parties to a dispute have 60 days for peaceful settlement of the conflict, meaning settlement of the problem through consultations. After the period of 60 days the claimant is entitled to require the formation of a dispute settlement panel.

The bilateral consultations which were held on 29 and 30 July 2013 did not lead to any bridging of differences. So in October 2013 the time frame of 60 days provided for reaching a peaceful agreement with the EU under the rules of the WTO ended. On 10 October 2013 the EU appealed to the WTO Dispute Settlement Committee with a proposal to form an arbitration panel to consider the question of the legality of the fee.

On 22 October 2013 a meeting of the WTO Dispute Settlement Committee was held and during that meeting the Russian representative challenged the request of the EU to the WTO on convening a panel of arbitrators to consider the existing mechanism of scrappage taxes in Russia on the basis that not all means of peaceful settlement had yet been undertaken.

In July 2013 the European Union authorities filed a complaint with the WTO which forced the Russian authorities reconsider their position. On 21 October 2013 the President of the Russian Federation, Vladimir Putin, signed the amendments to the Law 'On Production and Consumption Wastes' that levelled the conditions of the scrappage taxes on cars from both national and foreign producers. According to the new law, which came into force on 1 January 2014, utilisation fees will need to be paid not only for cars imported into the Customs Union, but also for cars produced within the Customs Union itself. Vehicles belonging to compatriots moving to Russia for permanent residence under special diplomatic programmes and consular missions are regarded as exempt. Additionally, rare vehicles manufactured a minimum of 30 years ago are also exempt from the fee.

On 25 November, 2013 a meeting of the WTO Dispute Settlement Committee took place and, during that meeting, at the renewed request of the European Union an arbitration panel was formed for the settlement of the dispute on the regime of utilisation fees for automotive vehicles levied in the Russian Federation. According to the principles of the organisation, a renewed request cannot be denied. Thus the first panel proceedings against the Russian Federation have begun since Russia entered the WTO in 2012.

The WTO should send the Russian party a list of arbitrators, and, within two weeks of receipt of the list, Russia, together with the EU must agree on the list. If, within this period, they are not able to come to an agreement, the case will be handed to the Director-General of the WTO in order that he can designate the arbitrators himself.

The panel must then decide within six months which party to the conflict is right. At this stage it is very important that the governments of the countries which are parties to the conflict are provided with the support of qualified advisers and from the authorities of other countries whose interests could be affected by the results of the dispute resolution.

According to statistics, 60% of decisions of the panel are appealed to the Appeal Board however changes to, or cancellations of, the decisions of the panel are very uncommon. It should be noted that decisions made by the Appeal Board are not subject to further appeal and become the basis of the case law of the WTO.

China, India, Japan, Korea, Norway, Turkey, Ukraine and the USA expressed their willingness to take part in the investigation as third parties.

On 23 December 2013 Russia lodged the first legal complaint in the whole existence of the World Trade Organisation against the EU on the issue of so-called 'energy corrections' in conducting antidumping investigations.

Prior to 2002 the EU, regarded the Russian Federation as a state with a non-market economy, defining its assessment of dumping, on the basis of comparing Russian export prices with the selling prices within the domestic markets of undeveloped countries. In 2002 the European Union acknowledged the Russian Federation's status as a country with a market economy. But for the determination of dumping, in relation to Russian exporters, so-called 'energy corrections' were still used. In the calculation of the value of a product the prices at which Russian exporters purchased gas or electricity were not taken into account. Instead, the EU used the higher prices for energy in other countries that do not have access to their own

resources; this fact automatically transferred Russian enterprises into the category of infringers of trade regulations. This policy is still being implemented.

From 1995 until 2012 the European Union introduced 17 antidumping measures against Russian exporters, the majority of those measures were adopted in breach of international rules and caused significant losses to the Russian producers of fertilisers, ferroalloys, tubes and other steel products and of aluminum foil.

On 1 February 2014 five EU antidumping measures directed against Russian products were effective¹:

- *Ammonium nitrate* - from 12.07.2008 to 12.07.2013 a unified specific duty at the rate of €41.42 – 47.07 per tonne, depending on the type of a product, was effective. With respect to the company OAO «Eurohim» individual duties are effective – €28.88 – 32.82 per tonne. The measure was first introduced on 23 August 1995. On 12 July 2013 a five-year review of antidumping measures was initiated.
- *Seamless tubes* - from 5.07.2012 until 4.07.2017 a duty at the following rate is effective: OAO 'Chelyabinsk metallurgical Plant' and OAO 'Pervouralsk New Pipe Works' – 24.1%, from 28.12.2012 enterprises of the Pipe Metallurgical Company (PMC) – 28.7%, for other Russian companies – 35.8%.
- *Ferrosilicon* – from 01.03.2008 till 28.02.2013 a duty at the following rate was effective: Bratsky Ferroalloy Smelting Plant – 17.8%, for other Russian companies – 22.7%. On 28 February 2013 a five-year review of antidumping measures was initiated.
- *Welded unalloyed pipes* – from 19.12.2008 till 20.12.2013 a duty at the following rate was effective: enterprises of the group the United Metallurgical Company (UMC) – 10.1%, enterprises of the group PMC – 16.8%, for other Russian companies – 20.5%. On 19 December 2013 a five-year review of antidumping measures was initiated.
- *Pipe fittings* – from 17 January 2013 a duty at the rate of 23.8% for import of pig-iron and steel fittings is effective for all Russian companies.

The unfair antidumping policy of the EU has been discussed during many expert consultations, but it has not led to any changes in the position of Russian major trading partner. Under conditions where all other forms of conflict management have been exhausted, the resort to the WTO procedures is an inevitable, but at the same time important, measure for restoring normal trade terms with the EU.

In accordance with the rules of the WTO, consultations were held within 60 days from the date of the request, i.e. until 22 February 2014. During this period the parties did not manage to find a solution to the problem. In one month Russia therefore has the right to initiate the formation of an arbitration panel (arbitration court of the WTO) in the course of its action against the 'energy corrections' implemented by the European Union.

¹ <http://www.ved.gov.ru/mdb/information/database/>

Section 5. Social Sphere

5.1. The Living Standards of Russia's Population in 2013

Over 2013, the population's real disposable income rose by 3.3%. The salary level in the budget-funded sphere was being raised at a high rate – which, however, proved to be insufficient to meet the targets set in the President of the Russian Federation's Executive Order of 7 May 2012, No. 597 'On Measures Aimed at the Implementation of Government Social Policy'. The income inequality index over the period January–September 2013 somewhat increased. The poverty level over the first 9 months of 2013 was 0.5 pp. above its level over the corresponding period of 2012, due in the main to the alterations introduced into the methodology applied for estimating the subsistence level. The impact of social transfers on the child poverty level in Russia is low by comparison with that in the European Union.

5.1.1. Population Income

In 2013, the average nominal monthly charged wage amounted to Rb 29,960, having risen on 2012 by 12.3%. As the Consumer Price Index increased by 6.8% in 2013¹, growth of the real average monthly charged wage over the course of that year was 5.2%.

Over the course of 2013, the average nominal monthly wages in arrears increased on the previous year by 24%² – from Rb 2,046.7m to Rb 2,536.9m. The real amount of average monthly wages in arrears remains at a low level: as of 1 January 2014 it amounted to less than 1% of companies' total monthly wages fund. The number of employees whose wages were in arrears over the year varied between 53 and 97 thousand. Wages in arrears arose, as a rule, due to lack of companies' own funds; the average monthly share of wages in arrears arising as a result of delays in money transfers from the budgets of all levels over the entire year, with the exception of February, was at the level of only 3–4% of the total amount of wages in arrears.

Over 2013, the size of labor pension was increased twice:

- from 1 February 2013, labor pensions were increased by 6.6 %,
- from 1 April, due an increase in the RF Pension Fund's revenues in 2012, an additional upward adjustment of labor pension by 3.3% was carried out.

In April 2013, the size of pensions paid under the government pension program was raised by 1.81%, while the monthly federal benefits paid to special categories of pensioners were increased by 5.5%.

¹ The period January–December 2013 against the period January–December of the previous year.

² Based on data reported by organizations other than small-sized businesses.

In August 2013, the size of pensions paid to working pensioners was adjusted, in accordance with the planned scheduler, by the amount of insurance contributions received in 2012 from their employers under the mandatory pension insurance program.

As result of all these measures, over the course of 2013 the average size of allotted monthly pension increased by 9.7%, thus amounting to Rb 9,918. Its growth in real terms amounted to 2.8%.

Over the course of 2013, the monthly per capita money income in nominal terms increased by 10.7% - to Rb 25,522. At the same time, the population's real disposable money income increased by only 3.3%.

The nominal indicators of the population's money income (salaries, pensions, other money incomes) for 2013 were slightly below the corresponding indicators for the previous year, while the inflation rate was higher (6.8% vs. 5.1% in 2012); as a result of these changes, growth of the population's real disposable money income over that period was less impressive than in 2012 (3.3% vs. 4.6% in 2012).

The movement of the real disposable money income in 2012 and 2013 is shown in *Table 1*.

Table 1

**Changes in the Real Disposable
Money Income, %**

	As percentage of	
	corresponding period of previous year	previous period
2012		
Q1	102.2	76.4
Q2	104.8	115.8
1st half year	103.6	
Q3	104.5	100.1
Q4	106.0	119.7
Year	104.6	
2013		
Q1	105.6	76.1
Q2	103.0	112.9
1st half year	104.2	
Q3	102.4	99.6
Q4	102.9	120.2
Year	103.3	

Source: data released by Rosstat.

The salary raise in the budget-funded sphere (funded, in addition to other sources, also by the dotations transferred to regional budgets from the federal budget) resulted in a situation where, in 2013, the fastest growth rates were demonstrated by the average monthly charged wage indexes (less social benefits) in the public education sector (123.2%) and the public healthcare and social welfare sectors (118.9%). As a result, the average monthly salary in the education sphere grew to Rb 23,421, and that in the public healthcare and social welfare sectors - to Rb 24,564. In 2013, the upward movement of these indexes pushed up the sectoral-to-national salary ratios in these three sectors, which became as follows: in the public education sector - 78% of the average national salary and 82% of the national average for the processing industries; in the public healthcare and social welfare sectors - 81% of the average national salary and 85% of the national average for the processing industries.

In general over the year 2013, the salary levels of the relevant categories of employees in the budget-funded sphere of each RF subject shown as a percentage of the average monthly wage index were as follows:

- in the public education sector: 73.5% of the average monthly salary of secondary school teachers in a RF subject for tutors employed at educational establishments providing extracurricular education to children; 94.9% of the average monthly salary in the general education sphere in a RF subject for tutors employed at pre-school educational establishments; for teachers employed at secondary schools and other general-education establishments, and for the faculty members of higher (professional) educational establishments – 96.9% and 134.9% respectively of the average monthly wage index in a given RF subject;
- in the public healthcare sector: for nursing staff - 47.8% of the average monthly wage index in a given RF subject, and for physicians and other healthcare practitioners with higher education diplomas, employed at medical institutions and providing medical care services to the population - 141% of the average monthly wage index in a given RF subject.

The targets set in the RF President's Executive Order of 7 May 2012, No. 597 'On Measures Aimed at the Implementation of Government Social Policy' for the years 2012 and 2013 are as follows:

- in 2012, the average salary level of secondary school teachers and the tutorial staff of other general-education establishments should be raised to match the average salary for a given region's economy;
- by 2013, the average salary of tutors employed at pre-school educational establishments should be raised to match the average salary level in the general education sphere of each region.

If the salary raise targets for the budget-funded sphere are set against the actually achieved results, it will become evident that, as late as 2013, the average salary level of the staff of general-education establishments was still below that of each region's average salary, although it had been planned that this target should be already achieved in 2012. When the salary levels of the staff of general-education establishments are analyzed in relation to the form of ownership of each establishment, it turns out that, at present, the actual salaries at federal general-education establishments and those owned by RF subjects are higher than the targets stipulated in the RF President's Executive Order of 7 May 2012, No. 597 'On Measures Aimed at the Implementation of Government Social Policy'; however, the salaries of the staff of municipal schools amount to no more than 85% of the average salary index in a given RF subject.

The same, in fact, is true with regard to the salaries of tutors employed at pre-school educational establishments: in 2013, their level was still below the average salary level in the general education sphere of each given region, while the salary level of tutors employed at municipal pre-school educational establishments amounted to only 86.2% of the average salary in the general education sphere.

5.1.2. Socioeconomic differentiation

In 2013, the inequality in distribution of the population's money incomes became slightly less prominent.

The income inequality indices dropped on 2012 as follows:

- the Gini coefficient¹ - from 0.420 to 0.418;

¹ The Gini coefficient (income concentration index) is a measure of statistical dispersion intended to represent the income distribution of a nation's residents. Its value may vary from 0 to 1. The higher the value, the more unequal is the income distribution.

– R/P 10%¹ - from 16.4 to 16.2.

The declining inequality in the distribution of the population's money incomes was largely caused by the shrinking share of the fifth quintile (highest incomes) in the population's aggregate income (by 0.1 pp.) and the increasing share of the second quintile (also by 0.1 pp.). In the main, the income share's shrinkage was spawned by changes in the income level of the richest 10%. In 2013, the share of the richest 10% amounted to 30.7% of the population's total income against 30.8% in 2012.

The share of the poorest 10% remained at its 2012 level, thus amounting to 1.9% of the population's aggregate income.

The population distribution by per capita money income level is shown in *Table 2*.

Table 2

The Population Distribution by Per Capita Money Income Level, %

	2013	2012
Total population	100	100
including with per capita monthly money income level under Rb 5,000.0	4.4	5.8
Rb 5,000.1–7,000.0	5.7	6.9
Rb 7,000.1–10,000.0	10.6	12.0
Rb 10,000.1–14,000.0	14.4	15.4
Rb 14,000.1–19,000.0	15.3	15.5
Rb 19,000.1–27,000.0	17.4	16.7
Rb 27,000.1–45,000.0	19.1	17.1
over Rb 45,000.0	13.2	10.6

Source: data released by Rosstat.

5.1.3. Subsistence level and poverty

In 2013, the subsistence level indexes were as follows (*Table 3*): national average – Rb 7,429 per month, including Rb 8,014 per month for the able-bodied population, Rb 6,097 per month – for pensioners, and Rb 7,105 per month – for children.

Table 3

Subsistence Level, Rb

	Total population	Able-bodied population	Pensioners	Children
2012				
Q1	6,307	6,827	4,963	6,070
Q2	6,385	6,913	5,020	6,146
Q3	6,643	7,191	5,229	6,387
Q4	6,705	7,263	5,281	6,432
Year	6,510	7,049	5,123	6,259
2013				
Q1	7,095	7,633	5,828	6,859
Q2	7,372	7,941	6,043	7,104
Q3	7,429	8,014	6,097	7,105

Source: data released by Rosstat.

The share of food in the consumer basket is highest (45.8%). The share of non-food products amounts to 23.4%, that of services – 23.6%. Mandatory payments and fees take up 7.2% of the consumer basket.

The ratios of the main population income indexes to the subsistence level in Q3 2013 were as follows:

– the ratio of per capita money income to the national average subsistence level – 335.5%,

¹ The ratio of the average income of the richest 10% to the poorest 10% (R/P 10%) describes a nation's socioeconomic differentiation.

- the ratio of the average monthly charged wage index to the subsistence level of the able-bodied population – 380.9%,
- the ratio of the average monthly charged pension index to the subsistence level of pensioners – 177.2%.

The poverty index for the first 9 months of 2013 was at the level of 17.8m, or 12.6% of the total population (*Table 4*), while the corresponding indexes for the same period of the previous year were 17.2m and 12.1% respectively. However, these changes are by no means indicative of a rising poverty level in Russia. The upward movement of these indexes has resulted from the alterations introduced into the methodology for calculating the subsistence level from 1 January 2013, which pushed up the subsistence level estimates.

Table 4

Number of People with Incomes Below Subsistence Level

	Million	As % of total population
2012		
Q1	19.1	13.5
Q2	16.4	11.5
1st half year	17.7	12.5
January–September	17.2	12.1
Q4	12.5	8.8
Year	15.6	10.9
2013		
Q1	19.6	13.8
Q2	17.2	12.1
1st half year	18.4	13.0
January–September	17.8	12.6

Source: data released by Rosstat.

5.1.4. The Child Poverty Rate and the Effect of Social Policies on the Child Welfare Levels in the Russian Federation and the European Union

To obtain the child poverty rate estimates comparable with those in the developed countries, and to assess accordingly the effect of social transfers on child welfare in the Russian Federation, the relevant approaches practiced in the developed countries were applied¹.

¹ The estimates for EU countries are based, among other sources, on EU-Statistics on Income and Living Conditions (EU-SILC). The estimates for the Russian federation are based on the results of 21st round of the Russian Monitoring of the Population's Economic Status and Health, which took place in October–December 2012.

The household's aggregate income was set against the value of the 'total money income of all members of a household' variable. Out of these two variables, the one with the higher value was selected.

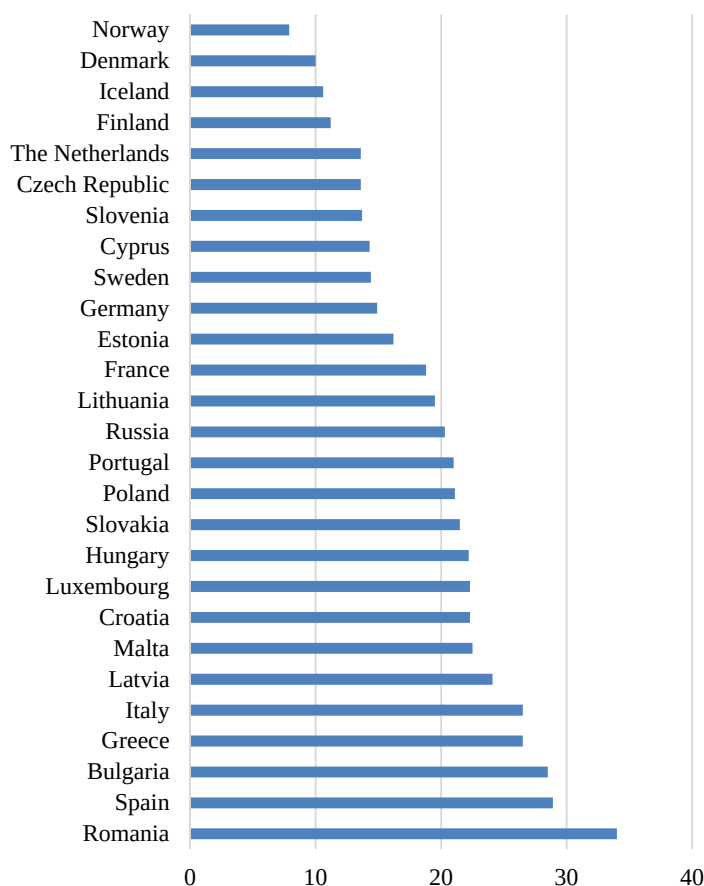
To adjust the results by economy of scale effect, the equivalence scale applied by the Statistical Office of the European Union (EUROSTAT) to weight household incomes in the developed countries was applied.

To determine the at-risk-of-poverty threshold, the value of 60% of the equivalent median disposable money income per household member was applied.

To measure the value of the total social transfer variable, the aggregate transfer index was applied, which included the following indices:

- dotations to cover the cost of fuel: natural gas, kerosene, coal, firewood, peat, etc.
- child care benefit, for parents with children aged under 1.5 years,
- monthly child benefit,
- welfare benefit,
- subsidies to cover the cost of housing rent and utilities,
- monthly money payments in lieu of in kind benefits,

Russia's child poverty rate, after the receipt of social transfers allocated in 2012, amounts to 20.3%. If Russia is to be compared with the developed countries, by its child poverty rate after social transfers it will fit somewhere in the middle of the list, as the at-risk-of-poverty threshold amounts to 60% of the equivalent median disposable money income of all households after social transfers (*Fig. 1*).



Source: calculations based on EU-Statistics on Income and Living Conditions (EU-SILC) and RLMS data.

Fig. 1. Child Poverty Rate after Social Transfers and Taxes, at the At-risk-of-poverty Threshold of 60% of the Equivalent Median Money Income in the EU Countries and the Russian Federation in 2012, %

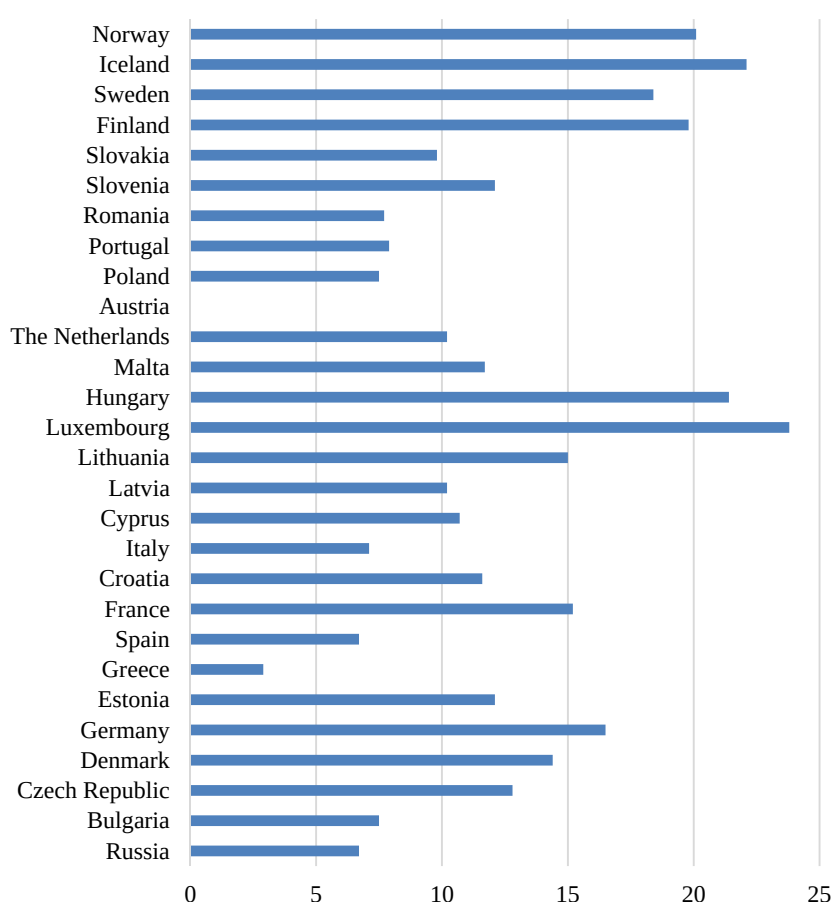
The amount of child social transfers in Russia, if set against the standards applied in the developed countries, is low; besides, such transfers are not highly targeted, and so it can

-
- pensions,
 - stipends,
 - unemployment benefits,
 - deductions from the cost of housing rent and utilities,
 - tax deduction granted to cover the cost of tuitions, medical care or purchase of housing.

For the purpose of imputation of minimum salary level data, the amount of salary declared by an adult able-bodied household member was set against that of the minimum salary index. If the amount of salary declared by an adult able-bodied household member was found to be lower than the minimum salary index, the latter value was entered in the statistics file.

hardly be expected that their effect will match the effect of their counterparts in the developed countries. Besides, it should be noted that the population welfare surveys conducted in the RF do not take into account the data on all the social transfers received by families with children. The results of our estimations are not adjusted by the effects of taxes on Russia's child poverty rates, because the relevant data are not available. As noted in many studies, the level of personal income information concealment in the RF is very high; people prefer not to report the amount of their real income not only to tax agencies, but also to the interviewers collecting data for the population welfare surveys.

In 2012, social transfers (less pensions) in Russia brought down the child poverty rate before social transfers by 6.7 pp. By the value of its index of 'effect of social transfers (less pensions) on the child poverty rate', the Russian Federation falls far behind almost all of the EU countries, with the exception of Greece (*Fig. 2*).

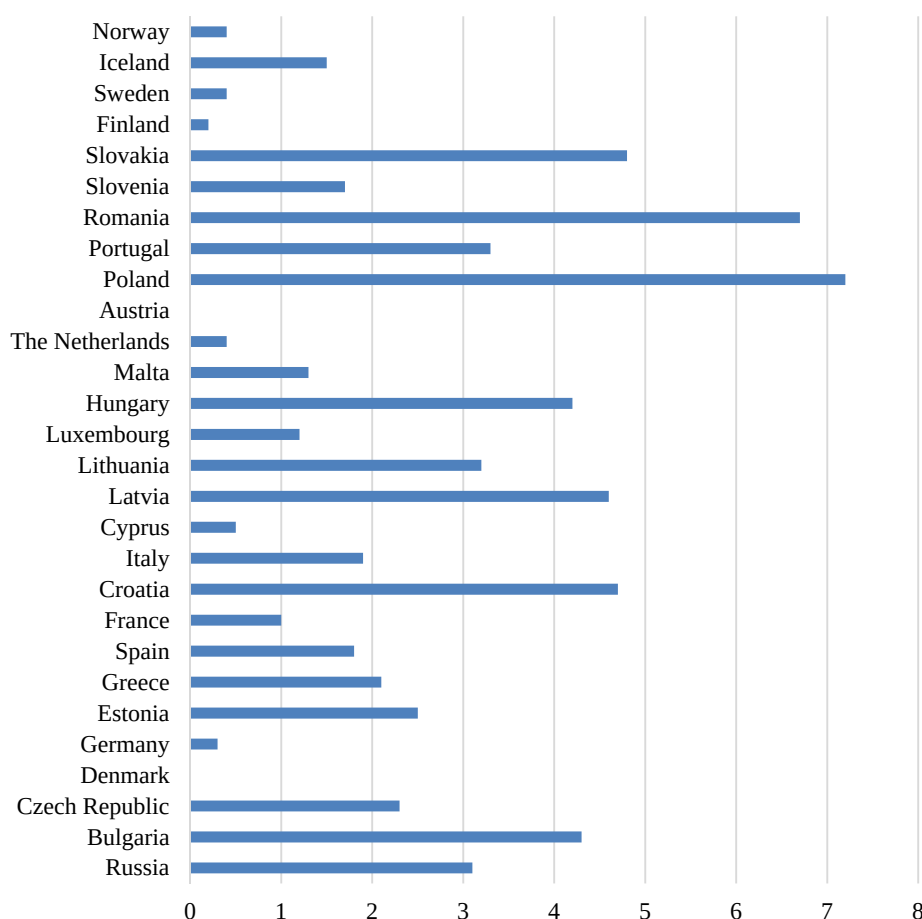


Source: calculations based on EU-Statistics on Income and Living Conditions (EU-SILC) and RLMS data.

Fig. 2. Differences between Child Poverty Rates before Social Transfers and Taxes (Pensions Not Included in Social Transfers) and Child Poverty Rates after Social Transfers and Taxes (Pensions Included in Social Transfers), at the At-risk-of-poverty Threshold of 60% of the Equivalent Median Money Income in the EU Countries and the Russian Federation in 2012, as Percentage Points

The effect of pensions on the child poverty rate in the Russian Federation, by the standards applied in the developed countries, is rather high. Such a situation is more typical of the EU

countries with lower levels of economic development, where grownup children after getting married prefer to stay in the home of their parents even after the birth of their own children. As seen in *Fig. 3*, the way that the amount of pension influences Russia's child poverty rate is closer to the similar effects observed in countries like Bulgaria, Hungary, Lithuania, Portugal, and Croatia, than in more developed countries like Denmark, Finland, Germany, or The Netherlands.



Source: calculations based on EU-Statistics on Income and Living Conditions (EU-SILC) and RLMS data.

Fig. 3. Differences between Child Poverty Rates after Social Transfers and Taxes (Pensions Not Included in Social Transfers) and Child Poverty Rates before Social Transfers and Taxes (Pensions Included in Social Transfers), at the At-risk-of-poverty Threshold of 60% of the Equivalent Median Money Income in the EU Countries and the Russian Federation in 2012, as Percentage Points

If we attempt to eliminate, in part, the effect of the factor of personal income concealment in Russia, and to replace the absent or evidently underestimated (by comparison with the minimum salary index) data on salary levels by the available data on the incomes of adult able-bodied RF citizens, the resulting children poverty rate for Russia will become somewhat lower (see *Table 5*).

These results have confirmed the necessity of conducting some additional studies in order to develop a methodology for additional data imputation in the personal income indexes

applied in the Russian Federation, which will be suitable for estimating the child poverty rate and the effects of social transfers and taxes on child welfare on the basis of the methodologies applied in the EU countries.

Table 5

**Child Poverty Levels in the RF Without and With Imputation
for Minimum Salary Data, %**

	Without imputation for minimum salary data	With imputation for minimum salary data
Child poverty rate after social transfers and taxes, calculated for poverty threshold set at 60% of median household income after social transfers, %	20.3	18.7

Source: calculated on the basis of RLMS data.

5.2. The Migration Policy and Migration Processes

In 2013, both sudden growth in public interest in migration issues and explosive increase in the number of statutory acts initiated in that field were observed. A new surge of interest in migration was triggered by the Biryulovo developments in October and the election campaign of the Mayor of Moscow which took place a little earlier¹.

5.2.1. Changes in the Institutions of Residence and Temporary Residence in the Russian Federation

Amendments to the legislation regulating (often tightening) the situation of migrants in Russia were introduced into all the key federal laws on migration. In particular, in 2013 amendments to the **Federal Law on the Legal Status of Foreign Nationals in the Russian Federation**² were introduced 16 times (for comparison: 6 times in 2012)³.

The above amendments dealt with the following key points:

1. The period of a temporary stay in the Russian Federation of a foreign national who arrived in the Russian Federation in accordance with the procedure which does not require a visa *cannot exceed ninety days totally within each period of one hundred and eighty days* except for cases provided for by the existing Federal Law, as well as in case such a period has not been extended in accordance with the existing Federal Law (Federal Law No.389-FZ as amended of December 28, 2013);

2. From 2014, an amendment will be in effect as regards *a possibility to reduce the period of a temporary stay of foreign nationals* "if the conditions changed and circumstances under which a foreign national was permitted to enter the Russian Federation ceased to exist. *The period of a stay of a foreign national in the Russian Federation is reduced in case a decision on a ban on entry into the Russian Federation was taken in respect of that national in accordance with the adopted procedure, as well as in other cases provided for by the Federal Law*" (Federal Law No.224-FZ as amended of July 23, 2013 and Federal Law 386-FZ as amended of December 28, 2013);

3. The grounds for refusal in issuing or cancellation of a temporary residence permit (Article 7), residence permit (Article 9) and work permit (Article 13) have been tightened,

¹ For more details – see L.B. Karachurina. Migration Processes //Economic Development of Russia. 2013. No.12. pp. 38–41.

² Federal Law No.115-FZ of July 25, 2002 on the Legal Status of Foreign Nationals in the Russian Federation

³ A portion of amendments came into effect as early as 2013, while other, from 2014.

including the following: “a temporary residence permit to a foreign national *is not issued, while the one issued earlier is cancelled in case a decision on undesirability of a visit (stay) in the Russian Federation or a decision on a ban on entry by that foreign national into the Russian Federation have been taken in accordance with the adopted procedure*” (Cl.1.2 of Federal Law No.224-FZ as amended of July 23, 2013)¹;

4. The terms of participation of foreign nationals in employment relations with legal-entity–employers have been specified: *the age of 18* and the existence of a work permit with a foreign national and an employer’s permit to employ foreign nationals (Article 13), as well as the list of criteria which those conditions do not apply to:

- persons studying in the Russian Federation at professional vocational establishments and higher education establishments and performing jobs (rendering services) during holidays or working during their free time at those educational establishments, business entities or business partnerships established by state-financed or autonomous establishments of higher education in which they undergo training;
- persons invited to the Russian Federation as researchers or educators to carry out research or teaching activities;
- persons who are workers of accredited representative offices of foreign legal entities registered in the Russian Federation;

5. The procedure and *the time-limits for an exchange of information on foreign nationals between executive authorities in the field of migration and tax authorities* have been determined. The individual taxpayer number is becoming an immanent factor and responsibility for all the foreign nationals;

6. An requirement has been introduced that in applying for a permit to work in housing and public utilities, retail trade or public amenities *a person is to have a command of Russian at the level which is not lower than the base one* and that level is to be confirmed by one of the listed documents (the state test certificate or documents on education) (Cl. 4 of Federal Law No.185-FZ as amended of July 2, 2013);

7. The specifics of carrying out by foreign nationals of labor activities in the territory of the Russian Federation due to measures provided for by the Federal Law on Preparation and Carrying Out of the 2018 FIFA World Cup and the 2017 FIFA Confederations Cup in the Russian Federation have been determined;

8. A few amendments as regards specification of the deadlines and the procedure for a temporary stay of students in Russia have been introduced;

9. The specifics of performance of labor activities by high-skilled experts (HSE)-foreign nationals, the eligibility criteria of that group of workers (work experience, skills and achievements in a specific line of activities and the amount of remuneration), as well as requirements to employers of such workers have been elaborated on. The mechanism of supervision over such employers which engage HSE has been tightened as regards fulfillment by employers of their obligations related to payment of wages and salaries, timely submission by them of the information on termination of labor contracts and provision to them of unpaid leaves for a period of more than a calendar month within a year and other;

¹ Similar to residence permit – Cl. 2 of Federal Law No.224-FZ as amended of July 23, 2013; work permit - Cl. 9.1 was introduced by Federal Law No.60-FZ of May 6, 2008; Federal Law No.224-FZ of July 23, 2013 as amended.

10. The terms of re-admission¹ – handover, delivery, temporary accommodation, personal inspection of persons subject to re-admission and other - have been specified.

So, the general line of the amendments introduced is quite evident: it is a trend towards tightening of administrative control and creating of barriers on the way of migration from CIS states in conditions of a visa-free regime (it is to be noted that though that regime is still in force it is highly disputed)². Toughening of requirements concerned primarily those foreigners who failed to secure within the first 90 days either a work permit or license to work with individuals. If earlier upon the expiry of the above period those migrants could leave Russia for their homeland or go to the nearest bordering country to return to Russia on the next day to continue their stay in Russia, from 2014 the above practice becomes illegal. Having left Russia upon the expiry of a 90-day period, a foreign national is allowed to return only 90 days after. If a foreign national exceeds the period of a stay, he/she faces an administrative fine with deportation or a ban on entry to Russia in case he/she attempts to enter the country next time.

The second trend consists in making it simpler for students from CIS states to come and work in Russia. At present, those students can work in Russia without securing a permit from the Federal Migration Service (FMS) and beyond the quota.

The Draft Law on Rubber Flats was debated throughout 2013 and approved late in the year³. The Law on Rubber Flats introduced amendments to the Law on the Right of Nationals of the Russian Federation to Freedom of Movement and Choice of the Place of Stay and Domicile Within the Limits of the Russian Federation⁴, the Law on Migration Registration of Foreign Nationals and Stateless Persons⁵ and the Criminal Code of the Russian Federation and the Criminal Procedure Code of the Russian Federation.

In accordance with the approved amendments to the existing statutory acts, for a sham registration at the place of a stay and the place of residence of Russian nationals, foreign nationals and stateless persons a fine of Rb 100,000 to Rb 500,000 can be charged and penalties in the form of compulsory labor for the term of three years or imprisonment for the same term can imposed.

In addition to the above, an article as regards a stay in an apartment of a national of the Russian Federation without registration and approval by the owner of the housing of such a stay for over the established period (90 days) was introduced in the Administrative Violations Code. For such a violation, tenants, owners of apartments and legal entities will be charged a fine of Rb 2,000-Rb 3000, Rb 2,000-Rb 5,000 and Rb 250,000-Rb 750,000, respectively.

At present, one can stay without registration only with his/her relatives and in the entire territory of the constituent entity provided that one has been registered at the place of domicile in the same constituent entity of the Russian Federation. In addition to the above, residents of the Moscow (Leningrad) Region may stay without registration in Moscow (St. Petersburg) and vice versa.

¹ Re-admission is a consent by the state to receive back to its territory its nationals (and in some cases foreigners which earlier stayed or resided in that state) who are subject to deportation from a foreign state.

² From 2015, one will be allowed to enter Russia only with a passport for trips abroad and not with an internal passport as it is practiced at present. In a sense, the above measure can be regarded as a first step to introduction of visas.

³ Federal Law No. 5242-1 of June 25, 1993 of the Russian Federation.

⁴ Federal Law No. 5242-1 of June 25, 1993 of the Russian Federation.

⁵ Federal Law No.109-FZ of July 18, 2006.

Different amounts of fines have been set for capital cities, their regions and the rest of the country. Experts say that such a situation is in conflict with the constitutional norm under which all the nationals are equal before the law regardless of the place of their residence.

In addition to the above, actual implementation of the draft law will require active measures on the part of district police officers who, firstly, have to prove that a person stays without a registration for over 90 days and, secondly, violate Article 182 of the Criminal procedure Code of the Russian Federation under which it is prohibited to enter the apartment without a consent and knowledge of the resident of that apartment unless there is a search warrant signed by a judge¹.

Experts believe that approval of the above draft law may have some negative consequences: on the part of district police officers there will be higher corruption related to migration and leaseholds rates will go up in case large-scale fines are issued on the basis of neighbors' evidence. According to V. Mukomel, Head of the Migration and Integration Processes Research Sector of the Institute of Sociology of the Russian Academy of Sciences, though the law is aimed at tightening of registration of foreign nationals it will complicate the life of Russians: "The issue of mobility of the Russian population is becoming more complicated as the Law is oriented at the Soviet-era model of registration. At present, we live in different conditions: people are registered at one region and work at another. The Law in question is a continuation of violations of Russian nationals' rights. In the 1990s, the Constitutional Court made a few decisions and rulings under which the existence or absence of registration should not prejudice the rights of nationals"².

Federal Law No.114-FZ of August 15, 1996 on **The Procedure for Entry to the Russian Federation and Exit from the Russian Federation** was also supplemented with the following points which provide for a ban on entry by foreign nationals to the Russian Federation if:

- within three years foreign nationals were repeatedly (two or more times) brought to administrative responsibility in compliance with the legislation of the Russian Federation for committing administrative violations in the territory of the Russian Federation – within three years from the effective day of the latest decision on bringing to administrative responsibility”;
- within a year a foreign national or a stateless person was repeatedly (two or more times) brought to administrative responsibility for committing an administrative violation related to infringement of a public order and public safety or the regime of stay (residence) of foreign nationals or stateless persons in the Russian Federation or the procedure for carrying out by the above persons of labor activities in the territory of the Russian Federation – within five years from the effective day of the latest decision on bringing to administrative responsibility”.

The amendment on the ban on entry to Russia by foreign nationals who committed an administrative violation (for instance, traffic rules) was introduced into the Federal Law on the Legal Status of Foreign Nationals in the Russian Federation.

¹ V. Novikov. Draft Law on Rubber Flats: Great Commotion About Nothing //Novosti RAPS. http://rapsinews.ru/legislation_publication/20130228/266554840.html#ixzz2qRYnPNmE. Date of application 17.02.2014.

² Yu. Mukhametshina, E. Pogorelova Moscow is Not Boundless //Gazeta. Ru. 23.12.2013. <http://www.gazeta.ru/social/2013/12/23/5816521.shtml> . Date of application 17.02.2014.

Late in 2013, the Government of the Russian Federation submitted for consideration **the draft law on amendments to the Labor Code of the Russian Federation**. Under the above draft law, in addition to the existing list of documents required for entering into the labor agreement “a foreign national or a stateless person who is seeking employment is to present to the employer an agreement (a policy) on voluntary medical insurance which is effective in the territory of the Russian Federation (except for cases where the employer concludes an agreement with a medical institution on provision of paid medical services or the agreement (policy) of voluntary medical insurance) – for foreign nationals or stateless persons who come to Russia for a temporary stay (except for foreign nationals or stateless persons who were engaged as high-skilled experts in accordance with the legislation on the legal status of foreign nationals in the Russian Federation)”¹.

Unlike 2012, in 2013 the issue of control over the situation in the field of employment of foreign workers from countries which maintain a visa-free regime with Russia was a topic of the **Annual Message of the President to the Federal Assembly**². The main emphasis was made on the following:

- continuation of the successful experience in issuing of licenses to workers from CIS states who work for individuals, legal entities and individual entrepreneurs. “The cost of a license will be determined by a constituent entity of the Russian Federation depending on the situation on the regional labor market and the average level of income of households in that territory. The system of licenses should be a differentiated one and create an incentive for, primarily, skilled and educated workers with knowledge of the Russian language and culture to come to Russia ... the license should be effective only in that region where it was bought”;
- tightening of control over the purposes of entry by foreign nationals to Russia and limitation of the period of a stay and banning of the entry to Russia by migrants who violated the rules of a stay (“Depending on the gravity of the violation, the period of a ban may vary from three to ten years”).

Realization of a larger portion of legal innovations starts on January 1, 2014. Some instruments were actively engaged as early as 2013. For example, by the beginning of 2014 the rule of “a ban on entry to Russia of migrants who violated the rules of a stay” resulted in the fact that 500,000 migrants were denied entry to Russia. The imposition of that sanction in respect of those migrants took place due to violation by them of the rule of a stay in Russia. They were banned to come to Russia for three to ten years³.

So, in 2013 the total number of legislative initiatives in the migration field was that big so it can be regarded as the year of a new migration reform which took place a year after the

¹ Draft Federal Law No. 393946-6 on Introduction to the Labor Code of the Russian Federation of Amendments Related to the Specifics of Carrying Out by Foreign Nationals of Labor Activities.

² The Message of the President to the Federal Assembly. December 12, 2013. Published at <http://kremlin.ru/news/19825>. The date of application: 17.02.2014.

³ Such data was given at the press-conference of senior officials of the Federal migration Service of Russia with journalists. For more details see S. Lyutykh Malicious Offenders of the Migration Legislation will be Denied Entry to Russia for 10 Years //Vechernyaya Moskva. January 15, 2014 <http://vm.ru/news/2014/01/15/zlostnim-narushitelyam-migratsionnogo-zakonodatelstva-zakroyut-vezd-v-rossiyu-na-10-let-230980.html>. The date of application: 17.02.2014.

approval of the *Guidelines for the State Migration Policy of the Russian Federation until 2025*¹ which did not imply the above initiatives.

5.2.2. The Effect of Migration on the Number and Pattern of the Country's Population

Within 10 months of 2013 (January – October), the number of the population of Russia rose by 261,600 (migrants accounted for 93% of that growth). Within the above period, growth in migration amounted to about 245,000 persons and did not actually change as compared to the respective period of 2012.

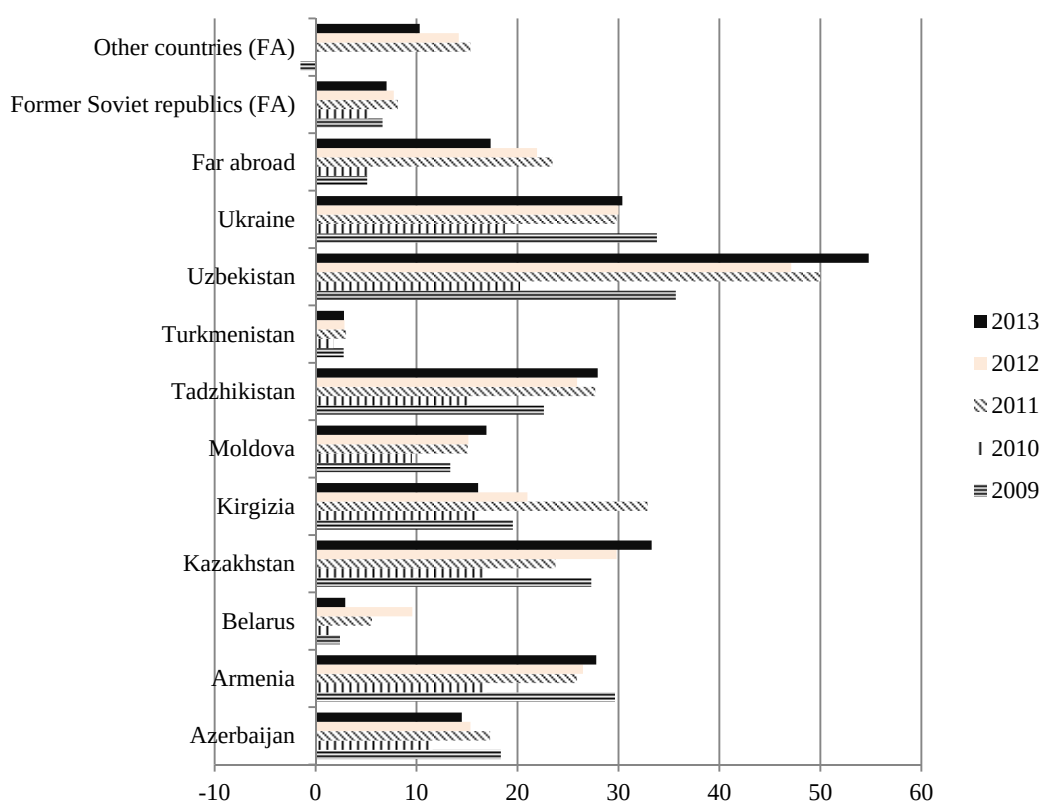
However, it is to be reminded that from 2011 in migration growth not only persons registered at the place of residence are accounted for (as it was from 1995 when that type of registration replaced the system of registered domicile), but also those registered at the place of their stay for the period of over 9 months. Changes in the methods had an effect on the number of *arrivals* to Russia registered by the statistics nearly from the beginning of 2011, while closer to the end of 2011 and starting from 2012, that is, with a certain time lag they had an effect on the dynamics of *departures* from Russia: from that period the number of departures rose dramatically as they started to be registered “automatically”, that is, upon the expiry of the period, for example, of 9 months in registration at the place of a stay. In that sense, in 2013 the general pattern of migration which was formed in the previous year did not change neither in terms of its dynamics, nor from a perspective that a certain share of a temporary (labor) migration is now statistically accounted for in Russia's migration growth. According to the estimated data, in 2012 external migrants registered in Russia at a new place of a stay accounted for about 35% of migration growth in Russia (that is, a little more than 100,000 persons). Others were registered for different periods of temporary registration which means that earlier (as a minimum migrants registered for the period of 9 months are included in that growth) or later (5 years) they will be automatically deregistered. Some will renew then their registration, other will not. Indirectly, a country vector of departures from Russia permits to determine the extent of a share of the labor migration in migration growth. In 2012, of all the migrants earlier registered at the place of their stay and who left (automatically) for foreign countries 32% of migrants went to Uzbekistan, 10% each to Kirgizia and Tadzhikistan and 8% to Ukraine. So, the actual migration growth in Russia which could be considered in traditional coordinates of growth in the number of the population of the country is much lower than the reported one. In addition to that, there is a large number of migrants who stay in the country for an indefinitely long period of time and are invisible to the statistics, but it is another story². Like many other indices, the distribution of the net migration by the period of registration in 2013 has not been calculated by the Rosstat yet. However, nearly a complete matching of the “base” figures of migration growth and its pattern by the type of migration

¹ Web-site “The President of Russia”, June 13, 2012 <http://президент.рф/acts/15635>. The date of application: 17.02.2014.

² According to the data of K. Romodanovsky, Head of the Federal Migration Service of the Russian Federation, “...in the territory of Russia there is 3.6m labor migrants who can be attributed to the so-called risk group. Those migrants work illegally and exceeded the period of their stay “ // The FMS of the RF counted 3.6m illegal migrants in Russia and recognized the fact of existence of ethnic conflicts. Web-site: Newsru. December 16, 2013. <http://www.newsru.com/russia/16dec2013/fmsnelegaly.html>. The date of application 17.02.2014.

flows in January – October 2013 with those of the respective period of 2012 permits to suggest that such distribution is stable.

If in January-October 2013 the volume of the net migration with the CIS states was almost identical to that of the previous year, some specifics was observed in the exchange with individual countries (*Fig. 4*). The main changes concerned the exchange with Belarus; the volume of growth in migration from that country fell more than three times over. The factor behind that was sudden growth in departures with almost the same volume of arrivals in Russia. However, there are no real explanations of the observed surges in the exchange with Belarus. It is to be noted that bilateral migration relations between Russia and Belarus were specific in the 1990s, too. Unlike all the other republics of the former USSR, Russia has annually a small, but stable net loss in the exchange with Belarus. In the 2000s, for Russia the migration exchange changed from negative to positive, but a number of factors (special grounds for migration within the frameworks of the Union State and preservation of a special procedure for “statehood” in the Republic in combination with territorial proximity to Russia and its individual most poorest regions of the European part of the country) make the migration exchange with Belarus unstable.



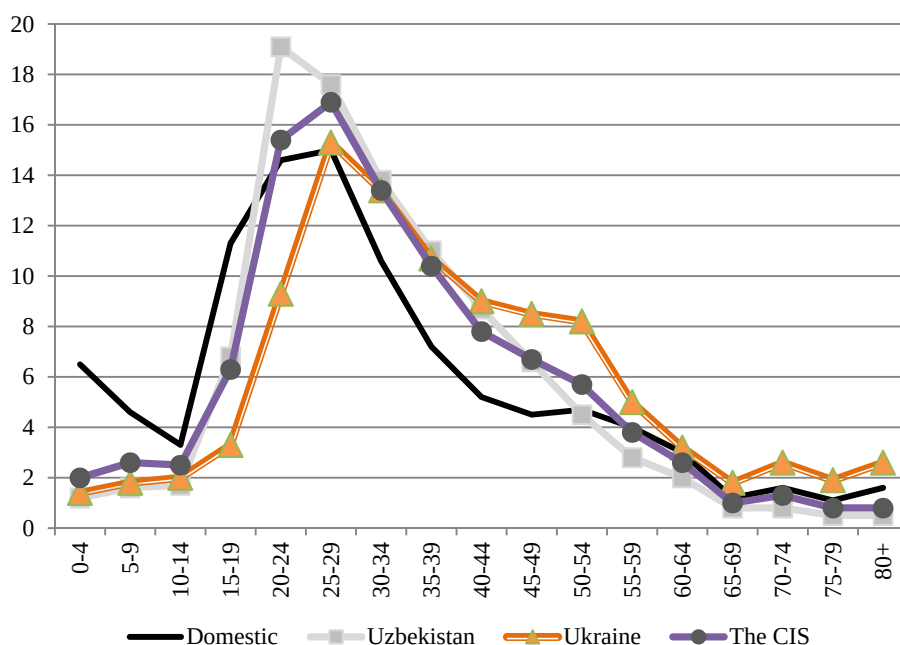
*FA is the far abroad (it includes countries of “traditional abroad, as well as the Baltic States and Georgia).

Sources: The Social and Economic Situation in Russia. The 2009-2013 Statistical Bulletin of Rosstat. Rosstat, 2009, 2010, 2011, 2012 and 2013.

Fig. 4. Russia’s migration growth with the CIS states and far abroad states, January-October 2009–2013, thousand persons

From year to year, in Russia's migration growth the unit weight of the Central Asian vector is growing with absolute domination of Uzbekistan. At present, the Central Asian component amounts nearly to 42%, while that of Uzbekistan, to 22%; it is to be noted that five years ago the above indices amounted to 33% and 15%, accordingly. It is the Central Asia which the center of population growth in the post-Soviet space. Throughout the past quarter of a century, average annual growth rates of the population in Tajikistan, Uzbekistan and Turkmenistan amounted to 3% and more¹. By virtue of the above, they have the youngest workforce in the post-Soviet space which forms the outgoing young migration flows.

Migration activity in any country is formed at young age groups; a selective function of migration is evident in that. In migration flows arriving in Russia, it is intensified due to the above young age pattern of the population of the Central Asia which is Russia's main migration donor (Fig. 5).



Source: the data of the Rosstat.

Fig. 5. The age pattern of migrants arriving in Russia by individual lines in 2012, %

5.2.3. External Labor Migration

The extent of the temporary labor migration to Russia is still considerable and difficult to estimate. As before, those difficulties are related to the following two components: quite unclear extent of migration flows to the country, uncertain large volumes of the informal economy and informal employment in Russia². It is impossible to exit from that situation with knowledge of only one side of the issue.

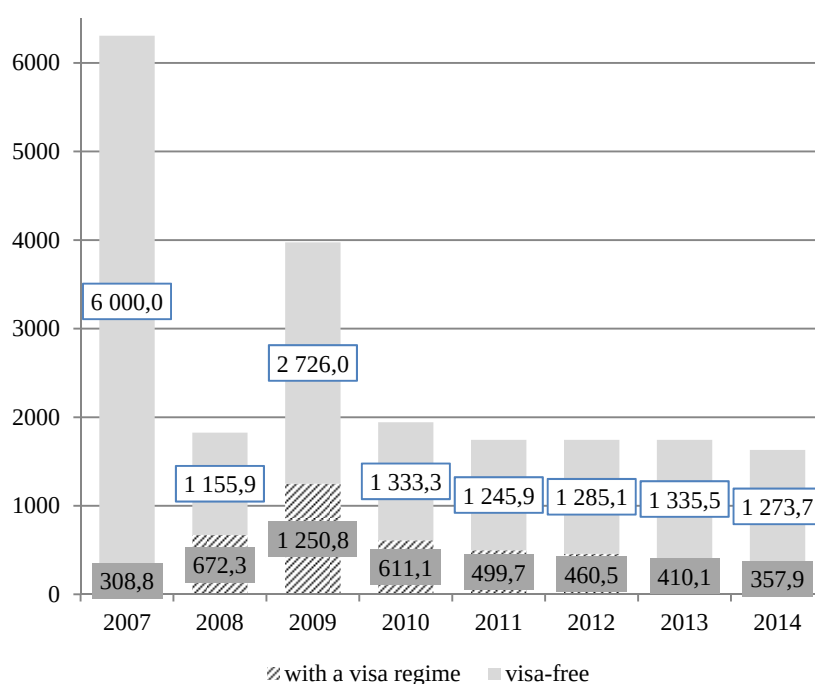
¹ E.M. Scherbakova. 25 Years from the Date of the Last All-Union Census of 1989 //Demoskop Weekly. No. 581-582. January 1-26, 2014. <http://demoscope.ru/weekly/2014/0581/barom02.php>

² For more details, see: In the Shadow of Regulation: Informality on the Russian Labor Market. Scientific Editor V.E. Gimpelson and R.I. Kapelyushnikov. Moscow: Publishing House of NRU HSE, 2014.

At present, there are a few channels of attraction of foreign workers to Russia:

- on the basis of a permit to work (with a legal entity) – for migrants from any country within the frameworks of the annual quota for employment of foreign workers and beyond the quota – granted to representatives of individual professions in accordance with the annually approved list;
- on the basis of a work permit issued to high-skilled experts (HSE);
- on the basis of the license (for work with individuals) – issued to migrants from the CIS states;
- without permit documents – for migrants from member-states of the Customs Union within the frameworks of the Eurasian Economic Community (Kazakhstan) and union state -- Belarus.

Work Permit. In 2013, the need in foreign workforce whose formation from the very beginning of calculation of that parameter leaves many questions unanswered and, nevertheless, is a turning point in determination of the size of quotas amounted to 1,745,584 persons. With accuracy up to the last digit, the same number was set in government documents in 2011 and 2012 (in the total calculation of workers from countries with a visa regime and visa-free countries) (*Fig. 6*). In economic terms, such stability means as a minimum a lack of connection to any macroeconomic parameters of development of the country, as well as weak elasticity of the instrument. The above mentioned tightening of the migration policy which took place in 2013 contributed to a 7% reduction in the declared need in foreign workers in 2014.



Source: Resolutions of the Government of the RF (for each subsequent year) On Determination of the Need in Attraction of Foreign nationals into the Russian Federation and Approval of Relevant Quotas for 20...

Fig. 6. The declared need in foreign workforce (quotas), 2007–2014, thousand persons.

The pattern of need in section of professional and skilled groups is shown in *Table 6*. The most explicit trend is annual reduction of work permits to unskilled workers. The above may point either to a substantial growth in labor efficiency and refusal by the economy to utilize on a large- scale basis the unskilled workforce, or overstated rates of utilization of such labor earlier or the new need in such labor with Russians.

Table 6

Distribution of the need in attraction of foreign workers to Russia by the most represented professional and skilled groups in the 2012–2014 period, %

	In 2012	In 2013	In 2014
Workers engaged at mining, mining-capital, building and installation and repair and building jobs	30.4	33.4	34.1
Unskilled workers, general for all branches of the economy	24.0	21.0	16.9
Drivers and operators of mobile equipment	6.4	7.0	7.3
Workers of metalworking and engineering industries	5.6	6.2	6.6
Skilled workers of commercial agriculture, forest industry, game husbandry, fish farming and fishing industry with market orientation	6.4	6.0	5.2
Other professions of skilled workers of large and small industrial enterprises	4.5	4.8	5.0
Managers of entities, institutions and enterprises and structural units thereof (services)	5.0	4.3	4.9
Other	17.7	17.3	20.0
Total	100	100	100

Source: Resolution No.892 of November 3, 2011 On Determination of the Need in Attraction of Foreign Workers to the Russian Federation and Approval of Relevant Quotas in 2012; Resolution No.1137 of November 3, 2012 On Determination of the Need in Attraction of Foreign Workers to the Russian Federation and Approval of Relevant Quotas in 2013; Resolution No.977 of October 31, 2013 On Determination of the Need in Attraction of Foreign Workers to the Russian Federation and Approval of Relevant Quotas in 2014.

On the basis of the need in foreign work force, work permit quotas and invitations for work are issued to migrants from the visa-free space of CIS states and countries which Russia maintains a visa regime with, respectively. In 2013, they amounted to 1,335,458 and 410,126, respectively.

From the very introduction in 2007, the mechanism of quotas has drawn much criticism¹, however, lobbied by the Ministry of Labor it remains the main effective player on the field of foreigners' work with legal entities. In some years, quotas used to be exhausted many times over before April-May and then were gradually increased. However, with introduction of licenses such a need became less acute. Law-abiding migrants started to avoid situations where it is impossible for them to receive a work permit due to exhaustion of the quota (and consequently legalize their work) and buy a **Patent**, that is, a license to work with private households (baby-sitters, housemaids, janitors, gardeners and other – representatives of 37 professions in total). In the past few years, a comparative analysis of the data points to a trend in redistribution of importance of channels of labor migration (*Table 7*). In 2013, the number of people who received work permits decreased considerably by 10 p.p. as compared to 2012 and the number of migrants working on the basis of a patent exceeded for the first time the number of workers working on the basis of a work permit. The patent as an instrument to obtain a legal status and avoid the corruption-intensive mechanism of securing a work permit is used more and more actively. It is to be noted that on the basis of a sociological survey

¹ For more detail on that, see the previous Reviews: The Russian Economy in 2008: Trends and Prospects. Moscow: IEP, 2009. Section 4.2. pp. 342-359; The Russian Economy in 2010: Trends and Prospects. Moscow: IEP, 2011. Section 5.3. pp.343-361; The Russian Economy in 2012: Trends and Prospects. Moscow.: The Gaidar Institute, 2013. Section 5.2. pp.371-386.

carried out by the Levada-Center for the NRU HSE in 2011 61.5% of migrants with patents have no experience of work with individuals¹.

Table 7

**The main indices of the international labor migration to Russia
in the 2010–2013 period, thousand**

		2010	2011	2012	2013
Quota (general)		1944	1746	1746	1746
Work permit	Total	1170.0	1219.8	1403.6	1274.0
	FW* without visa	894.2	941.1	1121.7	1274.0**
	FW with visa	208.5	199.5	210.4	
	Those with TRP***	67.3	79.2	71.5	
Patents (sold to nationals from "visa-free" countries)		156.9	862.4	1289.2	1537.8
High-skilled and skilled workers ****		3.1	11.3	55.8	155.8

*FW is foreign workers

** the data of the FMS of the Russian Federation is presented in the aggregated form for two groups of foreign workers

***TRP is a temporary residence permit; before 2012 included persons with TRP had to secure a work permit.

****The high-skilled workers category started to emerge from July 2010; before that there was only the skilled workers category.

Source: the data of the 1-RD form of the FMS of the Russian Federation.

The cost of the patent amounts to Rb 1,000. With monthly or quarterly contribution of Rb 1,000 made to the account of the Tax Service the term of the patent is extended; a payment receipt is a confirmation of validity of the patent and no confirmation of labor activities with an individual-employer is required. The latter is probably the most attractive factor for visa-free CIS states because if workers seek employment for the first time with legal entities they need to present a labor contract with the employer in order to secure a work permit (it is to be noted that they have to do that within 90 days from the day of entry to the territory of the Russian Federation). Another factor which makes a patent more attractive as compared to a work permit is the fact that a foreign worker does not need to apply to the migration service and other services which situation permits to avoid corruption payments and schemes. In the past few years, there was a wide-spread scheme under which intermediary firms giving themselves out for real employers participated in the campaign for formation of quotas for the next year, while later resold the granted quotas to those who actually needed workers charging up to Rb 25,000 per work permit². According to the 2012 statistics, 47%, 22% and over 9% of the patents were bought by nationals of Uzbekistan, Tajikistan and Kirgizia, respectively. Nationals of Azerbaijan and Ukraine bought 5% of the patents each, while Moldavians, 4%.

In 2012, the calculated monthly average number of workers with patents amounted to 355,200 persons³. A third of those workers is concentrated in the Moscow Region. Other

¹ O.S. Chudinovsky, M.B. Denisenko and N.V. Mkrtchyan Temporary Labor Migrants in Russia //Demoskop Weekly. Topic of the Issue 2013. No. 579-580. <http://demoscope.ru/weekly/2013/0579/tema02.php> . Date of application: 18.02.2014.

² O.S. Chudinovsky, M.B. Denisenko and N.V. Mkrtchyan Temporary Labor Migrants in Russia //Demoskop Weekly. Topic of the Issue 2013. No. 579-580. <http://demoscope.ru/weekly/2013/0579/tema02.php> . Date of application: 18.02.2014.

³ As patents can be issued for the term of 1-3 months and extended till a year, it is impossible to determine the accurate number of migrants working concurrently on the basis of a patent. The presented calculations are

regions, including Moscow accumulate maximum 5% of workers with patents each. By that index, St. Petersburg even together with the Leningrad Region is not in the top ten of regions. There are many workers with patents in the Tula Region, the Novosibirsk Region, the Rostov Region, the Irkutsk Region, Tatarstan, the Krasnoyarsk Territory and the Krasnodar Territory. Except for the Tula Region, capital cities of all the above regions are major Russian cities and have both vast labor markets and fairly high solvent demand.

In that sense, regional distribution of work permits as an instrument oriented mostly at the big business shows a vector in favor of industrial regions: in addition to capital cities and regions, as well as the Krasnodar Territory (Olimpstroi) a high unit weight of work permits (as compared to the nationwide index) is demonstrated by such regions as the Khanty-Mansiisk Autonomous Region, the Yamalo-Nenets Autonomous Region, the Sverdlovsk Region, Kaluga Region and the Primorsky Territory.

About 113,000 persons (within 11 months of 2013) beyond the quota of the so-called list of professions of the Ministry of Labor and Social Protection came to Russia as skilled workers¹. The list² numbered 59 professions (positions), which is 18 positions more as compared to 2012. It was formed for representatives of three groups: theatre and drama workers (21 positions in the list), managers (directors of departments, plants, representative offices and other – the total of 20) and engineering personnel (18). Growth in the latter group of workers is probably related to a sudden increase in the number of foreigners engaged over that channel of migration (a 150% increase on the 2012 figure).

The flow of high-skilled workers coming to Russia rose considerably by nearly 100% and amounted to 23,300 persons (within 11 months). They include foreign nationals “who have work experience, skills or achievements in specific areas of activities if conditions of engagement of such a worker in labor activities in the Russian Federation suggest receipt of a pay (remuneration)”³ in the amount: minimum Rb 1m a year for instructors and researchers; minimum Rb 700,000 for those attracted by residents for labor activities in a special technical promotional economic zone (except for individual entrepreneurs); without requirements to the amount of the pay for foreign nationals participating in realization of the Skolkovo project; minimum Rb 2m for other foreign nationals. A larger part of foreigners attracted as high-skilled workers are managers. The data on flows of high-skilled workers in 2012 shows that those workers are mostly male persons (93%) at the mature age of 40-49 years old.

Late in 2007, after events in Kondopoge (Karelia) sectorial limitations on labor activities by foreign nationals were introduced in Russia⁴. Officially, the “zero quota” in respect of sellers was introduced to make work places available to Russians and reduce the rate of unemployment. Actually, the above measure was aimed at reduction of flows of illegal

approximate ones and based on the number of migrants who received and extended patents for the period of 1, 2 and 3 months.

¹ O.S. Chudinovskikh, M.B. Denisenko and N.V. Mkrtchyan. Temporary Labor Migrants in Russia //Demoskop Weekly. Topic of the issue. 2013. No. 579-580. <http://demoscope.ru/weekly/2013/0579/tema01.php>. Date of Application: 18.02.2014.

² Order No. 568 of December 3, 2012 of the Ministry of Labor of the Russian Federation on Approval of the List of Professions (Professions and Positions) of Foreign Nationals – Skilled Workers Seeking Employment in Accordance with their Profession to Which the 2013 Quotas on Labor Activities by Foreign Nationals in the Russian Federation are not Extended.

³ Article 13.2 of Federal Law No. 115-FZ of July 25, 2002 on the Legal Status of Foreign Nationals in the Russian Federation.

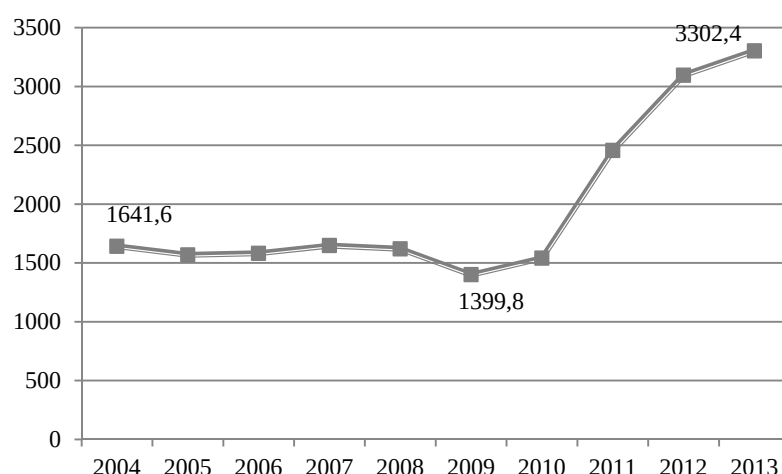
⁴ For more details on that see: The Russian Economy in 2007: Trends and Prospects. Moscow. IEP, 2008, Section 4.2. p.p. 379 – 394.

migrants. Sectorial limitations which were in effect in the 2007–2012 period were related to a few sectors (types of activities); it is to be noted that shares of possible presence of foreigners change almost every year. For example, the quota of utilization of foreign workers in retail trade in the 2008–2011 period was a zero one, while later, in 2012, a 25% quota for workers in the sphere of sale of alcohol, including beer was introduced. The above quota was in effect in 2013, too, but in 2014 it is to be reduced to 15%. According to A. Korochkina, Vice President of the *Pillars of Russia*, “the business climate in Russia suffers a lot from such swings: one year the quota is a zero one, another year – 25%, still another year – 15% and then back a zero one again”¹. In 2013, there was a zero quota on employment of foreigners in retail trade in pharmaceutical goods and retail trade in market outlets and a 25% quota on “other activities” in sport (it includes activities related to organization and holding of various sport events, as well as activities of independent sportsmen and athletes, referees, coaches, instructors and other). Tight quoting in retail trade actually results in suppression of the small business in that sector as large retailers have different options to employ workers “under some schemes” or via outsourcing, while small shops “within a walking distance” do not have such an opportunity.

5.2.4. Migration Inside the Russian Federation

The volumes of migrants inside Russia kept growing (*Fig. 7*). In January– October 2013, the number of migrants who moved inside Russia for a long term (domiciliary) or for an indefinite shorter period (at the place of stay for the term of over 9 months) amounts to 3.3m persons. On the basis of the outputs of the year, for the first time in the post-Soviet period the number of internal migrants came closer or became equal to that of the year 1989 when that index amounted to 4m persons. The statistics data does not permit to determine the number of “long-term” migrants who moved to a new place of domicile in 2013 and that of short-term migrants (at the place of their stay). The last time it was possible to do that on the basis of the statistics of 2011 when the share of migrations with a change in domicile amounted to 68% of all the domestic migration. In any case, at present there is growth in mobility demonstrated by many factors, including those ranging from growth in the interregional social and economic differentiation which gives an impetus to large-scale migration flows and contributes to interregional flows to migrations related to reformatting of administrative borders in connection with establishment of municipal entities which situation has an effect on the extent of the interregional migration.

¹ A. Yevstigneyeva and A. Levinskaya. Migrants are Ousted from Shops //RBK daily. October 09, 2013. <http://rbcdaily.ru/economy/562949989173604> . Date of application 19.02.2014.



Sources: *Social and Economic Situation of Russia*. The 2004-2013 Statistical Bulletins of Rosstat. Rosstat, 2004-2013.

Fig. 7. Domestic migration in Russia (interregional and intraregional), January – October 2004–2013, thousand persons.

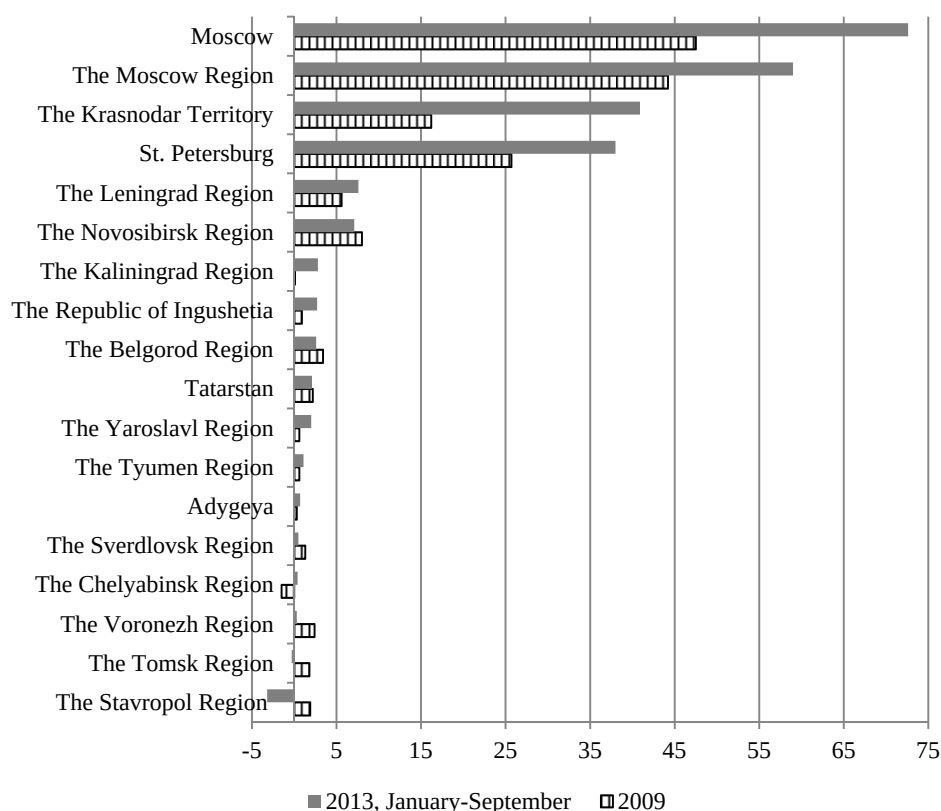
Analyzing different factors behind migration of workforce and capital, Western researchers have come to a conclusion that “internal migration provides opportunities of economic growth and convergence of the welfare level ¹ and that is undoubtedly an advantage.

So, the volumes of domestic migration grew, but the correlation of the interregional migration to the intraregional migration changed insignificantly: 52% to 48% in the total migration volume. In the previous years, it was normally 55% to 45%.

Growth in the domestic migration in Russia is **not** accompanied by the following two expected (though to a different extent) developments: formation of new magnet-regions for domestic migrants and an eastward vector of migration.

Geographically, the domestic migration attractiveness of regions has long become “stagnant”: 16 constituent entities of the Russian Federation had a positive migration growth in interregional migrations in 2013. Five years before that, in 2009, the number of such constituent entities amounted to 17. The lists of attractive regions coincide almost completely (*Fig. 8*): these are capital cities and their regions, the Krasnodar Territory, the Kaliningrad Region, the Belgorod Region and Tatarstan. In the East of the country, stable positive net migration is observed only in the Tyumen Region (without districts) and the Novosibirsk Region.

¹ The Factor of Mobility and Migration of Population //The Report on Global Development -2009: A New View of Economic Geography. Chapter 5. Moscow: Ves Mir, 2009. pp. 146-169.



Source: the Rosstat's data.

Fig. 8. Russia's regions with positive migration growth in the domestic migration, 2009, 2013 (January – September), thousand persons.

The messages of support to internal migrants¹ – which messages are made occasionally by the state and particularly often in 2013 – who are ready to move to the Eastern part of the country actually result in nothing. The statistics still points to the opposite: if the Western vector in migration has not become stronger, it did not disappear. The outflow of migrants was observed from all the regions to the East of the Novosibirsk Region. If in the 1990s and the 2000s there were at least weak, but local magnets, such as the Krasnoyarsk Territory and Khakassia, at present there are none. Not a single worker responded to a proposal made to workers by the closed-down Nadvoitsky Aluminum Plant (Karelia) to move to Boguchany (a new aluminum plant in the Krasnoyarsk Territory within the frameworks of the same Rusal Holding) with paid fares of workers' families and two-week hotel accommodation, provision

¹ At the meeting chaired by Premier D. Medvedev in Tutaevo (the Yaroslavl Region) in November 2013, M. Topilin, Minister of labor and Social Development said that "With taking into account the fact that in mono-cities there was a redundant workforce it would be expedient to apply and organize programs of displacement for such populated areas ..." and proposed to grant to migrants to the Far East Rb 400,000 per worker and another Rb 800,000 for his family. Under the program it is planned to displace 60,000 persons /A. Protsenko. Minister Topilin's Stolypin-Style Call //Trud. No. 161. November 15, 2013. http://www.trud.ru/article/15-11-2013/1303086_stolypinskij_prizyv_ministra_topilina.html . Date of application 19.02.2014.

of housing at a new place, allocation of Rb 15,000 as resettlement benefits and ensuring of day-care centers for workers' children¹.

In addition to the above, it can be stated that the "East" has spread over to Privolzhie which used to be attractive both to external and internal migrants in the 1990s and the 2000s. At present, the outflow of migrants from the Privolzhsky Federal District in general and its individual regions in particular is probably the highest one (in terms of the absolute size, but as regards the rate of outflow the situation in the Siberian Federal District and the Far Eastern Federal District is even worse).

Attractiveness of Moscow and the Moscow Region to migrants remain very high: they both accumulate nearly 55% of the positive migration growth of Russia's all the 16 regions. It is to be noted that from 2011 the migration balance between Moscow and the Moscow Region has tilted towards the latter. It is the result of spreading of Moscow over to the Moscow Region where most cities have high rates of commissioning of new housing² and serve as Moscow's dormitory suburbs.

5.3. Key Trends in the Education System Development

The year 2013 in Russia's education system was marked by the following major developments:

- 1) enactment of the new Federal Law 'On Education in the Russian Federation' (of 29 December 2012, No. 273-FZ);
- 2) implementation of the Executive Orders of the President of the Russian Federation: of 7 May 2012, No. 597 'On Measures Aimed at the Implementation of Government Social Policy', and No. 599 'On Measures Aimed at the Implementation of Government Policy in the Field of Education and Science»;
- 3) mounting tension around the issue of the Unified State Examination (USE) and the attempts of the education system supervisory bodies to somewhat soften the attacks aimed at the USE;
- 4) completion of the second round of monitoring the performance level of higher educational establishments and their affiliations;
- 5) development, by the RF Ministry of Education and Science, of financial allocation norms for higher educational establishments, and difficulties involved in the coordination of these norms with the standpoint of the RF Ministry of Finance.

1. New Federal Law 'On Education in the Russian Federation' (No. 273-FZ), was adopted at the very end of 2012. Prior to its adoption, the law had been repeatedly written and rewritten, discussed adjusted. It seems that it was finally adopted just in order to break the interminable *vicious circle*. As a result, the version of the Law that came into force from 1 September 2013, instantly gave rise to several serious contextual and economic problems.

Pre-school education – universal comprehensive education level. Firstly, the new Law establishes that pre-school education should become a component of the universal compulsory education system (Article 63). In the summer of 2013, rather hastily, the Federal State Educational Standard (FSSES) in the field of pre-school education was introduced. Its authors

¹ O. Gerasimenko. The Most Interesting Thing will Happen When People Have Spent Those Six Wages and Salaries: A Report from the Capital of Desolation //Kommersant. January 20, 2014. <http://www.kommersant.ru/doc/2381169> . Date of application 19.02.2014.

² The rate of commissioning of flats in the Moscow Region has been ahead of that in Moscow since 2006 while that with per capita norms taken into account, from 2002.

believe¹ that the FSES must ensure the necessary conditions for any child's pre-school development. However, the following rather tricky and delicate questions have remained unanswered:

- How should the secondary school education system treat those children who did not attend pre-school establishments and, consequently, received no pre-school education in accordance with the Federal State Educational Standard?
- In spite of all the efforts made by the RF Government and regional authorities, over the next few years it will still be impossible to enroll all Russia's children in the existing pre-school establishments, although this is explicitly required by the RF President's Executive Order of 7 May 2012, No. 599. Most probably, some unconventional and unorthodox methods will be applied in order to comply with the Executive Order - for example, private kindergartens will be opened in residential buildings (in private apartments), where several children (5–10) will be entrusted to the mother of one of them (at least, this measure is effectively envisaged in the Roadmap for involving not-for-profit organizations operating in socially important fields, developed by the Agency for Strategic Initiatives). However, it is difficult to say how, under existing conditions, the new Federal State Educational Standard for pre-school education can actually be implemented.
- If the parents, for some reason or another, do not want to enroll their child in a pre-school educational establishment, will they be required to provide their child with tuition designed to ensure the level of 'educational competence' in compliance with the Federal State Educational Standard? How will the child's development level be tested?
- If a child, for health reasons, cannot attend an educational establishment for children (EEC), may the child's parents apply to the education system bodies and request that a tutor, capable of ensuring the appropriate educational development level as established by the Federal State Educational Standard, visit the child at home?
- What will be the required amount of budget funding to cover all these expenditures?

The question concerning the amount of budget resources to be allocated to EECs in order to enable them to operate in the new conditions and to involve more children in the official pre-school education system is by no means an idle one. The new Law separated the expenditures on a child's tuition and upkeep at a state or municipal pre-school educational establishment (these must be shouldered by parents) from the pre-school education costs covered from the state budget. This measure, according to experts' estimations, was to result in an instant three-to-fivefold increase of the amount of fee to be paid by parents to pre-school educational establishments. So, it was no longer to be affordable for children from low-income families to attend EECs; meanwhile, it is the children from this social stratum that are most in need of the services provided by EECs, in order to equalize their educational opportunities prior to the enrollment in a secondary school. Consequently, this gave rise to the issue of compensation of these costs from regional and municipal budgets, which are already overstrained due to the necessity to increase the amount of salaries paid to the various categories of educational staff employed by the state and municipal educational establishments operating under the jurisdiction of and municipal authorities (as required by the RF President's Executive Order of 7 May 2012, No. 597).

¹ The task force that developed the Federal State Educational Standard for pre-school education was headed by Aleksandr Asmolov, full member of the Russian Academy of Education, Director of the Federal Education Development Institute.

Experts¹ have put forth several compensation schemes designed to refund parents' expenditures, in particular the plan envisaging that the relevant budget expenditures should be increased by approximately 23–25%, or budget-neutral plans that do not rely on increased budget expenditure but envisage that the compensations be paid to a very limited number of families that actually need such additional funding. So far, no ultimate solution has been provided to that problem, and the education system bodies are trying to apply some purely administrative measures in order to prevent any further growth of the educational fees. So, the new Law, in this part, has been dysfunctional or, to be more precise, actively sabotaged wherever possible.

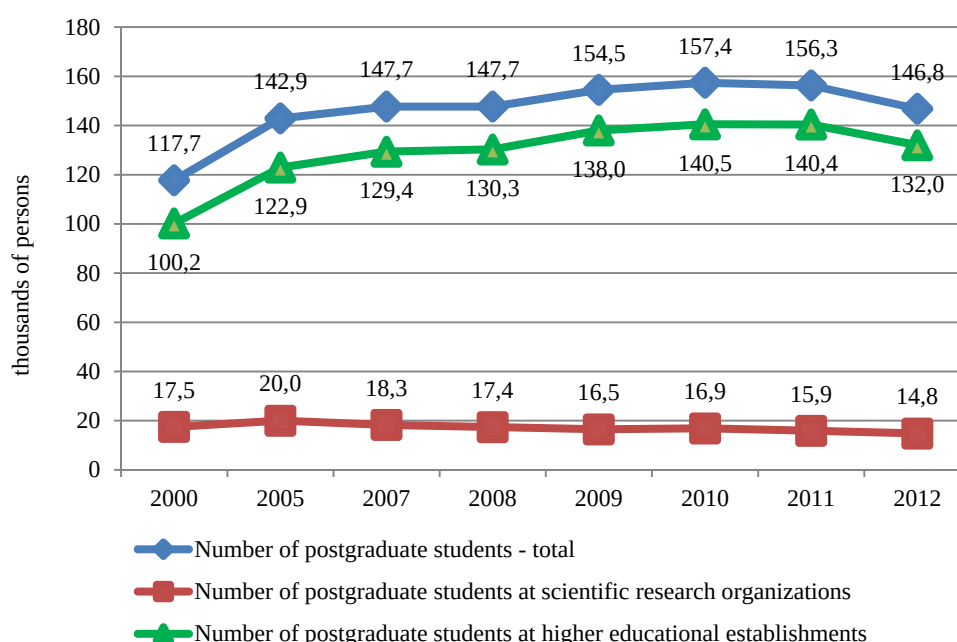
Alterations introduced in the procedure for charging the budget-funded students residing at the dormitories of higher educational establishments for their housing rent. Similarly grave problems arose in connection with the stipulations in Law No. 273-FZ concerning the housing rent to be paid by students for their use of dorms. In Part 3 of Article 39 it is specified that 'the amount of rental to be paid for the housing and utilities services provided for students by the dorms shall be determined by local normative acts adopted with due regard for the opinion of students' councils and students' representative bodies set up at the establishments operating in the field of education (if such bodies do exist)'. In other words, the amount of housing rent is no longer limited to 5% of the amount of scholarship paid to a budget-funded student, as it was established previously. Of course, the old norm needed to be adjusted, because the introduction of the Unified State Examination had drastically changed the existing situation, in that the inflow of students from other localities into higher educational establishment became noticeably higher, especially in major educational centers like Moscow and St. Petersburg, Tomsk and Novosibirsk, Krasnoyarsk and Rostov, Kazan and Samara, and some other big cities. These changes triggered the need for some different mechanism of covering the cost of lodging for budget-funded students, and the new Law represents the attempt to introduce such a mechanism. However, once again, no compensation was envisaged for the students affected by the new rules for their increased dormitory costs, the financial sources for the compensation were not properly defined, especially in view of the switchover of higher educational establishments to the system of financing based on normative costs. As a result, administrative pressure was exerted on the rectors of higher educational establishments to prevent any growth of the dormitory rent, or to allow it to grow only slightly. Thus, the new legal norm - similarly to that on kindergartens - is not being implemented for lack of proper economic backing.

Postgraduate education becomes the third tier of the higher education system. One more innovation introduced by the Federal Law 'On Education in the Russian Federation' is the new status of postgraduate departments, which are to become the third tier of the higher education system. The ultimate consequences of this decision have not yet been fully understood, though.

Prior to the adoption of Federal Law No. 273-FZ, postgraduate departments were for those individuals who have already completed their studies and graduated from a higher educational establishment, and so scientific research organizations could set up their own postgraduate departments and carry out thesis defenses, although higher educational establishments were still the core base for such activities. In this connection, the total share of postgraduate

¹ I. V. Abankina and L. N. Ovchariva (National Research University - Higher School of Economics) submitted to the RF Ministry of Finance the proposals for elaborating compensation mechanisms for refunding to parents the cost of child care services and meals provided to their children by the educational establishments for children.

students studying at scientific research organizations over the period between 2000 and 2012 ¹ dropped from 14.9 to 10.1% (*Fig. 9*).



Source: Statistical Yearbook of Russia. 2013. Statistics of Russia, M., Rosstat, 2013.

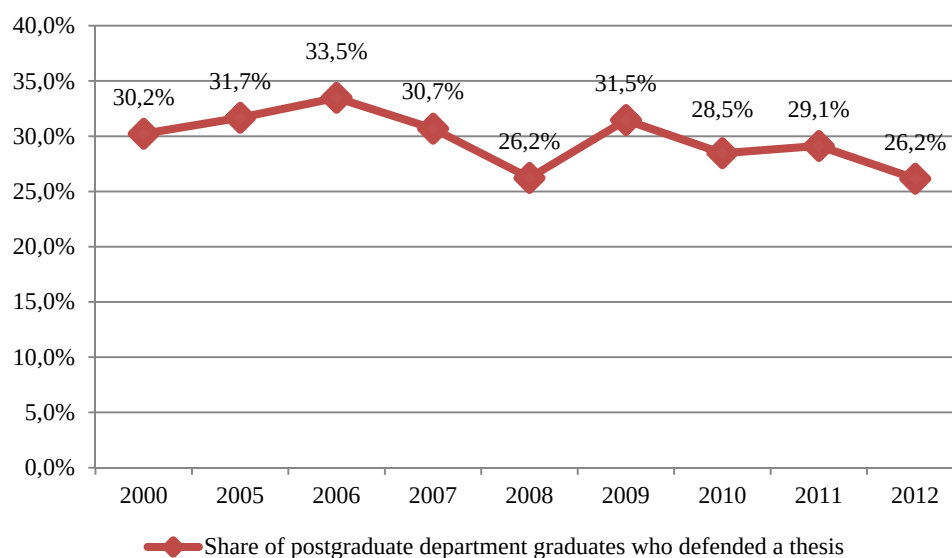
Fig. 9. Number of postgraduate students studying at the scientific research organizations of Russian Academies (the Russian Academy of Sciences, the Russian Academy of Medical Sciences, and the Russian Academy of Agricultural Sciences) and higher educational establishments in 2000–2012, thousands of persons

The new status of postgraduate departments as the third tier of the higher education system requires the issuance of a special decision to the effect that scientific research organizations may also set up and implement such programs.

If, in this connection, we draw a parallel with master's programs, it should be said that until recently those higher educational establishments that had no baccalaureate programs, were not allowed to implement master's programs, either. Consequently, there may arise a situation where scientific research organizations will have to either develop and implement comprehensive programs up from the baccalaureate level, or to apply for a special permission to implement only postgraduate education programs (given the current viewpoint of the RF Ministry of Education and Science, the latter approach is likely to gain the upper hand). Besides, it will also become necessary to make a choice as to where and how the relevant theses will be defended, because now these will effectively be treated as the qualification papers of the graduates of postgraduate departments (for example, can the student graduating from the postgraduate department of one higher educational establishment be allowed to defend a thesis at another higher educational establishment or at a scientific research

¹ Latest official data.

organizations, or *vice versa*)¹. In this connection it must be borne in mind that, over the last decade, the share of those who actually defended a thesis at the moment of graduation from a postgraduate department was between 26.2% and 1/3 of the total number of postgraduate students (*Fig. 10*).



Source: Statistical Yearbook of Russia. 2013. Statistics of Russia, M., *Rosstat*, 2013.

Fig. 10. The Share of Postgraduate Students Graduating from Postgraduate Departments with the Defense of a Thesis, in the Total Number of Postgraduate Students, in 2000-2013, as %

In 2012, the share of those postgraduate department students who have actually defended a thesis at the moment of graduation dropped to its 2008 level, and it quite possible that this downward trend will continue over the next few years. This means that the defense of a thesis as a qualification paper confirming the completion of the third tier of the higher education system will, most probably, be replaced by some other form (this is actually what happens, at present, in the West - although for somewhat different reasons). In Russia, young men quite often choose to enroll in a postgraduate department in order to avoid conscription into the army. The bulk of postgraduate students (even full-time students) hold jobs, and frequently - in organizations or companies that have nothing to do with scientific research. Very often, the involvement of such postgraduate students in the scientific research projects of a higher educational establishment or scientific research organization is only perfunctory or symbolic. Besides, even in those cases when postgraduate students during the period of their study at a postgraduate department actually work as tutors at their higher educational establishment or participate in scientific research, after graduation (especially if they have defended a thesis), having gained a higher social status, they usually leave the higher educational establishment or scientific research organizations where they have studied and get a job elsewhere (although of course, there are some exceptions to this 'rule').

¹ It is really difficult to imagine that the students completing their baccalaureate or master's programs will (on a massive scale) defend their qualification papers at other higher educational establishment or scientific research organizations.

So, the new Law has introduced the third tier of the higher education system too early, in conditions when even the transition to the two-tier higher education system (baccalaureate - master's program) has not yet been completed: what really should have become the focus of attention at the current stage is the improvement of quality of the master's program and the elaboration of stricter rules for their licensing and accreditation. That is why there is a strong risk that, once they have been turned into the third tier of the higher education system, postgraduate departments will do nothing to actually alter the organization of their current activity, thus making senseless all the innovations stipulated in the new Law.

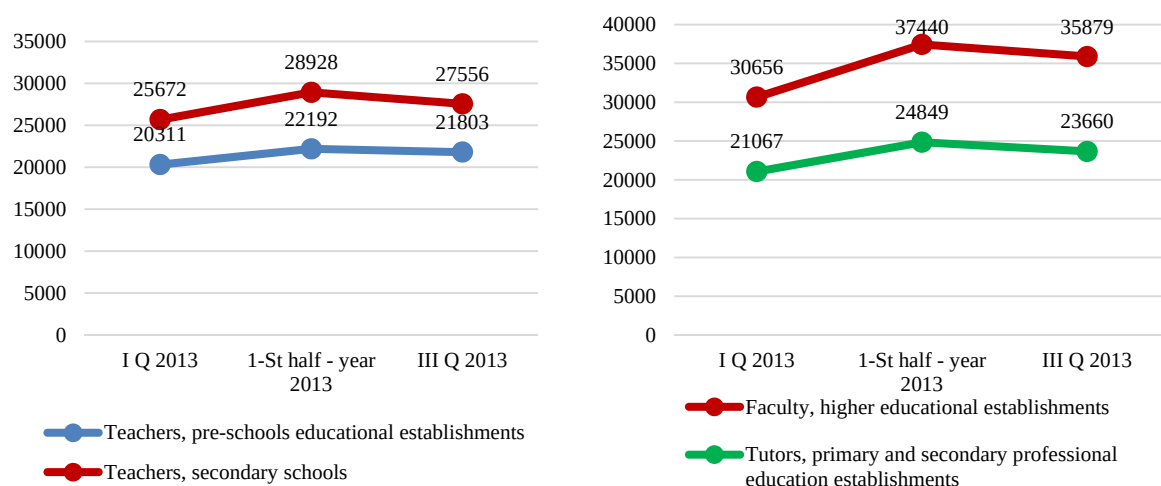
2. Implementation of the RF President's Executive Orders of 7 May 2012, No. 597 and No. 599. The May 2012 Executive Orders of the President of the Russian Federation envisaged, first of all, increased salaries for those employed in the social services sector and the introduction of 'effective contracts' in the education, public healthcare and scientific research systems.

Effective contracts. An effective contract concluded with a secondary school teacher of a faculty member of a higher educational establishment is understood as a contract setting such a salary level that will enable them to work only in one place (a secondary school or higher educational establishment) instead of seeking several places of employment, and spend a full workday there teaching students (during or in addition to classroom hours)) or providing consultations to them. In the course of surveys conducted in the framework of *Monitoring of Education Markets and Organizations (MEMO)*¹ it was found out that the appropriate level for secondary school teachers is the average salary for a given region's economy, and for the professors and tutors of higher educational establishments – double that amount. There is one noteworthy point, however: in Presidential Executive Order No. 597 it is stipulated that it is the *average* salary of a secondary school teacher that should be equal to the amount of average salary for a given region's economy, just as it is the *average* salary of a professor or tutors employed at a higher educational establishment that should amount to 200% of that average. But if we deal with averages, the actual spread of salary levels between such employees can be very wide, and so this measure does not really represent an adequate solution to the problem of 'holding in their places' those real salaries are below the region's average salary level.

So, the consequences may be paradoxical – good teachers and professors will no longer have several employments, while the vacancies that will appear as a result of such shift will be filled by those who cannot secure a good salary at their principal place of employment. Besides, it should be noted that what used to be the ultimate dream at the time when the amount of actual earnings was only 60–70% of a region's average salary – 200% of that amount - may well no longer be satisfactory once that level is secured, because the principle of income elasticity of demand (rising demand in response to a change in consumer incomes) will still remain a relevant factor. Therefore it will be necessary either to introduce legislative measures preventing people from holding multiple jobs, or to invent some non-standard ways of securing the principle of 'effective contract' - among other things, by increasing the workload of secondary school teachers and the faculty members of higher educational establishments (a practice that can already be observed at schools), so as to deprive them of any spare time that can be used elsewhere.

¹ The National Research University - Higher School of Economics' Project 'Monitoring of Education Markets and Organizations (MEMO)' has been underway since 2002. See <http://memo.hse.ru/>

Regular monitoring, by *Rosstat*, of the salary rate dynamics of some categories of education system personnel (including teachers at pre-school educational establishments, secondary school teachers, tutors at primary and secondary professional education establishments, and faculty members at higher educational establishments) has revealed that this index in Q3 2013 dropped on the first half-year of 2013 (*Fig. 11*).



Source: *Rosstat*, http://www.gks.ru/free_doc/new_site/PublishOTKR/index.html

Fig. 11. The Average Salary Rate Dynamics Registered in the RF Education System in Q1 - Q3 2013

It can be expected that, when the results of Q4 are released, it will become obvious that the amount of average salary for all categories of educational system personnel has been increased once again, because the government continually demands that the regions should comply with the two May 2012 Presidential Executive Orders, and the shrinkage of the salary indexes in Q3 only has made these demands more urgent.

At the same time, it is already evident that RF subjects will hardly be capable of maintaining the high level salaries in the education system any further – regional budgets are staggering under the burden of increased expenditures (especially in view of the necessity to simultaneously increase the salaries in healthcare, the welfare system, and in the spheres of culture and science), and so it can be expected that in 2014, tension will be on the rise in the social sphere, including the education system.

The monitoring of the secondary education system's performance indexes in response to the increased teachers' salaries, conducted by the Center for Continuing Education Economics, RANEP¹, demonstrates that teachers on the whole estimate the actual growth of their salaries over the past year to be negligible, while at the same, in the majority of cases, time pointing to their drastically increasing workload.

Entry of no less than 5 higher educational establishments in the top hundred of World University Rankings. Among the other goals set for the education system in the May 2012 Presidential Executive Orders, there was the entry, before 2020, of at least five 5 Russian

¹ The Project 'Concept Development, Approbation and First Round of Monitoring of the Performance Level in the General Education System in the Context of Increased Remuneration of the Education System Personnel'.

higher educational establishments in the top 100 universities in the world, as ranked by Quacquarelli Symonds Limited. Towards the implementation of this goal, 15 higher educational establishments have already been selected, on a competitive basis, from among Russia's federal universities (FU) and national research universities (NRU)¹, and became favorites in this contest, being allocated an additional subsidy for development in the amount of Rb 9bn (or Rb 600m each) in 2013 alone. For 2014 the allocation of a further subsidy to these higher educational establishments is planned, in the amount of Rb 10.5bn (or Rb 700m each). Later on, as can be seen from the Government Program 'Education System Development in 2013–2020', the expenditures earmarked for the achievement of that goal will be increased even further. This substantial amount of budget funds is allocated on the basis of 'roadmaps' prepared by the 'favorite' universities and outlining their movement towards the established goal². Similarly to the previously adopted Priority National Project Education, this is another attempt to follow the strategy 'money in exchange for obligations' (or, more precisely, 'money in exchange for the promise to secure the necessary results'). However, it is unlikely that such a goal can really be achieved, even by means of this heavy budget money inflow in a number of specially selected higher educational establishments.

At the same time, these measures have created unequal conditions for the other federal and national research universities and the selected 15 'favorites' - not mentioning the bulk of 'rank-and-file' higher educational establishments. Thus, it can be seen that, in Russia, the following multi-tier state higher education system has gradually begun to emerge:

- 1) 15 universities selected for the entry in *World University Rankings*, Moscow State University and St. Petersburg State University: 1st level of financial and administrative support;
- 2) 18 federal universities and 6 national research universities (not included in the list of 'Top 15' universities), as well as those higher educational establishment which, in accordance with the RF President's Executive Order, are granted the right to establish their own standards: 2nd level of financial and administrative support;
- 3) leading regional and branch higher educational establishments – 3rd level of financial and administrative support;
- 4) other higher educational establishments – 4th level of financial and administrative support.

Simultaneously, budget reform is being implemented (as established by Federal Law 83-FZ)³. In its framework, higher education is treated as a type of government service delivered to the population, with the unification of the norms whereby financing is to be allocated to each higher education program, depending on the specialty and area of professional training.

As a result, at present the higher education system is developing along two opposite vectors - differentiation on the one hand, and unification on the other. Such an approach

¹ 3 federal universities (FU), 11 national research universities (NRU), and 1 university – Saint Petersburg Electrotechnical University (LETI), which is neither a federal university nor a NRU.

² At the same time, it was pointed out to three higher educational establishments that they need to further elaborate their 'roadmaps'.

³ Federal Law of the Russian Federation of 8 May 2010, No. 83-FZ 'On the Introduction of Alterations to Some Legislative Acts of the Russian Federation in Connection with the Upgrading of the Legal Status of State (or Municipal) institutions'

seems to be fraught with some very serious problems, because many of the adopted administrative and economic decisions are blatantly and distinctly contradict one another.

Thus, in particular, the structure of state higher education system, as it is currently emerging in Russia, is in many ways contrary to the logic of per capita financing norms that have been practiced so far (we are going to deal with this issue in more detail later in the text). Now, the principles of budget financing of higher educational establishments are increasingly relying on the estimates of education quality and the individual ranking of each higher educational establishment, instead of the 'pure quantity' of this type of government service delivered to the population - the traditional foundation of the per capita financing norms applied in the sphere of higher education.

3. The situation around the issue of the Unified State Examination (USE). From 2008, the USE has been becoming the center of a battlefield, because its introduction, on the one hand, is a sign of entry of Russia's education system into the global higher education market, while on the other hand it has resulted in the destruction of old privileges and the emergence of some new ones.

Besides, the USE - which until recently has been regarded as the main epitome of reform implemented in the sphere of education - is now being used as a weapon in the struggle against any further attempts to reform it, and also in the campaign against the reformers, among whom the main one has been considered to be (whether justly or not) the RF Minister of Education and Science. Thus, those who are opposed to the USE view the task of its debasement as the debasement of educational reform as a whole, and personally the Minister.

In 2013, for the first time since the onset of scandals around the USE (including the postings of the USE content on the Internet, the facts of help provided to the students taking the USE by their teachers and specially selected tutors from higher educational establishments, transfer of many of eleven-graders to rural schools where the control over the USE procedure is less strict), Head of the Federal Service for Supervision in the Sphere of Education and Science (*Rosobrnadzor*) Ivan Muraviev was dismissed from his post, together with several heads of regional bodies.

At the same time, against the backdrop of these scandals, the pressure to alter the format of the USE has escalated, together with criticism as to its ability to adequately test the level of knowledge in the field of humanities. As a result, the format of written composition was once again introduced for testing the proficiency in the Russian language, alongside the previously existing form of examination. This will evidently give rise to more corruption and create opportunities for deliberate underestimation of the test's results, with the age-old verdict that 'the theme of the composition has not been properly explored'. However, this is the agenda for the forthcoming scandals of 2014.

In addition to the composition format, preparations are underway for the introduction of procedure whereby secondary school graduates will be granted the right of choice between taking either the USE or the traditional graduation examinations at schools and entrance examinations at higher educational establishments. In this connection, no explanations are offered as to how the USE results will be coordinated with the results of examinations taken in the traditional format.

The entire situation around the USE is the upshot of the collision of interests of different social groups. The survey conducted by the Center for Continuing Education Economics of the RANEPA among the parents of students of ninth and eleventh grades in secondary schools has shown that more than 2/3 of them believe it necessary to hire private tutors in

order to enable their child pass the State Final Attestation (SFA) or the USE. It is noteworthy that, as a rule, the private tutoring for the State Final Attestation has always been the prerogative of secondary school teachers, while the introduction of the USE resulted in the replacement of tutors from higher educational establishments (who formerly were traditionally employed in preparing secondary school graduates for taking entrance examinations at higher educational establishment) by secondary school teachers employed in the same capacity. The USE issue has become excessively politicized due to the attempts to apply its results as an estimate of the level of performance of secondary schools and their staff, as well as (to a certain extent) the performance of governors. If prior to the introduction of the USE it was higher educational establishments that were blamed for creating fertile ground for corruption at the entrance examinations, now they are no longer 'the target for attack' (with very few exceptions), because the general public now pins the blame for corruption on secondary schools. In conditions when a higher education diploma has become a social norm, any obstacles to achieving this much-desired goal trigger an extremely negative reaction on the part of the parents. Now, the parents have begun to jealously follow the developments around the USE not only in their own region, but also in other RF subjects, because the higher scores gained by the school graduates in 'other' regions lower that chances of 'their own' alumni to enter the most prestigious higher educational establishments. In this connection, the areas of highest tension are Moscow and St. Petersburg: if the entry to Moscow and St. Petersburg higher educational establishments signifies an elevated status for the students and their families, for their counterparts residing in Moscow and St. Petersburg the fact of studying in, say, Tver or Belgorod means a downgraded social status.

One more factor that will further increase the opposition to the USE in the nearest future is the shrinkage, for demographic reasons, of the number of students at higher educational establishments. And the outflow of potential students to other cities and regions is already perceived as the reason for questioning the feasibility of existence of a local higher educational establishment, and consequently, the performance of its faculty. Besides, prior to the introduction of the USE the mobility of young people in search of higher educational was low, now it is on the rise, while the probability that young people will return home after their graduation from a higher educational establishment is also questionable, and so the USE displeases the regional authorities and the potential employers alike.

So, resistance to the Unified State Examination is not so much an issue associated with the education system's functioning - rather, it is a socioeconomic issue, and thus no adequate solution can be provided by the education system alone because scandals will not cease, and tension will only become higher.

4. Monitoring of the performance level of higher educational establishments and their affiliations. In 2013, the second round of monitoring the performance level of higher educational establishments was completed. The results of the 2012 monitoring had caused sharp criticism, because the list of inefficiently performing establishments was found to contain such well-known names as the Moscow Institute of Architecture (State Academy) and Russian State University for the Humanities. In this connection, the 2013 monitoring was geared for the individual specificities of higher educational establishments. As a result, only those state-funded higher educational establishments that were well-known only in their own localities and some, a affiliations of state-funded higher educational establishments were recognized as 'inefficiently performing'. However, the main blow was delivered to non-state higher educational establishments and their affiliations. Thus, 23 state-funded higher

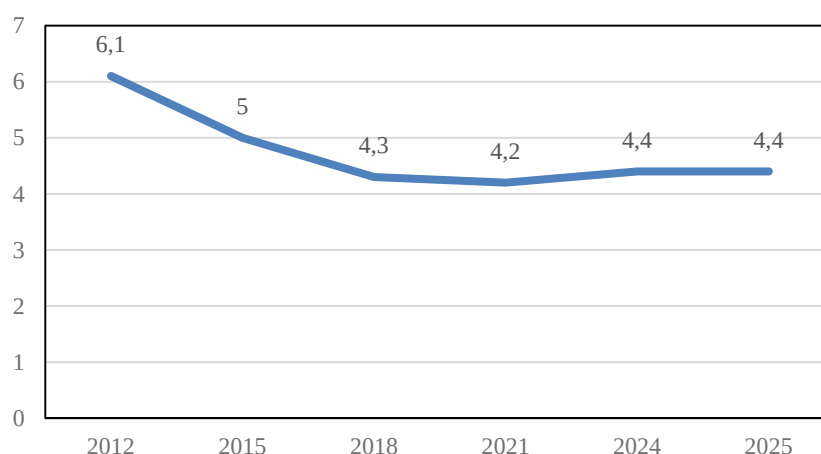
educational establishments, 7 non-state higher educational establishments and 15 affiliations of state-funded higher educational establishments were recognized 'to be in need of optimization of their activity', while 125 non-state higher educational establishments and 184 affiliations, and 7 state-funded higher educational establishments and 57 affiliations were defined as needing 'reorganization'.

In principle, the need for a kind of 'purge' in the higher education system has been felt for a long time: many non-state higher educational establishments have traditionally become 'factories' for the issuance of high education diplomas, and not highly qualified professionals. This practice is largely shared by some state-funded higher educational establishments, especially with regard to their part-time students. It is no secret that the non-state sector offers low-standard higher education to its students. Thus, while the law on the distribution of the government assignment for human resources between state-funded and non-state higher educational establishments was being elaborated,¹ it was pointed out that only 40 non-state higher educational establishments (out of 450) can truly aspire to achieve the control enrollment targets set for them, and so to actually receive budget subsidies to cover the tuition of budget-funded students.

The necessity for the optimization of the system of higher educational establishments is obvious (especially given the substantial recent drop in the number of students) (*Fig. 12*); however, questions arise as to why 'optimization' is undertaken on the basis of monitoring, and not in the framework of licensing and accreditation of higher educational establishments.

In this connection, it is the accredited higher educational establishments and their affiliations that are being 'optimized' and reorganized (by means of their liquidation), not mentioning the fact that they have been issued proper State licenses for the conduct of activities in the sphere of education (and the performance efficiency criteria include, in particular, indicators like total floor area of premises used for studies, per student, and faculty qualifications). Does this really mean that the procedure of monitoring is designed to replace (or reduce to a pure formality), or in the short-term perspective will actually replace the procedure of accreditation of higher educational establishments, and that the quality of education is going to be assessed specifically in this framework?

¹ See the Explanatory Note to the Federal Law of the Russian Federation of 16 November 2011, No. 318-FZ 'On the Introduction of Alterations to Some Legislative Acts of the Russian Federation in the Part of Setting, for Secondary Professional Educational Establishments and Higher Professional Educational Establishments with State Accreditation, the Control Numbers of Citizens to be Enrolled at the Expense of the Corresponding Budgets within the Budget System of the Russian Federation'.



Source: the author's calculations.

Fig. 12. Forecast of the Number of Students at Higher Educational Establishments in 2015–2025 (Basic Scenario), millions of persons

It should also be noted that, in 2013, one of the main criteria applied in assessing the performance level of higher educational establishments was the successful employment of their alumni. Thus, an attempt was made to link the performance of higher educational establishments to their ability to satisfy the demand on the labor market. However, in the situation of a slowdown of the economic growth rate and rising unemployment figures it is unlikely that an alumnus's ability to find a job can serve as a realistic indicator of his or her professional qualification obtained at a given higher educational establishment. It should be remembered in this connection that the curriculum structure was set up four or five years ago, while companies plan their recruitment policies for a year ahead - or, at best, for the next three years. Besides, higher educational establishments provide education to both budget-funded and self-paying students, but on their entry into the labor market these two flows merge into one, while the customers responsible for the emergence of the two flows are different (the State for the one, and households for the other), and their decision-making is based on different considerations. So, something that is not effective for one customer may turn out to be effective for the other (for example, when a former self-paying student takes over, on the labor market, the place of the former budget-funded student).

It also seems that those who estimate the performance level of higher educational establishments - among other things, in the framework of monitoring - have a very-narrow-minded view of the issue, understanding it simply as the cost effectiveness of budget expenditure. Meanwhile, it is no less important - or perhaps even more important - to obtain an answer to the following question: what is better for contemporary Russian society – an individual who has received a higher education, even if not of the best quality, or somebody who has failed to receive it, and so believes himself to be a social outsider (because, as noted earlier, higher education has become a social norm)?

Besides, another fact should be taken into consideration - that the progress of society is now vectored away from production of goods (the industrial era) towards production of human resources (the post-industrial era).

5. Per capita financing norms for higher educational establishments. In 2013, the approach to the estimation of normative costs of the delivery of government services in the form of higher education was somewhat altered, as compared to the situation in 2012 when

the RF Ministry of Education and Science for the first time introduced the per capita financing norms (normative costs per students) for baccalaureate, specialization and master's programs, depending on specialty and field of studies.

In 2013, when it became necessary to raise the average salary level of the faculty members of higher educational establishments to 200% of the average salary of each corresponding region, the RF Ministry of Education and Science suggested that adjustment coefficients should be introduced for each RF subject and applied to all the higher educational establishments situated in its territory. Besides, for those higher educational establishments that had been granted the right to set their own education standards, it was suggested that their per capita financing norms should be raised above the level of norms established for all the other higher educational establishments specializing in the same fields (or specialties)¹.

The RF Ministry of Finance, however, objected to the idea of establishing higher expenditure norms for this category of higher educational establishments, presenting its argumentation along the following lines: that the government services delivered by higher educational establishments – tuition under baccalaureate, specialization and master's programs – are based on universal standards (Federal State Educational Standards), and so the allocation of budget funding should be geared specifically to this standard set of services, similar throughout the entire territory of the Russian Federation, on the basis of single norms. As for any higher standards deviating from the Federal State Educational Standards set by the higher educational establishment by its specially granted right for its specific educational programs, the RF Ministry of Finance Russia believes that the related excess costs should be funded from that higher educational establishment's own resources. However, for a higher educational establishment to have its 'own resources' is a purely abstract notion, because all the monies received and spent by a higher educational establishment represent targeted funding. The income derived by a higher educational establishment from its 'commercial activity' represents, in the main, the off-budget resources received from self-paying students. But these monies should be spent strictly on the tuition of those students under the contracts that the higher educational establishment has concluded with them. The funding allocated to a higher educational establishment in accordance with a government assignment for scientific research, or the funding received under a government order for a research and development project must be spent strictly on the fulfillment of that assignment or order, and so on.

Consequently, if the government refuses to provide funding for the tuition of budget-funded students at higher educational establishments on the basis of increased norms, those students would then be obliged to pay out of their own pocket for any extra services delivered in excess of the Federal State Educational Standard. However, in the event of an additional service being offered, the student has the option of refusing to receive it, or a special contract for the delivery of such a service should be signed at the moment of enrollment in a higher educational establishment, and if a budget-funded student (or their parents, or their lawful representatives) fail to sign it, the student will not be enrolled. And this may become possible only on condition that some very significant alterations be introduced in Russian legislation on education because, under Article 43 of the Constitution of the Russian Federation, any student who has passed the entrance contest to a higher educational establishment is granted the right to study there free of charge (and now the entrance contest is effectively the USE

¹ See Decree of the Government of the Russian Federation of 3 June 2013, No. 437 'On Measures Designed to Ensure the Switchover to Per Capita Financing Norms of the Higher Professional Education Programs With State Accreditation'.

score, and not the student's consent to receive an additional paid-for service). In absence of relevant legislative acts - that is, without the introduction of increased per capita financing norms - federal universities and national research universities, as well as higher educational establishments with the right to set their own education standards as stipulated in the RF President's Executive Order¹, will not be able to enjoy that right, or it will be exercised with very severe limitations. Consequently, either the goal of increasing Russia's competitive capacity on the world higher education market will not be achieved, or the relevant higher educational establishments will be trying to achieve it at the expense of subsidies earmarked for other targets - which, in effect, will also mean a change in their per capita norms.

It should be noted that this practice has already become visible, for example, in the secondary school system in Moscow after the unification of per capita financing norms for gymnasiums, lyceums, advanced learning schools specializing in certain subjects, and ordinary schools. Now the best of them (as estimated by their rating scores) receive special grants, which effectively raises their per capita funding norms, while the special status of a school is determined in the framework of the rating procedure. Such a policy results in a situation where the establishments with highest rating scores begin to get rid of their inadequately progressing students, or force the parents of such students to hire private tutors, so that these students would not bring down the school's average score.

At higher educational establishments this process takes a more intricate form, but the selection of leaders in the 'race' for getting in *World University Rankings* and the allocation of substantial subsidies to the implementation of their roadmaps effectively pushes up their per capita norms and disrupts the entire logic of per capita funding allocation, which was initially presented as an attempt to introduce a competition mechanism in Russia's system of higher education.

The year 2013 has demonstrated that our assumptions (made in 2012) that the unification of financing norms will weaken the position of 'strong' higher educational establishments (those that are not entered in the special lists) and improve the position of 'weak' ones are becoming to fully materialize. In this connection, there is a threat that the overall level of higher education going to decline, not improve. One evident example is the Faculty of Mechanics and Mathematics of Moscow State University, which has been evolving for centuries to finally gain such a status. So, it cannot really be expected that if equal funding is allocated to the 'maths' specialty on a nationwide basis, a faculty of mathematics of, say, a regional pedagogic institute will be able to provide tuition at the same level as the famous MSU faculty. More likely, it will result in degradation of the latter².

¹ Lomonosov Moscow State University, St. Petersburg State University, higher educational establishments belonging to the category of "federal university" or "national research university", and federal state higher educational establishments entered in the list approve by the RF President's Executive Order are granted the right to independently approve their own educational standards for all higher education tiers. The requirements to the conditions for implementing the higher education curricula included in their standards, and the requirements to the results achieved by students after the completion of such programs, cannot be below the level of the corresponding requirements established by the existing federal state education standards (the Law 'On Education in the Russian Federation', Article 11, Part 10).

² It is clear that MSU's Faculty of Mechanics and Mathematics will have nothing to fear in connection with the switchover to the unified financing norms, because Moscow State University, with its status of 'national asset', will be allocated financing at a much higher level; however, this is just one example, in our opinion, of how the principle of 'unified approach to financing', which takes no account of existing historical traditions, fails when applied to the sphere of higher education. Moreover, it can even destroy the achievements of the past.

The introduction of unified per capita financing norms for each specialty or field may deliver an especially painful blow to the medium-sized higher educational establishment implementing their own unique programs. These higher educational establishments usually do not specialize in many fields (a factor which prevents them from attracting a very large number of students), their strength is their specialized advanced learning programs (for example, learning of several foreign languages). However, it is these establishments that are indicative of the vector of development that has emerged in the last few decades: the massive-scale availability of higher education launches the process of differentiation among higher educational establishments, which begin to offer higher education programs customized to individual needs. That is why, in the developed countries, per capita financing norms are never applied in their pure form - in addition to the number of students, consideration is also given to the quality of each implemented program. The experiences of 2013 demonstrate that this is the approach that Russia must practice when allocating budget funding to higher educational establishments, otherwise they may be deprived of their development potential - and what then will become of the competitive potential of Russia's higher education system in the world education market?

5.4. Situation in Russian science and innovation sector

The situation in the Russian science sector in 2013 differed largely from that in the innovation sector. The Russian Government launched a radical reorganization of the science sector. The so-called “academic” sector in science ceased to exist, the Russian Academy of Sciences was reorganized into an export entity, a new Federal Agency for Scientific Organizations was established to become the parent agency of the research organizations previously affiliated with the three Russian academies of sciences. A new scientific foundation with a substantial budget was established, thereby changing drastically the mechanisms of funding basic research and exploratory scientific studies.

The innovation sector saw a presumably temporal increase in activity of venture investors including business angels. This took place against the backdrop of aggravating general economic situation in the Russian industry as the principal consumer of technology innovation. No drastic changes to the national innovation policy took place, nor any significant innovation emerged.

5.4.1. R&D expenditures and results

Macroindicators of the situation in the Russian science sector remained stable in 2013 – the contribution of R&D expenditures to the gross domestic product remained unchanged and is predicted to remain the same in 2014 (*Table 8*).

In 2013, the United States remained the global leader with \$450bn of R&D funding in absolute terms. China took 2nd place (\$258bn), Japan (\$163bn), Germany (\$92bn), South Korea (\$61bn). Russia took 9th place (\$38bn).

R&D budget allocations have recently been growing in Russia. This is why the steadily maintained share of expenditures on science (as percentage of GDP) testifies that other sources of funding such as Russian private funding and foreign funding have been contracting. This is an essential characteristic of the science and innovation sectors. The developed countries showed an opposite trend in outstripping growth in R&D extrabudgetary funding with a bigger than in Russia contribution to funding from private sources. For instance, the US federal budget expenditures in 2013 increased 1.5% year-over-year against a

4% growth in private sector funding, given the fact that companies' contribution to total R&D funding was already more than twofold (71%) against budget allocations¹.

Table 8

Total R&D expenditures: Russia and the world, as % of GDP

Country	2012	2013	2014
Israel	4.3	4.3	4.2
Japan	3.4	3.4	3.4
U.S.A.	2.8	2.8	2.8
Germany	2.8	2.8	2.9
France	2.3	2.3	2.3
China	1.8	1.9	2.0
Great Britain	1.8	1.8	1.8
Russia	1.5	1.5	1.5
Brazil	1.3	1.3	1.3

Source: 2014 Global R&D Funding Forecast. Battelle, R&D Magazine, International Monetary Fund, World Bank, CIA Fact Book. December 2013. P.7.

The results of bibliometrically measured research performance of Russian scientists keep falling. Even in the case of gaining in absolute terms (e.g., the number of articles of Russian authors indexed in the Web of Science (hereinafter – the WoS) and Scopus) database, Russia's relative score has been declining because of faster growth rate in scientific productivity in other countries, especially China, India, South Korea, Canada, Spain, Italy².

The 2012 data show that Russia accounts for less than 2% of the global flow of research publications³. Furthermore, citing metrics were even lower for Russia: Russia took 14th place in the world on the number of articles, whereas 23rd place on citing of these articles⁴. An average citation ratio of Russian articles in the period of 2008 thru 2012 was 2.8, the lowest among the BRIC countries (3.3 in Brazil, 3.5 in India, 4.2 in China), and far below the average global flow of publications (4.8). Additionally, RAS institutions contributed most to scientific productivity while publication activity of the leading universities has recently increased mostly owing to joint publications with RAS institutions' researchers⁵.

5.4.2. Principal changes to the national science and innovation policy

The year of 2013 became a turning point in institutional reforming of science in Russia, when the three public academies – the Russian Academy of Sciences (RAS), the Russian

¹ 2014 Global R&D Funding Forecast. Battelle, R&D Magazine, International Monetary Fund, World Bank, CIA Fact Book. December 2013. P.8.

² In the mirror of Web of Science. 1998-2012. Ivan Sterligov's Blog. 21.06.2013. <http://sterligov.blogspot.ru/2013/06/web-of-science-1998-2012.html>

³ V. Markusova, A. Libkind. How much is to publish? Research cooperation of higher education institutions with the Russian Academy of Sciences in figures // Poisk No. 18, 03.05.2013. <http://www.poisknews.ru/theme/science-politic/5988/>

⁴ V. Markusova's report on "RAS and higher education institutions: Competition or Cooperation?" at the Moscow seminar on science studies M.: INION RAN, 30.10.2013. http://www.inion.ru/index.php?page_id=436&id=589&ret=435

⁵ For instance, in the Novosibirsk State University 90% of the published articles were co-authored with the RAS, 65% with the Moscow Institute of Physics and Technology, 60% with the National Research Irkutsk State Technical University, 40% with the National Research University - Higher School of Economics. Source: V. Markusova, A. Libkind. How much is to publish? Research cooperation of higher education institutions with the Russian Academy of Sciences in figures // Poisk, No. 18, 03.05.2013. <http://www.poisknews.ru/theme/science-politic/5988/>

Academy of Medical Sciences (RAMS), and the Russian Academy of Agricultural Sciences RAAS¹ – were reorganized, a new public agency – the Federal Agency for Scientific Organizations (FASO) and a new scientific foundation – Russian Scientific Foundation (RSF) – were established.

The principles and the criteria for the performance measurement of scientific organizations, reforming the system of conferment of academic degrees were actively developed at the same time.

However, a series of scheduled initiatives were never implemented, e.g., a project on establishing 1000 laboratories of a new type in this country, summarizing the results of the second stage of projects on establishing laboratories directed by leading scientists (mega-grants).

The situation with the innovation policy was less troubled. The legal and regulatory framework concerning exclusive rights to the results of intellectual activity was refined, development institutions kept working, they developed new strategies of their activity.

The focus was placed on the reform in the Russian Academy of Sciences thanks in no small part to its unexpected announcement and unpredictable logics of the subsequent steps of its implementation. At the same time, measures of establishing a new scientific foundation, performance measurement of scientific organizations, creating a new public agency, reforming the system of conferment of academic degrees were worked up in a backdoor manner. The results of the government's decisions more often than not was a total surprise, and, moreover, an atmosphere of chaos was mounting because of their frequent adjustments. This is why the past year reminds of the popular quotation “*First, get into a serious fight, then let chance decide*”...² by Vladimir Lenin.

5.4.3. Institutional changes

Reforming the academic sector of science

June 2013 saw maybe the most large-scale reforming process in the Russian science sector since the beginning of 1990s which began with the merger of the three public academies of sciences (RAS, RAMS, and RAAS) which at the same time ceased to be the parent company of their affiliated research institutions, the establishment of a new Federal Agency for Scientific Organizations, the development of new criteria and mechanism of performance measurement of research institutions.

The appearance of the draft law N305828-6 *On the Russian Academy of Sciences, Reorganizing State Academies of Science and Making Amendments to Certain Legislative Acts of the Russian Federation* came as surprise even to the administration of the Russian Academy of Sciences and therefore was not praised by the academic community. Not only did the draft law's contents, but also the method selected for reforming provoked indignation. The draft law was instantly submitted directly to the State Duma in violation of the applicable laws and regulations under which it should have been subject to a social discussion first. The line Ministry of Education and Science of the Russian Federation (MES) denied its participation in the development of the law, which seems to be absurd per se. Careful analysis

¹ RAS stands for the Russian Academy of Sciences, RAMS for the Russian Academy of Medical Sciences, and RAAS for the Russian Academy of Agricultural Sciences.

² V. I. Lenin “On our Revolution”. 1923. Complete set of works, Vol. 45, p.381. <http://revarchiv.narod.ru/lenin45/suhanov.html>

of the logics of the developments shows clearly that the MES was at least one of the ideologists rather than the driving force of the proposed version of reforming the RAS. For instance, Minister of Science D. Livanov stated in March 2013 that the academic organization of science has no prospects in the 21st century, it should be changed, and he will use his best endeavors to do that¹. However, President Putin didn't seem to be in favor of supporting drastic measures towards the RAS. He confirmed the need to further develop such "essential for us entity as the Academy of Sciences of the Russian Federation" at his meeting with RAS President Y. Osipov which was held as early as April 2013². However, a headlong process of changes was already launched, and neither protests from official entities, the academic community, nor international appeals could stop it.

It is characteristic that the draft law remained ill-defined and inconsistent even upon two readings in the State Duma. The RAS management submitted five essential amendments to the draft law after it passed two readings, being indicative of very drastic changes provided for by the draft law:

- 1) Instead of abolishing, reorganize the RAS through merging with the RAMS and the RAAS;
- 2) Formulate basic and applied research as the principal objective of the RAS;
- 3) Share powers among the RAS and the Agency (later called the Federal Agency for Scientific Organizations) so that the FASO only be in charge of managing the RAS's assets;
- 4) Recover the legal entity status of the RAS's regional branches.
- 5) Retain the two-stage system of the title of correspondent member and academicians, and keep the RAS being entitled to decide how and when new RAS members should be elected.

After the draft law passed three readings, the RAS management managed to uphold most of the five proposals including reorganization by merging the three academies of sciences, retaining the RAS functions of conducting basic and applied research, as well as coordinating research at higher education institutions, restoring the regional branches as stand-alone legal entities, retaining the Academy's status of chief controller of budget funds, including the manager of regional branches. Finally, the title of RAS correspondent member was retained. However, the RAS ceased to own the federal assets which were assigned to the research organizations previously affiliated with the RAS. Finally, it is the provision on research institutions that was left most inexplicit.

The Federal Law was adopted on September 27, 2013³, and the Presidential Decree *On the Federal Agency for Scientific Organizations* was issued on the same date⁴. It was not until then that the development of a provision on the FASO's principles of operation and vested powers was started. In fact, a new ministry of sciences emerged and became in charge of the institutions affiliated with the merged public academies. The FASO became in charge of both the assets of the former academies of science and management of the research institutions, including areas of research to be covered. Since such an organization inevitably results in changes to a substantial part of the science sector, a Commission for Social Supervision over the reform of the Russian Academy of Sciences was established. The situation acted as a

¹ Dmitry Livanov believes that the RAS has no prospects // *Rosyiskaya Gazeta*, 24.03.2013. <http://www.rg.ru/2013/03/24/livanov-site-anons.html>

² A meeting with President of the Russian Academy of Sciences Y. Osipov. Novo-Ogarevo, 16.04.2013. <http://kremlin.ru/news/17908>

³ No. 253 of 27.09.2013 <http://graph.document.kremlin.ru/page.aspx?1;3586986>

⁴ No. 735 of 27.09.2013 <http://graph.document.kremlin.ru/page.aspx?1;3587023>

catalyst for uniting civil society powers in science – the Commission embraced 10 non-governmental organizations of science and education¹. Such a union can be regarded as one of a few positive, indirect effects of the commenced reforms.

The Commission focused on making amendments to the developed provision on the FASO, because the Agency's role changed from a soft-line regulator to a hard-line centralized manager, according to the document which was prepared by the Government. In particular, such RAS's functions as coordination of institutions, expert evaluation, and methodological support were retained in the initial version of the draft law, but then removed from it². A special emphasis was paid to a scientific and steering board which should be established as mediator, a FASO's structural unit, to ensure interaction with the Agency, the RAS, and institutions. The principles of selecting candidates to the steering board and principal parameters of its operation were discussed.

The Russian Government's Regulation *On the Federal Agency for Scientific Organizations* was signed on October 25, 2013 (No. 950), and it derives from the approved provision that neither FASO's goals nor objectives were formulated, however all the key issues associated with funding, institutions' assets, social sector, procurement of equipment and chemical agents are its prerogative. The RAS proposals are only "considered" for the two types of activity, namely planning of basic research and exploratory scientific studies, as well as approving development programs of research organizations affiliated with the Agency, public assignments for basic research and exploratory scientific studies. Therefore, although planning of scientific activities wasn't totally assigned to the FASO, the RAS became to play a minor role. Furthermore, although the Academy of Sciences conducted negotiations on retaining affiliation of certain comprehensive institutions³ including a few museums and archives, a final list of the 1007 affiliates with the FASO included all organizations of public academies, from research institutions to in-house clinics and kindergartens⁴.

The Regulation only specifies that the scientific and steering board shall consist of scientists "conducting universally recognized scientific research". Perhaps, a special regulation on the steering board's formation principles and objectives would be issued, so far the FASO has been developing without a steering unit.

The FASO didn't hesitate too long before getting to work, RAS institutions' budget was approved in time, and they could keep working after January 1, 2014⁵. This result is much better than what the academic community predicted, anticipating that from now on the science in Russia would be administered by "dummies"⁶ and expert boards would be staffed with "punks"⁷. It appeared that the FASO was going to hire former RAS's managers, although

¹ Scientists establish a Commission for Social Supervision over the reform of the Russian Academy of Sciences, 08.10.2013 http://www.polit.ru/news/2013/10/08/public_control_in_science/ 08.10.2013 r.

² S. Samokhina, N. Gorodetskaya, A. Chernykh, Kh. Aminov. A complex situation// Kommersant, No. 184, 09.10.2013. <http://www.kommersant.ru/doc/2315297>

³ V. Vlasov. Premature rumors of science collapse // Polit.ru, 24.12.2013.] <http://polit.ru/article/2013/12/24/vlasov/>

⁴ The Prime Minister's Executive Order N2591-r of December 30, 2013 "On the Approval of the List of Organizations Affiliated with the FASO of Russia <http://government.ru/media/files/41d4b2ee4aa4fdc62ccb.pdf>

⁵ A financial approach towards the academicians has been found // Kommersant, 25.12.2013. <http://www.kommersant.ru/doc/2376244>

⁶ Waiting for dummies to come. Who is going to rule the science // Poisk, 12.07.2013. <http://www.poisknews.ru/theme/science-politic/6549/>

⁷ Experts will be replaced by punks. An interview with M. Gelfund // Nauka i Tekhnologii RF. 01.07.2013 http://www.strf.ru/material.aspx?CatalogId=221&d_no=57508#.Ur11bLSBY3k

scientific and research experience is not mandatory¹. The Agency instantly offered at least one incentive enhancing efficient performance, i.e. the FASO issued its first administrative order on a monthly salary supplement for various categories of its personnel².

It should be noted that the introduced changes indeed resolve the conflict of interests which was in place at the RAS, where allocation and spending functions were combined. The practice of dividing administration of assets and research activity is quite common worldwide. Furthermore, the “government owned, contractor operated” model³, when public entities (e.g., national laboratories) are administered by private companies, has proved efficient. However, the cost of the RAS⁴ reform wasn’t defined. More than that, none of the country’s long-term forecasts included assessment of the effect of the reform⁵. The situation remains uncertain, in particular there is no knowing what would be the Charter of the merged RAS which should be approved at a General Meeting of the merged Academy⁶.

The hit-or-miss quality of the reform became evident as early as October 31, 2013. President Putin imposed a 1-year moratorium on transactions with academic assets and staff changes, as subsequently specified in the list of his orders⁷. The term is realistic for developing measures to ensure further operation of the institutions which previously were affiliated with the RAS, the RAMS and the RAAS. Additionally, no criteria for measuring the performance of research organizations which were developed during a year have not yet been approved. The Government’s executive order on making adjustments to the system of performance measurement for research organizations was adopted on November 1, 2013⁸, but it took much longer to discuss the criteria and indicators. Selection of reliable measures has

¹ S. Krymova. To be taken under advisement. What kind of knowledge and skills do the FASO’s personnel need // Poisk, No. 51, 20.12.2013. <http://www.poisknews.ru/theme/science-politic/8631/>

² The Federal Agency for Scientific Organizations’ (FASO Russia) Administrative Order of December 18, 2013 No. 1n On the Approval of the Provisions on the Payment Procedure of Monthly Salary Supplements for Special Conditions of the State Civil Service to the State Civil Servants of the Personnel of the Central Administrative Office of the Federal Agency for Scientific Organizations and the Managers, Deputy Managers of the Regional Offices of the Federal Agency for Scientific Organizations, on the Bonus Payment Procedure for the State Civil Servants of the Personnel of the Central Administrative Office of the Federal Agency for Scientific Organizations and the Managers, Deputy Managers of the Regional Offices of the Federal Agency for Scientific Organizations, on the Procedure for Financial Aid, Lump Sum Financial Inducement for Honorable and Efficient State Civil Service and Lump Sum Payment in Granting Annual Paid Leave to the State Civil Servants of the Personnel of the Central Administrative Office of the Federal Agency for Scientific Organizations and the Managers, Deputy Managers of the Regional Offices of the Federal Agency for Scientific Organizations. <http://www.rg.ru/2013/12/27/fano1-dok.html>

³ Used extensively in the United States, the so-called GOCO (government owned, contractor operated) model. In this case, the government establishes the mission and research areas for the organization, and the private sector implements the mission, using best business practices. See, e.g., <http://www.sandia.gov/about/history/goco.html>

⁴ RAS President V. Fortov estimates that the RAS reform will cost Rb 60-70bn, which is close to the Academy’s 2013 budget. Source: The state will pay Rb 70bn for the RAS reform // Gazeta.ru. 01.10.2013. http://www.gazeta.ru/science/news/2013/10/01/n_3222769.shtml

⁵ N. Volchkova. The space of orders. The President orders a new science and technology policy // Poisk, No. 3, 24.01.2014 <http://www.poisknews.ru/theme/science-politic/8796/>

⁶ The Charter is to be adopted in March 2014.

⁷ Putin urges not to squander the assets and human resources// RVC daily, 31.10.2013. <http://rbcdaily.ru/politics/562949989414296>; The list of instructions issued at a meeting of the Board of Science and Education. 15.01.2014. Instruction 1, p. g). <http://www.kremlin.ru/assignments/20065>

⁸ *On Making Amendments to the Russian Government’s Executive Order of November 1, 2013 No. 312.* The Russian Government’s Executive Order of November 1, 2013, No. 979. <http://www.ras.ru/news/shownews.aspx?id=613a30f8-1475-4d9a-a6a3-75df1501be7a>

recently been become even more important, because such measures should be relied upon in auditing academic institutions to be affiliated with the FASO. The adopted executive order specifies the following principal approaches towards performance measurement:

- non-departmental nature, establishing a interdepartmental commission;
- merging scientific organizations into reference groups regardless of their departmental affiliation, factoring in scientific knowledge areas and types of scientific research;
- using the measures which the developed countries use to measure the performance of research organizations.

Non-departmental nature is expected to be ensured through establishing an Interdepartmental Commission for the Performance Measurement of Research Organizations. The Commission has a lot of assigned tasks to perform, inclusive of measuring lowest values, which is very important and predetermines largely the results of the performance measurement.

The second aspect is reference groups and general principles of performance measurement. This aspect needs further consideration, because the assessment is most likely to be exclusively quantitative. A combination of 6–7 measures of specific weight will be determined for every reference group, depending on institutions' academic profile. Deviation on final results will automatically classify an institution as stable or lost its scientific potential. The provision under which the number of winners may not exceed one third of the total number of participants of a respective reference group is potentially insecure. Consequently, if a reference group has many strong institutions, a part of them will have to be recognized as weak in any case¹.

The results are also rough because it is organizations that are subject to performance measurement, not scientific laboratories. Quantitative data must be supplemented with qualitative data, and expert evaluation is expected to be performed at the departmental level, but only to analyze institutions facing the threat of liquidation. No assessment of credibility of selecting “winners” on the basis of quantitative parameters is expected to be performed², although the previous experience of quantitative assessments shows that they may provide incorrect results³.

Forming reference groups also requires a serious expert approach, because it is not easy to make areas of knowledge comparable, especially factoring in the nature of performed works. Therefore, criteria for selecting experts also should have been specified in the Executive Order.

The Ministry of Education and Science presented by the end of 2013 a list of 25 performance measurement criteria for organizations broken up into four basic groups. The effectiveness of and demand for scientific research will be measured mostly on the basis of bibliometric data, as well as patent statistics, the number of established small enterprises, and

¹ The RAS Trade Union appeals to V.V. Putin on the need to make amendments to the performance measurement procedure for scientific organizations. 11.01.2014 <http://www.ras.ru/news/shownews.aspx?id=fa8cc4f7-0177-47f3-813e-74bcc9857751#content>

² P. Chebotarev. Expert evaluation: outside and inside // Troitsky variant – Nauka, No. 45, 14.01.2014. <http://trv-science.ru/2014/01/14/ehkspertiza-ikh-i-nasha/>

³ In particular, when the SPI (Scientific Performance Indicator) was in force, which was measured for every researcher at academic organizations, quantitative data was often than not less efficient employees received better scores, e.g., for giving a single course of lectures in several higher education institutions or frequent reports at conferences. For more details on the SPI see Russian economy in 2007. Trends and Outlooks. M. IET, 2008, P. 422.

fundraising amounts. The HR development is considered narrowly as trained (in terms of quantity) postgraduates and Ph.D. students, as well as the number of those who have completed their internship. Integration into the global scientific community is bibliometrics again, but in this case it should be international co-authorship metrics.

This system of measuring is distinguished by its heavy reliance upon bibliometric data whose limits are well known. Moreover, adverse effects of using bibliometrics for the purpose of performance measurement have recently become more apparent in the global science¹. In particular, the practice shows that papers which are not necessarily important but covering a trendy subject matter show growth in citations. There is a wide practice of journals driving up the number of citations of published articles in order to improve their impact factors². There is a discussion on that bibliometrics is useless for measuring organizations and teams and only can be used to solve local objectives such as recruitment, career enhancement, allocation of grant, as well as selection of winners, and only in combination with expert evaluation³.

The system of performance measurement of Russian organizations proposed the MES still remains to be improved. It remains to be defined which metrics are mandatory for all, how specific metrics are to be calculated, where to find the required number of experts on narrow areas of research, having no conflict of interest.

Overall, it should be emphasized that there is no ideal set of metrics especially quantitative ones, and most objective assessment can be achieved in combination with expert evaluations. Such a work can hardly be performed frequently, because it takes a lot of time and financial resources. This makes the role of research institutions even more important, as they can measure the performance (effectiveness and quality) of their personnel. Although such an approach faces the threat of biased assessment, it can be mitigated through advancing completion- and grant-based forms of research funding.

In the meantime, the Russian system of measurement has begun to follow the way towards centralization, as evidenced by “The Russian Science Map”, another project of the Ministry of Education and Science of Russia which has received a controversial response.

Developing the Russian Science Map

The Russian Science Map (hereinafter – the Map) project was launched in the middle of 2012⁴. The Map was initially designed to be used for identify “research teams operating at high international level, as well as promising areas of science”. However, the ill formulated objective caused concerns and speculations in the scientific community⁵. The concerns increased when PricewaterhouseCoopers Russia B.V., which has neither experience in such work, nor adequate knowledge, won the contract. Regrettably, all the concerns proved true by the end of 2013, when a pilot version of the Map, which was made available to the public on November 12, 2013, showed that there are technical and methodological problems, and the

¹ B. Alberts. Impact Factor Distortions // Science, vol.30, May 17, 2013. P.787.

² S. Belyaev. An impact isn't a fact? Scientific journals are suspected of impurity? // Poisk, No. 26, 28.06.2013. <http://www.poisknews.ru/theme/science/6447/>

³ On the proper use of bibliometrics to evaluate individual researchers. Report presented on 17 January 2011 to the Ministry of Higher Education and Research. Institute de France. Academie des sciences.P.6.

⁴ Dmitry Livanov promises to compile a Russian Science Map // Nauka i Tekhnologii RF. 18.06.2012. http://www.strf.ru/material.aspx?CatalogId=221&d_no=47268#.UufTTftrIU

⁵ Russian scientists will be measured on performance // Nauka i Tekhnologii RF. 29.11.2012. http://www.strf.ru/material.aspx?CatalogId=221&d_no=50459#.Ur6p9LSBY3k

Map can't be used, even if technical errors would gradually be corrected, because it provides a wrong picture in general.

Moreover, it is still unclear what exactly the Map was designed for. It was written in the text of the bid offer that such maps "can be used for measuring the performance and competitiveness of the Russian science, for making administrative and financial decisions on scientific organizations and research teams, as well as developing measures aimed at further developing scientific activities"¹. It is the fact that the Map can be used for measuring the performance of organizations and making administrative decisions on them that caused most of the resentment. At the same time, MES's representatives stated late in the year that the Map will not be used for performance measurement, this is a useful database for scientists, the state, and businesses,² so that anyone can obtain information about who, where, what kind of research area, and how efficient he/she is engaged in.

However, none of the above listed objectives can be resolved with the Map. The main challenge is the use of a research area classification which is not in place in the Russian science³. The Map provides for entries which link incorrectly research areas with certain areas of knowledge, and, moreover, the classification lacks a few important areas. This problem can't be solved even if every scientist, having access to the Map, corrected his/her data which still contain many technical errors (incompleteness, issues with authors having similar names and initials, numerical data mismatch with what is available in other databases, etc).

A less important issue is how often scientists will have to manually correct their data entered in the Map. Additionally, it is not understood whether the future RAS assessment of institutions is linked with the Government's decision to accelerate the development of academic research at universities, which includes allocating considerable financial resources to 15 higher education institutions, of which at least five should be ranked among the top-100 world universities by 2020⁴. Perhaps, it is financial injections and various types of training events that were regarded as serious tools to help the higher education institutions catch up with the international level.

It is characteristic that the existing university rankings use different groups of metrics, and it seems to be up to the universities to decide which rankings they want to be ranked. However, the level of scientific research plays an important role in all of the rankings, whereas Russian universities show a weak research component. The performance measurement of National Research Universities (NRUs) conducted by the Ministry of Education and Science of Russia in 2013 showed that they, first of all, are behind foreign universities on such metrics as scientific and technological activities – publication activity, and, above all, citation, as well as patenting⁵. At the same time, 11 NRUs and two federal

¹ M. Feigelman. The improper Russian Science Map and its supporters // Troitsky Variant, No. 144, 2013, P.4. <http://trv-science.ru/2013/12/24/krm-im-i-susanina-i-ee-zashhitniki/#more-34032>

² Navigating in the world of scientific knowledge// Nauka i Tekhnologii RF. 19.12.2013. http://www.strf.ru/material.aspx?CatalogId=221&d_no=72618#.Ur7Rm7SBY3k

³ Key comments on the Russian Science Map. The Commission for Social Supervision over the reform in the science sector. <http://www.rascommission.ru/index.php/documents/statements/57-zamechaniya-k-karte-rossiyskoy-nauk>

⁴ In 2012 the Russian Government set an objective to help a few of Russian universities become world's leaders by 2020, through allocating substantial budget funding to 10-15 higher education institutions selected on a competitive basis.

⁵ T. Kondakova. All other things being unequal. NRUs have been measured at no discount of the difference in potentials // Poisk, No. 41, 11.10.2013, P.6.

universities made up the 15 winners which were announced in July 2013¹. These higher education institutions received substantial budget funds, which were also allocated for the development of the research framework, during the preceding years, and were supposed to increase their volumes of extrabudgetary funding. However, their dependence on budget funding remains high, and therefore the new governmental initiative keeps them operating with privileged funding. In October 2013, all of the selected institutions presented their road maps of development until 2020, of which 12 were approved. The quality of these programs allowed the institutions to receive Rb 1,1bn to Rb 1,5bn until the end of 2013 and for 2014.² Indeed, these institutions have a golden opportunity to engage scientists from the former RAS institutions facing a tough period of reforms and streamlining. This is quite a pragmatic approach against the backdrop of weakening RAS and low research results even in leading institutions.

The ongoing institutional changes cause pessimism. Experts have predicted a heavier outflow of young scientists to other countries, but most of them are anticipated to seek employment at research units of domestic companies, especially those engaged in such areas as biotechnology, biomedicine. And it is quite possible, indeed. All in all, emigrational moods have increased especially in the community of young scientists, and the need to choose between an occupation and a country has become more evident than ever. However, the external outflow is limited, at least for now, by the capacity of the external labor market, especially in the United States. At the same time, seeking employment in the domestic private sector can be regarded as positive change, although there are constraints there too. Russia is running short of high-tech companies with a serious approach to the development of in-house R&D units. Speaking of the sciences which refer to basic ones, the ongoing reforms can hardly be useful to enhance effectiveness in this segment. From now forward, a lot will depend on the type of practical steps that will be taken towards performance measurement and administration of the former academic institutions.

5.4.4. Establishing Russian Scientific Foundation

The institutional changes include the establishment of the Russian Scientific Foundation last year, which has considerably changed the composition of institutions supporting scientific research. The Foundation will manage much more budget funds than the two other scientific foundations – the Russian Foundation for Basic Research (RFBR) and the Russian Foundation for Humanities (RFH) – do (*Table 9*). Furthermore, the establishment of RSF has stopped, pursuant to the Presidential Order, financing of basic research and exploratory scientific studies through federal targeted programs (FTPs)³ and, therefore, changed the structure and mechanisms of research funding in this country. According to RSF's Director General A. Khlunov, the budget of the Foundation can further be increased, because the Presidential Order covers about one third of the existing FTPs⁴.

¹ Fifteen higher education institutions win a competition for subsidies to enter the global rankings of universities 08.07.2013. <http://минобрнауки.рф/новости/3503>

² N. Shatalova. The battle of ambitions. A dozen of Russian higher education institutions are allowed to become world's leaders // Poisk, No. 44, 01.11.2013. <http://www.poisknews.ru/theme/science-politic/7985/>

³ The list of instructions issued at a meeting of the Board of Science and Education. 15.01.2014. Instruction 1, pp. <http://www.kremlin.ru/assignments/20065>

⁴ A. Chernykh. Science will shine with grants. The President make changes to the research funding framework // Kommersant.ru, 17.01.2014. <http://www.kommersant.ru/doc/2385314>

Table 9

Budget funding in scientific foundations in Russia, billions of rubles.

Organization	2014	2015	2016
Russia's asset contribution to the RSF	11,4	17,2	19,1
RFBR	9,2	10,93	14,3
RFH	1,54	1,82	2,37

Source: The Federal Law *On the Federal Budget for 2014 and the Planning Period of 2015 and 2016*, No. 349-FZ of December 2, 2013 <http://pravo.gov.ru:8080/page.aspx?70792>

The need to expand grant financing of science and provide a variety of foundations has long been spoken of. However, the new Foundation plays a unique role among other scientific foundations. Under the Federal Law *On the Russian Scientific Foundation and Making Amendments to Certain Legislative Acts of the Russian Federation* (of November 2, 2013, No. 291-FZ), "The Foundation is intended to support basic research and exploratory scientific studies, the development of research teams leading in certain areas of science", which has much in common with what the RFBR and the RFH normally do. Additionally, the Foundation will provide support to scientific and research organizations and higher education institutions through creating world-class laboratories and departments, developing their experimental capabilities for scientific research.

At the same time the Foundation may be engaged in business activity, set up business companies. However, the Foundation may not be declared bankrupt, although federal funds account for major part of its budget. It therefore is an amazing hybrid of all that can and can't be combined in other scientific foundations holding the legal status of budget-funded agencies, although a possibility of reorganizing scientific foundations into the form of foundation was considered as early as 2001. Moreover, the MES prepared a draft project of the government regulation *On Investing Idle Resources of the Russian Scientific Foundation (RSF)*¹. The draft project established a list of permitted assets, the procedure and terms of investment of RSF's temporarily idle resources and the procedure for investment transactions. ROSNANO and Russian Venture Company (RVC) make such investment, which is reasonable because of difficulty of selecting quickly promising innovation projects. In the case of RSF, the argument is that investment income may be used for day-to-day operations of the Foundation, thereby increasing the volume of funds allocated to support science².

Therefore, the Russian Government tends to provide the RSF with most favorable treatment, similar to the special terms and conditions offered for Solkovo Foundation. Furthermore, the need to establish a new foundation was explained by the need for more efficient funding of research and technological activities. However, the same objective could have been achieved through the existing scientific foundations, because there was nothing that could interfere with granting them the "foundation" status with the powers that are currently vested with the RSF. Since economic feasibility of establishing a new unit – including respective costs on organization, setting up new expert councils and the development of a series of regulations – is questionable, the emergence of a new unit may be regarded as, above all, realizing political interests. Theoretically, however, the establishment of a parallel donor organization in science has a positive aspect, because it may promote competition and facilitate more efficient performance of foundations. However, the fact that the RSF and other

¹ Temporarily idle funds in the Russian Scientific Foundation to invest in various securities. 21.01.2014. <http://www.finmarket.ru/shares/news/3609662>

² Akexandr Khlunov told reporters about grants in the Russian Scientific Foundation. http://polit.ru/news/2014/01/29/khlunov_about_rscf/ 29.01.2014.

foundations were originally offered different terms and conditions makes the new foundation beyond competition.

5.4.5. Personnel issues in science and ways to a solution

Dissergate and “Dissernet”

The issue of fraudulent dissertation papers, plagiarism, forged scientific publications which should contain the results of a research, and overall deterioration in the quality of dissertations came to the forefront during the year. A growing wave of disclosures of fraudulent dissertations was called “Dissergate”. Although since the beginning of the 2000s the quality of dissertation papers has dropped in all areas of sciences, here is a stand-alone problem in social disciplines, i.e. government officials and politicians prefer to hold a degree in economics, politics, sociology, law. Over the past decade, according to statistics, the number of approved Ph.D. dissertations in social and technical sciences has insignificantly declined (save for chemistry, a growth of 15.5%), whereas it has increased in social science. Political sciences (the number of approved dissertations doubled in the period of 2000 thru 2011) and economic sciences (a gain of almost 1.5 times)¹ should be outlined against others.

Spontaneous disclosures gradually transformed into a social movement (a networking community), “Dissernet”, which launched its website in September 2013. It embraces scientists of various disciplines participating in the scrutiny of Ph.D. and doctoral dissertations defended in Russia since the end of the 1990s. The results of the scrutiny were published to reveal plagiarism by some high-ranking persons in the field of education and science², as well as some politicians³. “Dissernet” shows the existence of mafia networks involved in writing and defending dissertations, covering both academic and educational institutions and experts employed at the State Commission for Academic Degrees and Titles (SCADT). It should be noted that it is mostly education employees – from professors to rectors of higher education institutions – that are involved in the networks⁴.

“Dissernet” has received mixed reviews. For instance, the MES which at the initial stage of a dissertation-fraud muckraking campaign set up 10 workgroups on various areas of sciences to develop recommendations on how to set up dissertation councils, conduct proficiency evaluation of their members, as well as define the criteria for organizations seeking to open postgraduate schools and doctoral schools, believes that the SCADT is the only reputable expert organization⁵.

After all, “Dissernet” has facilitated some changes including an extension from 3 to 10 years of the statute of limitations on plagiarism in dissertations⁶. However, the new rule only covers the dissertations which were defended three years ago or earlier, whereas other science

¹ Science metrics: 2013. Statistical Book. M.: HSE NRU, 2013. p.63.

² P. Kotlyar. Let'em decide by themselves who steals from whom. Dissernet accuses six former officials of the Ministry of Education and Science of being the authors of fraudulent dissertations 14.11.2013 http://www.gazeta.ru/science/2013/11/14_a_5752705.shtml

³ <http://ru.wikipedia.org/wiki/Диссернет>

⁴ A. Rostovtsev. Three fountains of scientific crap // Gazeta.RU. 27.12.2013. http://www.gazeta.ru/science/2013/12/27_a_5821533.shtml

⁵ P. Kotlyar. Let'em decide by themselves who steals from whom. Dissernet accuses six former officials of the Ministry of Education and Science of being the authors of fraudulent dissertations. 14.11.2013. http://www.gazeta.ru/science/2013/11/14_a_5752705.shtml

⁶ The results of the Council of Science's performance have been summed up. 25.12.2013. <http://минобрнауки.рф/новости/3854>

degree holders have virtually been amnestied. Overall, however, the SCADT continues its operation despite “Dissernet’s” activity, ignoring frequently reported cases of dissertation fraud and plagiarism, which is indicative of lack of interconnection between the government’s activity and the social movement for “clear” scientific degrees.

Increasing the level of research by engaging foreign scientists

Last year the program on mega-grants¹ continued, second priority projects which were financed in 2011² were appraised, the 4th contest’s results were summarized, 42 winners which will set up new laboratories were announced. Despite criticism of the program for various reasons, its provisional results deserve a good score. One hundred and nineteen laboratories operating as part of the program have, since their inception, published their results in 800 top-rated journals. Productivity has been found to be seven articles per laboratory against the formal requirement of at least one article per year. More than one third of the heads of laboratories belong to the “middle-age generation” of scientists at the age of 45 to 60, which is quite a good figure³. A positive effect comes from not only growth in publications and favorable age composition of heads, but also from the fact that these laboratories became centers of diffusion of new knowledge outside their home organizations. They organize seminars and conferences, and even, to a certain extent, facilitate the development of interdisciplinary research. There is an adverse effect which comes from personnel moving to other countries, especially young employees, from the laboratories, because such laboratories have uncertain prospects in Russia, on the one hand, and their well-trained personnel are in demand in the labor market, on the other hand. It therefore is important to develop other laboratories along with this program, in particular, provide support to new and existing laboratories. The MES planned to announce such a contest in November 2013, and now similar projects will be launched in 2014 in the Russian Scientific Foundation⁴.

The results of the projects implemented since 2009 and managed by Russian-speaking scientists were summarized last year.⁵ The idea of this measure was to draw on the experience and knowledge of the Russian scientific community, engaging them “to take charge of the research of Russian scientific teams, as well as arrange scientific seminars in Russia so that Russian researchers can enrich their knowledge, master new scientific methods”⁶. Project managers were supposed to spend in Russia at least two months annually within two years. The data collected over five years allows conclusions to be made on the results of collective work on the selected projects. However, the information requested and collected by the MES isn’t yet sufficient for assessing sustainability of the established partnerships in prospect.

¹ For more details on the program on mega-grants see: Science and Innovation // Russian economy in 2012. Trends and Outlooks. Gaidar Institute Publishing House. 2013. pp. 410-412.

² Results of the assessment should have been presented in September 2013 and the projects extended at the same time, but it didn’t happen.

³ M. Muravyova. Mega-grants: the program proves successful // Nauka i Tekhnologii RF. 19.06.2013. http://www.strf.ru/material.aspx?CatalogId=221&d_no=57230#.Ur7xRrSBY3k

⁴ Alexander Khlunov briefed the journalists about the grants of the Russian Scientific Foundation. http://polit.ru/news/2014/01/29/khlunov_about_rscf/ 29.01.2014 г.

⁵ The projects were supported as part of the *Scientific and Scientific-Pedagogical Human Resources for Innovative Russia* in 2009-201 Federal Targeted Program (hereinafter – “Human Resources”) (event 1.5. Conducting scientific research by teams headed by external researchers). Rb 1,6bn were allocated from the federal budget to the projects.

⁶ <http://he.ntf.ru/p6aa1.html>

Two thirds of the external researchers are employed in the United States (31%) and Western Europe. This in general corresponds to the composition of emigration of scientific personnel which has been shaped since the disintegration of the Soviet Union. Most (76%) of them are employed at universities while 17% in scientific institutions (affiliated with the academies of science in the CIS countries, as well as public and private or major international research centers) and 7% in other organizations (this group is made up of all private research organizations)¹. Almost half of the external researchers (44%) are employed as professors while 26% as researchers.

The data on the results of the projects shows that the quality of publications of the participants was higher than the average in the Human Resources Federal Targeted Program (Table 10).

Table 10

Publication activity as part of the Human Resources Federal Targeted Program and the projects headed by external researchers, 2009 – 2012

	Total number of articles indexed in WoS	Total number of references available in WoS	Articles average citation ratio in 2009–2012	Number of most cited articles
The entire Program	4502	5554	1,23	16
Projects headed by external researchers	878	1580	7,7	5

Source: The data published by the National Training Foundation.

Table 10 shows that the publications made within cooperation with external researchers are cited seven times the total number of the publications made as part of the program. The assessment of the external researcher's contribution, which was performed in the annotated reports of those who participated in the projects, gives a certain description of the effects of this measure. Although this section of the report was completed in no particular format and their data can't be structured into a single structure, a few qualitative conclusions may be made.

In most cases, the role of external scientists was reduced to the following functions:

- General management and control over the project;
- Transfer of knowledge, experience, and research methods;
- Collective publications;
- Conducting seminars. All external scientists participated were involved in holding the seminars in the organizations covered by the project. Some arranged seminars abroad, engaging Russian colleagues.

In some instances the participation of an external scientist made it possible to obtain an access to a unique equipment at foreign laboratories and scientific centers. They also played an important role in helping master a respective western model of organization of research activity, which appears to be a very important result amid relative autarchy in the Russian science sector. Foreign scientists helped get in contacts with other foreign organizations, promoting network interaction.

Many participants plan to continue cooperation. Preparation of publications, as well as collective training of postgraduates is the key forms of cooperation for both external researchers and Russian teams. However, there is a few evidences of establishing more serious scientific relations, e.g. collective applications for Russian and foreign grants and

¹ The data published by the National Training Foundation.

tenders. Perhaps, there are constraining factors such as the level of research conducted in Russia, on the one hand, and unwillingness of representatives of the scientific community to make regular visits to Russia, on the other hand.

Researches' internal labor mobility

Internal (domestic) labor mobility of researchers is an important factor enhancing the performance of science. Labor mobility facilitates growth in the quality of scientific results through transfer of knowledge, allows best practices to be adapted, improves the situation in the labor market, promotes growth in productivity and innovative capacity through growth in social capital of academic researchers. Most effective is cross-sectoral labor mobility including labor mobility from public scientific organizations and institutions to the corporate sector and vice versa. Research shows that such labor mobility promotes growth in scientific productivity in the form of publications and patents.

The figures of internal labor mobility in Russia and globally have since quite recently been collected, although the need to scrutinize trends in internal labor mobility of researchers was stated in the EU countries as early as 2006, and the first papers covering this topic emerged late in the 1990s. Russia has two distinctive features:

1) An extremely low level of internal labor mobility, even to compare with countries having much smaller research sectors. The remarkable fact is that Russia shows the slowest labor mobility among the BRIC countries (*Table 11*).

Table 11

Researchers cross-sectoral labor mobility in the BRIC countries, 1996-2010

Country	Labor mobility to corporations, persons.	Labor mobility from corporations, persons.
China	8732	8280
India	1628	1415
Brazil	1208	935
Russia	718	592

Data source: International Comparative Performance of the UK Research Base – 2011. A report prepared for the Department of Business, Innovation and Skills. Elsevier, 2011. P.77.

2) Labor mobility is mostly driven from scientific-research institutes. The same institutions receive the principal flow of labor force from the corporative sector. This might be explained by persisting relations between the sector-specific scientific-research institutes and companies (enterprises) which existed in the U.S.S.R.. It is researches at universities that show the highest mobility in other countries. Additionally, universities are principal recipients of labor force from corporations.

It was not until recently, 3-4 years ago, that a few labor mobility incentive measures were announced in Russia, although they are non-systemic and in a test mode. They are mostly aimed at developing cooperation between academic and higher education personnel, as well as researchers from the public sector of science and industrial sector. Technology platforms can be considered as incentive for internal labor mobility. However, a research work the author conducted in three technology platforms¹ shows that only one of these platforms gave consideration to labor mobility and how it can be promoted within such platforms.

In addition to the foregoing, platforms' representatives share the opinion on the state of internal labor mobility and constraining factors. They consider it very low because of the

¹ I. Dezhina. Developing mechanisms of knowledge transfer through occupational mobility with the participation of technology platforms. Report on scientific research assigned by the Ministry of Education and Science of Russia. M.: Russian Technology Development Foundation, 2013.

quality of human resources, making certain traditional types of labor mobility incentives (e.g., professors' consulting in companies) ineffective and therefore useless. Staff training and onsite training measures were regarded as essential. Tougher measures, according to platforms' representatives, are needed related to some kind of "forced mobility" – through introducing a labor mobility indicator into the reporting indicators for scientific-research institutes and higher education institutions.

The platforms constitute a tool which can help address the HR problems, although the platforms have sector-specific features and different missions which impose some restrictions on mobility incentives. Moreover, a reluctant labor mobility is unreasonable in some areas, because it may lead to potential disclosure of confidential information, rather than transfer of knowledge.

Labor mobility may be increased with the help of Centers for Collective Use of Equipment (CCUE) which provides a sound basis for the development of closer cooperation between higher education institutions (scientific-research institutes) and companies. Russia has currently a broad CCUEs network embracing about 390 Centers¹. The focus on CCUEs will be much stronger in the short run. In particular, the MES is to execute the Presidential orders on defining priorities with a view to ensuring more efficient use of the federal centers for collective use of equipment network (Pr-2426 of October 18, 2013)².

5.4.6. Relations within the innovation system: technology platforms and clusters

The technology platforms tool designed to strengthen relationships within the innovation framework developed in 2013 too, and the government began to increasingly use technology platforms as experts on specific sector-specific and cross-sectoral issues. The total number of technology platforms increased to 34. The MES and the Ministry of Economic Development (MED) suggested that the platforms should be engaged in formulating the contents of federal targeted programs, because they represent the consolidated stand of various stakeholders including businesses, not just the point of view of stand-alone organizations. About 10 of the proposals made by 25 platforms engaged in formulating the contents of the Federal Targeted Program *Research and Development on the Priority Development Areas of Science and Technology Sectors in Russia in 2014–2020* were recognized as high quality ones³. The result shows that the platforms are still weak. This in part can be explained by that the government provided no financial support at the initial stages of the development of this tool.

Nevertheless, there are some reasons for cautious optimism. The MED plans to provide the platforms with larger grants as part of federal targeted programs so that they can conduct competitions for contracts under the terms and conditions of their post-sharing funding by the platforms⁴. The platforms' performances was measured by the end of the year, and support will be provided to those platforms which tend to be communication platforms. A few of the

¹ A meeting of the Board for Science and Education. Moscow, Kremlin, 20.12.2013. <http://news.kremlin.ru/news/19865>

² An information report on the collection of proposals on top-priority scientific tasks. November 22, 2013. <http://минобрнауки.рф/новости/3770>

³ A. Gorbatova. A selective support. 31.05. 2013 http://strf.ru/material.aspx?CatalogId=221&d_no=56890

⁴ A report made by Director of the Department of Innovative Development at the Ministry of Economic Development of Russia A.E. Shadrin at The Triple Helix, government, and innovation policy plenary session, The Triple Helix XI International Conference, London, July 8, 2013. <http://tha2013.org/tha/index.php/tha/index/pages/view/programme#Workshops>

platforms managed to create evaluation systems, while about one third of the platforms can conduct a comprehensive scientific and technological and economic evaluation, which also includes the evaluation requested by development institutions¹. Furthermore, 2/3 of the platforms stated that their proposals and evaluation reports were referred to in various documents of the executive power bodies, being a good result.

In addition to the foregoing, most successful in terms of best practices, according to the estimates made by the Interdepartmental Analytical Center,² are those platforms which are closer to the market demand, where companies account for at least 50% of the participants. Ideologically, they resemble their European analogues.

The platforms may draw much more attention in the year to come, because the annual Presidential Address to the Federal Assembly³ places a special emphasis on technology platforms as a tool to enhance innovation capacity, which also means that the platforms should rely on “reaching specific results, obtaining patents and licenses, getting developments into actual practical use”. At the same time, it is important to retain what the platforms are originally designed for, as interconnection tool. This is not a team of developers who patent their inventions, although technology platforms’ success may indeed facilitate creation of alliances, thereby leading to the emergence of patents and know-how.

Innovation clusters developed along with technology platforms. Budget funds (subsidies) were allocated late in 2013 to innovation clusters for implementing educational programs (onsite training, short-term advanced training programs), purchasing technology equipment, conducting exhibition and trade fair activities. In addition to the foregoing, the funds had to be spent as soon as possible, because it was not until the middle of November 2013 that an executive order on the allocation of subsidies to 11 clusters was issued⁴. It is the development of innovation and education infrastructure facilities that attracted the highest demand⁵, which is absolutely reasonable, because clusters are facing such issues as staff shortage in all areas, from cluster managers to specialists sought by resident companies⁶.

Clusters are expected to see system-wide development in 2014. In particular, this measure is planned to be synchronized with other government’s initiatives, such as innovation development programs of public companies. An “involuntary” approach has been selected once again, i.e. companies will be obliged to cooperate with clusters as part of their development programs. This is unlikely to facilitate skyrocketing growth in innovation activity amid adverse business environment. What raises hackles is that none of the post-Soviet countries has yet managed to implement the cluster theory in practice.

¹ The data of a survey conducted by the Russian Technology Development Foundation at a visiting meeting of technology platform held in Puschino on July 2-3, 2013. The survey covered 22 coordinating organizations of technology platform.

² V.I. Dovgy. Technology platforms and cross-platform relations in implementing major cross-sectoral programs and projects. Presentation at the Technoprom-2013 International Technological Development Forum in Novosibirsk, 14.11.2013]

³ The annual Presidential Address to the Federal Assembly of the Russian Federation. Moscow, 12.12.2013. <http://www.kremlin.ru/news/19825>

⁴ Russian Government’s Executive Order of November 18, 2013, No. 2128-r.

⁵ Clusters to receive money in December // Russyskaya klasternaya laboratoria. 04.12.2013. <http://cluster.hse.ru/news/1298/>

⁶ N. Ulyanov. All hands to quarters! // Biznes Zhurnal. 21.10.2013. <http://www.computerra.ru/business/57860/vse-po-mestam/>

5.4.7. Innovation activity incentives

Analyzing the results of innovation development, one should factor in a few macro-trends which do have an effect the current innovation activity and its prospects. First, the MED announced that the innovation scenario will be replaced with a conservative one in the long-term forecast (until 2030). It is the innovation scenario that was based on accelerated development of science and innovation sector. Second, persisting capital outflow from the country. Third, the deepest over the last four years decline in output in the manufacturing industry. There was some local success in certain segments of venture capital financing. However, the venture capital market, according to the RVC, will be developing without direct correlation to general economic indicators¹. Perhaps, there is a hope on that innovation activity might increase amid a crisis.

Business angels were indeed more active last year. They mentioned the following factors that have a positive effect on their activity²:

- Developing new market segments;
- Cooperating actively with seed funds;
- Increasing projects' transparency, lowering entry barriers;
- Showing optimism about industry's future development.

At the same time, another study of the early-stage venture capital market³ shows a series of serious barriers to business angels. Following listed are the key barriers:

- 1) Public development institutions have an adverse effect on this segment in the venture capital market, because public organizations basically allot R&D grants. Knowledge intensity of established businesses becomes too high, an inherently risk-averse "grant" ideology develops.
- 2) Large corporations lack culture of purchasing small firms as a way of acquiring new technologies.
- 3) Administration of applicable laws and regulations remains complex, Russian courts' rulings cannot be predictable because of violent interpretation of definitions or actions in the innovation sector.
- 4) Lack of well-defined procedures for exiting from start-ups.
- 5) Finally, there is weak confidence among all participants of venture relations.

Neither is optimistic the overall situation with small-sized innovation entrepreneurship, because small companies have begun to shutdown in response to doubled insurance premiums since the beginning of 2013⁴. In addition to the foregoing, just 14% of small innovation enterprises are private, according to the European Bank for Reconstruction and Development (EBRD)⁵. Manufacturers are in minority among innovation companies, which can be explained by that Russia has no large companies whose business results in manufacturing

¹ D. Butrin. RVC announces the creation of a venture capital market // Kommersant, No. 214, 21.11.2013, p. 6. <http://www.kommersant.ru/doc/2348804>

² The annual study of the angel investment market. Results, dynamics and new challenges. 2013. The Business-Angels National Association (Russia), Atom&Partners, RVC.

³ Early-stage venture capital market: key trends. WCIOM, RVC. M., 2013. pp.36-43. http://www.rusventure.ru/ru/programm/analytics/docs/201302_vciom.pdf

⁴ M. Papchenkova. A Heaven that remains to be seen // Vedomosti, No. 150, 20.08.2013. <http://www.vedomosti.ru/newspaper/article/512591/raj-pod-voprosom>

⁵ E. Noskova. Banks seek innovations // Rossiiskaya biznes gazeta – biznes i vlast. 03.09.2013. <http://www.rg.ru/2013/09/03/securitizaciya.html>

technology products. Therefore, businesses are overregulated and operate in a non-competitive environment.

At the same time, there were a few positive changes which can facilitate innovation activity. For instance, President Putin signed on January 2, 2013 a federal law under which representatives and employees in large foreign companies investing within Russia, as well as those who engaged in the Skolkovo Foundation's projects, may be entitled to a 5-year visa instead of one year.

Nonetheless, there are few optimistic figures. The number of transaction in Russian early-stage venture capital market increased 65% year-over-year in 2013; the volume of business-angels' transactions increased 70%. The amount of investment in early-stage projects with the participation of Russian business angels totaled \$116,5m through the first 11 months of 2013, almost 4.5 times the value recorded in 2012¹. However, the seed stage accounts for less than 5% of the investment available in the investment market. It is late stages that are basically financed. Internet-projects account for more than 70% of the investment, most of which is e-commerce, rather than long-term or emerging developments². Experts explain this by undeveloped applied sciences³. However, regrettably, Thomson Reuters's review shows that Russia is not ranked in the top-100 promising areas of science⁴ and, therefore, behind in the applied research, basic research and exploratory scientific studies which have always been ranked the strongest in this country. This is another reason why there is no point to wait for the appearance of emerging projects attractive for venture capital financing.

The situation can be mitigated by development institutions, although their effectiveness remain in abeyance despite that some of them have been operating for about seven years.

Although development institutions have key performance indicators (KPIs), their effectiveness can hardly be assessed. It is well-known that through its foundations the RVC financed 135 projects including nine foreign projects. In addition to the foregoing, the projects in Moscow accounted for the most of investment (58.03%), projects in the United States (15.35%), and St. Petersburg (6.37%)⁵. The initial wave of RVC-created foundations' exist from portfolio companies is not expected until 2014⁶.

ROSNANO has put into operation a progressive total of 35 plants⁷, production output increased, although a target of Rb 300bn volume of sales of products manufactured with the participation of ROSNANO can hardly be reached by 2015, because production output was merely Rb 23,5bn at the end of 2012 (the latest data available)⁸. In fact, ROSNANO will

¹ The data of the Report on *Money Tree TM: Venture Capital Market Navigator and the Results of the Business-Angels National Association (Russia) Research*. Source: The Russian venture capital market development in Russia in 2013: RVC contribution <http://www.rusventure.ru/ru/press-service/news/detail.php?ID=25893>

² M. Kozlov. A sowing season is suffering. Start-up investors still in shortage. // *Poisk*, No. 26, 28.06.2013 <http://www.poisknews.ru/theme/innovation/6433>

³ Opinion of the Managing Partner of Almaz Capital Partners A. Galitskiy. Source: I. Tsukanov, Y. Nekhaichuk. RVC opens a sowing season // *Vedomosti*, No. 215, 20.11.2013. <http://www.vedomosti.ru/newspaper/article/572711/rvk-otkryvaet-posevnuyu>

⁴ C. King, D. Pendlebury. ResearchFronts 2013. 100 top-ranked specialties in the sciences and social sciences. Thomson Reuters. April 2013. <http://img.en25.com/Web/ThomsonReutersScience/1002571.pdf>

⁵ Based on the data as of December 29, 2013. http://www.rusventure.ru/ru/innovative_projects/

⁶ I. Tsukanov, Y. Nekhaichuk. RVC opens a sowing season // *Vedomosti*, No. 215, 20.11.2013. <http://www.vedomosti.ru/newspaper/article/572711/rvk-otkryvaet-posevnuyu>

⁷ Based on the data as of December 29, 2013. <http://www.rusnano.com/projects/portfolio>

⁸ I. Tsukanov. Chubais takes charge of Rosnano to be privatized till 2020 // *Vedomosti*, 18.12.2013. <http://www.vedomosti.ru/companies/news/20378071/upravlyayuschaya-kompaniya-rosnano-stanet-polnostyu-chastnoj>

obtain off-the-shelf technical solutions for manufacturing innovation products, i.e. supporting import substitution. To be more specific, this cannot be regarded as true innovation activity.

It is characteristic that the RVC and ROSNANO plan to follow new, similar development strategies designed to divide between asset management and asset holding functions. Asset managers (AMs) will be established to exercise the asset management function. ROSNANO will hold a 80% interest in AMs and then sell it stagewise within 2016–2020¹. Having created MCs, the RVC plans to reserve the right to strategic and financial control over the companies owned by the holding company². In addition to the foregoing, the RVC plans to focus on seed and even preseed stages and establish 4 to 6 foundations with a total of Rb 3bn to Rb 4bn. This is almost equal to the annual budget of the Foundation for Assistance to Small Innovative Enterprises in Science and Technology. Therefore, there is ongoing process of interexchange of initiatives in development institutions³. Theoretically, it may make them compete for best projects and provision of services of higher quality.

5.4.8. Changes to the regulation of rights to the results of intellectual activity

Intellectual property rights is an aspect related to promoting innovation activity, which has an impact on commercialization of projects developed in scientific-research institutes and higher education institutions. Some improvements were achieved in this area last year.

The Russian Government Executive Order (No. 458 of May 30, 2013) *On Making Amendments to the Rules of Exercising by Public Sector Customers of the Russian Federation's Rights to the Results of Civil, Military, and Dual Purpose Intellectual Activity* was adopted, which triggered further changes. Prior to the adoption of the Executive Order there were rules in effect which secured the results of intellectual activity and allowed public sector customers to unreasonably retain the rights to the results, thereby constraining seriously to commercialization of intellectual property created as part of public contracts. The Executive Order No. 458 raised *de facto* barriers to this practice, because from now on every public sector customer must annually revise and publish on its website a list of unused results of intellectual activity and notify the developer of such results of that the Russian Federation's right may be alienated in his favor. In other words, this measure discourages public entities to reserve the rights "just in case", by tradition, as well as based on their wrong impression of the fact that the state should retain the budget-funded results obtained through funding from the federal budget.

Furthermore, updates to rules and terms of securing rights to the results of intellectual activity (the draft government executive order *On Making Amendments to the Executive Order of the Government of the Russian Federation of April 22, 2009, No. 342 On Certain Issues of Regulation of Securing the Right to the Results of Scientific and Technological Activities*) were considered during the year, but they haven't yet been adopted. It was suggested to change the terms of securing exclusive rights to the results of intellectual activity to the Russian Federation. The grounds for securing the rights to the state have been

¹ Chubais calls off the sale of Rosnano's share. 13.06.2013. <http://lenta.ru/news/2013/06/13/rosnano/>

² OJSC RVC plans to establish an RVC holding company to set up business entities. 20.11.2013. http://ria.ru/nano_news/20131120/978724145.html

³ For instance, RVC has started debt financing of projects (see, e.g. information on the Fund Civil Technologies, Ltd http://www.rusventure.ru/ru/investments/opk/index.php?sphrase_id=26291), and plans to further establish a venture shared financing foundation, thereby duplicating the activity of the Russian Technological Development Fund.

narrowing to create conditions for securing them to those who create intellectual products. This is an overall positive development of public regulation. It would be important, however, to specify the terms, because the draft executive order's provisions seems to be more of a concept than guidelines for those who will in practice be securing and executing the rights to new intellectual products.

Another aspect of the draft executive order is that a free nonexclusive license to the results obtained through funding from the federal budget is secured to the state. This measure well corresponds to the US experience originated from The Bayh–Dole Act (1980). It is characteristic that the government of the United States hasn't yet exercised the right to use a license, which can easily be explained by the fact that the Government is far from being most efficient entrepreneur.

Does it mean that the introduced changes will promote more of registered intellectual property? Patent statistics is likely to improve. It doesn't mean, however, that commercialization of ideas will increase, because the demand for patents and licenses will not increase until certain conditions are created. The internal demand for such results of intellectual activity has been weak so far. Although changes to the legal and regulatory framework do create more favorable conditions for commercialization of intellectual property, they per se cannot provide new incentives for growth in commercialization.

* * *

Hence, 2013 can be described as having seen serious changes to the organizational structure of science. This is, first of all, related to the fact that the academic sector of science ceased to exist, the RAS was reorganized into an expert organization without affiliates. It is hard to estimate what kind of effect it may have on the performance of scientists, the development of new areas of science, further integration of the Russian science into the global science. A lot depends on the new entity's (FASO) performance, soundness of the policy towards scientific organizations, methods of performance measurement. These tasks are not easy to accomplish: any attempts to conduct an "unbiased" performance measurement of both scientific-research institutes (by the RAS) and higher education institutions (by the MES) haven't yet been successful.

The establishment of the Russian Scientific Foundation, whose budget overtakes the total amount of funding of the existing scientific foundations, became a significant event. The grant form of supporting scientific research will be expanded after the establishment of the RSF. Still obscure is economic feasibility of the framework having several foundations which are financed with the federal budget funds, assigned with similar tasks but subject to radically different basic terms and conditions for operation.

Innovation activity developed in several segments last year, which also included growth in private venture capital investment. Development institutions' growing interest in supporting early-stage projects, for all the efficiency of such a solution, might not help achieve the expected results, because Russia has no large companies manufacturing high-tech products but has adverse conditions which don't allow small firms to grow and develop. Innovation activity can hardly increase in the medium-term perspective against the backdrop of worsening business environment and moving away from the innovation-based development scenario.

Section 6. Institutional problems

6.1. Public sector and privatisation

The core events which took place last year and which are related to the issues under consideration are the approval of a new three year privatisation programme for 2014–2016, including corporate control of market transactions associated with Rosneft and Gazprom, as well as the restructuring of the space industry, which is similar to that performed in relation to the aerospace and ship building industries.

6.1.1. The scale of the public sector in the Russian economy

In the middle of 2013 the Russian government approved a new privatisation programme. This document, like previous ones, contains data for the beginning of the calendar year on the number of federal state unitary enterprises (FSUEs) and joint stock companies in the capital of which the RF (Russian Federation) has an interest. Unfortunately, there is insufficient information to assess objectively the dynamics of these components of the public sector at the start of 2013.

However it should be noted that, in the period between 1 January 2010 and 1 January 2013, the number of FSUEs decreased by fifty percent in total (from 3,517 to 1,795), the number of joint stock companies the shares of which are in federal ownership, reduced by more than 1/5 (from 2,950 to 2,337). It is also worth mentioning that, as shown in the new privatisation programme, the number of unitary enterprises at the beginning of 2013, is equal to that which prevailed on 1 February and was announced by A. Belousov, the former Minister of Economic Development of the Russian Federation, at the session of the Government of the RF, on 7 February 2013, for the approval of the new programme for federal property management. Meanwhile the number of joint stock companies with state interest is slightly different (2,337 vs. 2,325 as of 1 February 2013). According to the Department of the Federal Property Register of the Federal Property Management Agency, the data on the shares of 2,337 joint stock companies and on interest in 19 limited liability companies were recorded in the register as of 31 December 2012.

The total number of facilities recorded in the federal property register in 2012 increased by 102,336 (1,471,782 facilities as of 1 January 2013 vs. 1,369,446 facilities as of 1 January 2012)¹, or by 7.5%.

Following the results of monitoring the composition of the public sector conducted by Rosstat (Federal State Statistics Service) the following quantitative dynamics of the business

¹ www.rosim.ru, 15.05.2013.

entities comprising this sector was observed between the middle of 2011 and autumn 2013 (*Table 1*).

Table 1

**Number of public sector organisations within the of economy, as recorded
by regional directorates of the Federal Property Management Agency and bodies
for the management of public property owned by RF subjects in 2011–2013**

Date	Total**		PUE (state unitary enterprises) including fiscal enterprises		Public institutions		Business enterprises of which 50% of the shares (interest) in the charter capital are			
							in public ownership		in the ownership of business companies which are parts of the public sector	
	items	% as of 1.07.2011	items	% as of 1.07.2011	items	% as of 1.07.2011	items	% as of 1.07.2011	items	% as of 1.07.2011
As of 1 July 2011*	72,047	100.0	6,245	100.0	59,483	100.0	3,928	100.0	2,391	100.0
As of 1 January 2012*	69,689	96.7	5,805	93.0	57,839	97.2	3,733	95.0	2,312	96.7
As of 1 July 2012*	69,251	96.1	5,282	84.6	58,049	97.6	3,593	91.5	2,327	97.3
As of 1 January 2013	67,003	93.0	4,891	78.3	56,247	94.6	3,501	89.1	2,364	98.9
As of 1 July 2013	66,131	91.8	4,589	73.5	56,100	94.3	3,201	81.5	2,241	93.7
As of 1 October 2013	65,272	90.6	4,502	72.1	55,244	92.9	3,195	81.3	2,331	97.5

* – federal property accounting is provided in accordance with RF Government Regulation No. 447 On Improvement in Federal Property Accounting as of 16 July 2007;

** – including organisations for which publicly registered constituent documents do not indicate specific types, but 50% of the shares (interest) of which (excluding joint stock companies) are in joint public and foreign ownership.

Source: About the development of public sector of the economy of the Russian Federation in the first half of 2011 (pp. 7–11), in 2011 (pp. 7–11), in 2012 (pp. 7–11), in the first half of 2013 (pp. 7–11), in January – September 2013 (pp. 7–11). M., Rosstat, 2011–2013.

As shown in *Table 1* the total number of public organisations decreased by 9.4% (by approx. 6,800) in the period between 1 July 2011 and 1 October 2013, therefore totalling about 65,300 by the end of this.

The key factor contributing to these results was a decrease in the number of unitary enterprises by 27.9% (or by almost 1,750). The percentage decrease in entities was not as big (by 7.1%), however the absolute decrease (by more than 4,200) was more significant. By 1 July 2013 the number of business companies, 50% of the shares (interest) in the charter capital of which are in public ownership, had decreased by a far greater proportion (by 18.7%, or by 730 units). As a result, the number of businesses, 50% of the shares (interest) in the charter capital of which are in the ownership of companies which belong to the public sector, decreased by 2.5% (by 60). Therefore, on 1 October 2013 there were more than 2,300 of these business entities, which is almost equal to the number observed in the middle of 2012.

However in the first three quarters of 2013 the total number of public organisations decreased by 2.6% (by more than 1,700).

The number of unitary enterprises decreased the most (by 8% or by approx. 400). Although the number of public institutions decreased by just 1.8%, the absolute decrease was actually larger than that of the unitary enterprises (about 1,000). At the same time, the number of business companies, 50% of the shares (interest) in the charter capital of which are in public ownership reduced by 8.7% (by more than 300). The number of businesses 50% of the shares

(interest) in the charter capital of which are in the ownership of companies which are part of the public sector reduced by 1.4% (or 30 items), although in the third quarter of 2013 after decreasing to their lowest level for two years (to 2,240 items) their number increased by 4%, or 90 units), whereas in the first half of 2013 there had been a decrease of more than 120 units.

It should be emphasised that this analysis of the quantitative dynamics of public organisations was based on the number of such organisations at a specific date, which only allows estimation of the most general trends, characterised by a decrease in the public sector entities. The available statistics do not allow for an assessment of the demography of each category of business entity within the public sector – their creation, liquidation, reorganisation into other forms of incorporation, i.e. the analysis which would be possible with a number of observations over a period of time.

Regarding the State presence in the economy as a manufacturer of goods (works, services) the following can be noted. Monitoring conducted by Rosstat partially confirms the widespread idea that the public sector share in different summary indicators of business activities has grown when compared to the pre-crisis period (*Table 2*).

Table 2

Share of the public sector in the economy, based on main indicators of business activity in 2007, 2010, 2012 and 2013, %

Indicator	2007	2010	2012	January-September 2013
Volume of shipped goods of own production, works and services performed with the use of own resources				
- mining	12.8	9.8	16.5	21.2
- fossil fuel production	11.8	9.0	16.6	21.7
- manufacturing	8.4	8.7	9.8	10.9
- production and distribution of power, gas and water	11.4	17.8	25.7	25.1
volume of construction works performed with the use of own resources	4.0	4.1	3.8	3.9
Passenger turnover of transport organisations*	65.9	56.1	64.5	63.0
Volume of commercial transportation (dispatch) of goods performed by transport organisations (excluding pipeline transportation)	72.9	78.4	76.0	75.3
Commercial freight turnover performed by transport organisations (excluding pipeline transportation)	94.6	93.6	92.9	93.2
Communications services**	9.8	15.2	14.2	14.1
Internal costs of research and development activities	72.4	73.4	75.4	73.9
Volume of paid services rendered to the population	16.4	18.9	18.9	19.4
Investments in fixed assets	19.5/	24.5/	28.8/	27.7/
From all sources of financing***	15.0	17.8	20.9	18.9
Net proceeds from sale of goods, products, works and services (excluding VAT, excise tax and other similar obligatory payments)	10.2	18.9	12.6	12.0
Average number of employees in the public sector	24.9	24.9	25.8	26.8

* – excluding municipal electric passenger transport organisations;

** – net proceeds from sale of goods, products, works and services (excluding VAT, excise tax and other similar obligatory payments);

*** – the numerator excludes small business subjects and investments which cannot be observed by using direct statistical methods.

Source: On the development of the public sector economy in the Russian Federation in 2007 (pp. 9, 42, 90-91, 92, 103, 134–135, 136, 143–144, 164), in 2010 (pp. 13, 46, 48–49, 50, 53, 61–62, 63, 67–68, 89), in 2012 (pp. 13, 35, 37–38, 39, 42, 50–51, 52, 56–57, 78), in January - September 2013 (pp. 13, 33, 35–36, 37, 40, 42–43, 44, 48–49, 70). M., Rosstat, 2008, 2011–2013.

However, despite some growth, as observed in *Table 2*, in 2012 and following the results of the first three quarters of 2013, as in the 2000s, the public sector share, based on most

indicators, remained small (not more than 20–25%). It was larger in terms of investments (20–30%) and employment (about 25–26%).

Nevertheless, the official statistics show a significant increase in the relative weight of the public sector in 2012–2013, as compared to 2010, in mining (including fuel and energy production), in the production and distribution of electricity, gas and water and in investments into fixed assets.

The largest increase in the share of the public sector was observed in the production and distribution of electricity, gas and water. In 2012, and in January - September 2013, this share exceeded 25% (vs. 18% in 2010). There was a significant increase in the public sector share in the mining industry (including fuel and energy production) reaching 16.5% at the end of 2012, and more than 21% at the end of the first three quarters of 2013, against less than 10% in 2010.

Of special note is transportation. In 2012–2013, as compared to 2010, a decrease in the relative weight of the public sector could be observed in terms of the cargo volume (from more than 78% down to 75–76%), although not in cargo turnover - up from (92% to 93%), while the share of public sector organisations in passenger traffic, compared with that of private transport organisations, grew in comparison to 2010, although following significant growth in 2011 (more than 65%) it then tended to decrease¹.

If we consider the situation in detail we can see that at the end of 2012, and in the period from January to September 2013, the public sector was dominant in only some types of activity (cargo and passenger transportation by rail, reforestation, and domestic expenditure on research and development).

In most other cases the relative weight was 20%, except in the extraction of oil including gas condensate (the share of the public sector in January - September 2013 was about 22%), the transportation of cargo and passengers by air, as well as by road (excluding small businesses) and all types of paid services² (according to the statistics) where the share of the public sector still does not exceed 50%.

Thus, the size of the public sector as shown by the official statistics does not, for most indicators, clearly illustrate the general status of the economy; while in industry, the public sector as a whole covers some types of activities in which government participation is common for other countries as well (science, social services, transport (partially), the defence industry and the fuel and energy industry). With regard to the relative weight of the public sector in investments it should be noted that the year 2013 indicated the importance of maintaining investment activity, since the completion of a number of large projects, either directly or indirectly financed by the state, including by state companies, led to a slowdown of investment in the economy as a whole. Employment in the public sector is mostly determined by events within the subsector of budgetary institutions, mainly in the social sphere. Here the specific features enable optimisation especially as a result of problems in assessing the results of activity, and the absence of a uniform method for interpreting labour efficiency and non-commercial effectiveness.

However, the above data should be considered as a minimum, taking into account the formal non-state character of the ownership of the assets of state corporations established in

¹ As to the indicators characterising the transport industry the said trends should be clarified following the yearly results as a whole.

² Within the given context transportation, medical, sanitary and health improvement and educational services are emphasized in the statistical reporting.

2007–2008, and the complexity of assessment of the relative weight of the public sector, since it can be assumed that some companies within specific economic fields concentrate on lower floors of ‘agent chains’.

Thus, for example, in the past year Dobrolet, a low cost airline subsidiary of the Aeroflot Group, and the regional airline Aurora were established. The latter was incorporated, being based on the companies Vladivostok Avia and Sakhalinskije Aviatrassy, however, according to the agreements entered into with the Sakhalin region, Aeroflot owns 51% of the shares, while 49% are owned by the regional government¹. In the current conditions of obvious non-transparency of ownership of any enterprise, and the availability of a multistage corporate control system which includes several levels in public companies (analogous to private companies) this is relevant to the calculation of the state share in the goods and services markets.

6.1.2. Privatisation policy

On 1 July 2013 the Forecast Plan (programme) covering federal property privatisation and its the main directions in 2014–2016 was approved in Order of the RF Government No. 1111-p. This is the second three-year programme for federal property privatisation.

This structurally approved privatisation programme, as before, consists of two sections. In the first section are stated the main positions of the government, forecasts of the effects of privatisation on structural changes in the economy, including plans for the privatisation of the largest companies which are leaders in their relevant industries, together with the expected federal budget receipts from the sale of federal property. The second section, as in previous years, contains a list of facilities which it is planned to privatise under the normal procedure (514 SUEs, 436 JSCs, 4 CJSCs and 94 facilities which are other properties related the RF treasury).

However, there are significant differences between the new privatisation programme and the previous similar document for 2011–2013, as approved in November 2010.

Firstly, the document does not directly articulate state policy objectives in the area of privatisation, which is atypical for any privatisation programme since 2002².

They are replaced partly by a reference to the purposes and objectives provided by the state programme of the Russian Federation ‘Federal Property Management’ approved by the Order of the RF Government No. 191-p as of 16 February 2013 (without any details), but mainly by reference to Decree No. 596 On the Long Term State Economic Policy as of 7 May 2012. This provides for the completion of the state withdrawal, by 2016, from the capital of ‘non-resource’ companies which are not subjects of natural monopolies or the defence industry. In this document there is a reference to subclause ‘c’ of clause 1, where the government is

¹ A. Zakharov. Dobrolet from Demodedovo // RBK daily, 11 October 2013, pp. 1, 7; N. Kosyakova. Far East Aurora // Arguments and Facts, No. 46, p. 30. In addition, at the end of 2013 to attract investments into the reconstruction and development of airport infrastructure in 2013–2017, under conditions of public-private partnership in the amount of RUR 7,783.3m by the government of the Sakhalin region it was decided to transfer to regional ownership the federal shareholdings (100%) of 5 airports on the island, Sakhalin Airport and a number of airport property complexes.

² In the previous privatisation programme for 2011–2013 these were the creation of conditions for extra budget investments into the development of joint stock companies based on new technologies; reduction in the public sector in order to develop and stimulate innovative initiatives by private investors; improvement in corporate management; securities market development; formation of integrated structures in strategic industries; the generation of federal budget revenues.

commissioned to take measures, by 2018, to increase the share of high-tech and knowledge-intensive industries in the gross domestic product by 1.3 times as compared to 2011 (amongst other indicators).

This correlation has raised some eyebrows as instructions to the government related to privatisation and improving the management of public property are contained in subclause 'c' of the second (not the first) clause of the Presidential Decree No. 596 as of 7 May 2012. If however, this is not a trivial mistake, then correlation between the sale of different state assets and growth in the output of high-tech and knowledge-intensive products is not going to be observed in the new privatisation programme.

Returning to the document content it should be noted that there are additional exceptions to the number of companies from the capital of which the state intends to withdraw by 2016, namely (1) from joint stock companies and enterprises included in the list of strategic organisations, (2) from minority public stakes in joint stock companies which are subsidiaries of parent companies in vertically integrated systems - for subsequent inclusion in the charter capitals of the parent companies of the relevant integrated structures, as well as (3) from single shares of joint stock companies which are in federal ownership, where the costs of preparation for privatisation exceed the possible income from such privatisation.

Secondly, the forecast of the effect of property privatisation on structural changes in the economy represents, for the first time, the break up and distribution of businesses in public ownership where it is planned to privatised them in terms of their economic activities rather than industry sector. This means that the content of the privatisation programme is brought into line with the classification which has been used in statistical reporting from 2005 and to which the Auditing Chamber of the RF refers repeatedly. The problem of such a change is the impossibility of correctly matching the structures of the businesses in federal ownership.

Meanwhile, as in the previous privatisation programme the forecast of the effects of property privatisation on structural changes in the economy has been performed only 'on paper' since it does not even provide an overall assessment of the overall expected changes in the share of the public sector, quite apart from the effect of privatisation on the dynamics of output, employment, investment and innovation, or on the tax burden on public property, state tax discipline, etc.

Thirdly, the plans for privatisation of the largest companies have undergone dramatic changes as compared to those in force under the 2011-2013 privatisation programme, this process being described in detail in the Order of the RF Government No. 1035-p as of 20 June 2012.

The list of assets to be privatised is largely unchanged. Excluded from the list are Rosagroleasing and Rosselkhozbank (previously the state planned to terminate participation in the capital of both companies by 2016) and FGC UES (it was planned to reduce the size of the state holding by 75% plus 1 share), while, added to the list were: ROSNANO (a planned reduction in the state's share in the capital by 90% by the issuing and allocating additional shares), Rosspirtprom, Rostelecom, the State Transport Leasing Company and two metropolitan airports.

However, as opposed to the 2011-2013 privatisation programme, in the version as of June 2012, the reduction of the Russian Federation participation in the charter capital of many of the largest companies provides for maintaining corporate control, or at least, the possibility of influencing corporate governance procedures through 'blocking' stakes (25% plus 1 share).

This last option of state participation is provided in relation to the JSC, ALROSA, (with the coordination of the sale of shares in the public ownership of the Republic of Sakha (Yakutia) and in municipal ownership), OJSC Aeroflot – Russian Airlines and Modern Commercial Fleet. For 2016, the share of the State in the capital of RusGidro and VTB Bank is to be 50% plus 1 share, while the share of the state's holding in the capital of Zarubezhneft will be reduced to the same value by 2020 (the intermediate value before 2016 is 90%). The previous privatisation programme provided for the withdrawal of the State from the capital of all above mentioned companies by 2016 but assumed the special right (a golden share) to allow the Russian Federation to participate in the management of joint stock companies such as Zarubezhneft, RusGidro, Aeroflot and ALROS.

The State Transport Leasing Company was added to the list including Russian Railways, the Joint Stock Company for Oil Transport, Transneft, the Dzerzhinsky Scientific and Production Corporation, Uralvagonzavod, previously included as a group where the minimum state share would be 75% plus 1 share.

There are plans to stretch the reductions of the share of the Russian Federation in the United Aircraft Corporation (UAC) and the United Shipbuilding Corporation (USC) until 2024 with the preservation of the previous change in the value of the State share in the UAC (50% plus 1 share) and a reassessment of the previous planned change in the State share in the USC (up to 75% plus 1 share vs. the previous: 50% plus 1 share).

In this context it is unclear why the State's share in the capital of INTER RAO UES (at 0% plus 9 shares) should be preserved, as earlier it was planned that the State would withdraw from its capital completely by 2016 (currently the company is included in the list of strategic organisations).

One of the most significant differences from the previous privatisation programme is the reduction in the share of OJSC ROSNEFTEGAZ in the charter capital of Rosneft by 50% plus 1 share by 2016 (earlier it was stated that there would be a complete withdrawal by this time limit). It is possible that, up to 2015, Rosneftegaz may act as an investor in relation to the fuel and energy sector companies where there are plans to privatise their share holdings, on the condition that it submits a programme for financing these transactions which provides for the use of dividends from the shares of the companies which are in the ownership of the joint stock company.

It is stated in the programme that a possible reduction of the State's share in OJSC VTB Bank by more than 50% plus 1 share will be coordinated with the decrease in the State's share in Sberbank of Russia¹, although the new head of the Central Bank of the Russian Federation asked for the removal from the text of the projected privatisation, items related to the possible changes in the equity in the banks after 2016, and reported that the Central Bank of the Russian Federation does not have any plans for decreasing the Russian Federation share in the capital of Sberbank.

In 2014–2016 the State will withdraw from the capital of 7 companies (Rossiyskaya aviatsionnaya kompaniya, the United Cereal Company (UCC), ROSNANO, Rostelecom, Sheremetievo International Airport (SIA), Vnukovo Airport and Vnukovo International Airport), amongst which only the UCC and SIA had this perspective before 2016 according to the previous privatisation programme. However, with regard to the three metropolitan airports, the decisions of the RF

¹ According to the Ministry of Economic Development and Trade of the RF and the Federal Property Management Agency VTB will lose its competitive advantages in the case of any further decrease in the State's share, with the retention of the relevant share in Sberbank.

President and the RF Government for strategic development of the Moscow airport hub will be taken into account. These companies and a range of others (UCC, ALROSA, Rostelecom) may use the special right to allow the Russian Federation to participate in the management of joint stock companies (golden shares).

In addition, it should be noted that the withdrawal of the State from the capital of each such company will most probably trigger further issues.

First of all, regarding Rostelecom in respect of which the Spring 2012 Presidential Decree approved reorganisation in form of amalgamation with the Investment Communications Company (known as Svyazinvest) with the exclusion thereof from the list of strategic organisations, on the condition that the state and Vneshekonombank control more than 50% of the ordinary shares of Rostelecom. Meanwhile by the beginning of 2013 the reorganisation of the public sector within the telecommunication industry was only at the stage of the issue of additional shares to Svyazinvest itself, within the framework of which the State will transfer the holding core assets (including shares in Central Telegraph, Bashinformsvyaz and other companies). If Rostelecom intends to retain its share in Svyazinvests (25% plus 1 share, with the remaining capital owned by the State) the company is to participate in the additional issue of monetary resources.

In this regard we must remember that the last sale of shareholdings by Svyazinvest was repeatedly postponed for a variety of reasons. In the 2000s, apart from the reorganisation and optimisation of the holding's corporate structure, there were several social and regional issues (tariff reform, social problems of regional communication operators being its subsidiaries and affiliates) and restrictions related to national safety (providing communication services to defence and law enforcement agencies to protect the interests of these special users of communication services). The practical mechanisms to resolve such problems whilst implementing the new format for absorbing Svyazinvests into Rostelecom have not yet been disclosed.

As for Rosnano, attention is paid to the issue of compensation for the budget expenditure incurred in recent years in order to provide the asset contribution of the State into this former State corporation, together with the issue of the effectiveness of development institutions as a whole. As to the UCC the issue is the use of funds raised by closed subscription in 2012, as well as the storage of state grain reserves and its participation in commodity and purchasing interventions. For Rosspirtprom the focus is on its control over the alcohol market where there has been an obvious decrease in the legal sales of alcoholic beverages after the increase in excise duties (being a traditional source of budgetary income in Russia. As to the metropolitan airports, attention is paid to their power to attract further budgetary funding for restructuring, and the degree of transparency of the new capital structure in the light of multiple problems identified in the mid-2000s involving Domodedovo Airport (long term proceedings with the Federal Property Management Agency related to the problem of ownership of a number of structures and facilities and the unclear ownership structure, detected while solving issues of transport safety).

The new privatisation programme as a whole appears to be more moderate and reasonable, taking into account the maintenance of state corporate control over some companies which are natural monopolies, the infrastructure which is involved in capital intensive types of activity associated with long term payback' and over structures which play an important role in the implementation of structural and industrial policy and which acted as agents of the State while implementing anti-crisis measures during the acute phase of the crisis in 2008–2009.

The volume of budget revenues from privatisation is significantly decreased if we exclude consideration of the value of shares in the largest companies which occupy leading positions in their respective industries. In 2014–2016 budget revenue is expected to achieve RUR 3bn annually, as compared to the estimates under the previous privatisation programme of RUR 6bn in 2011 and RUR 5bn in each of 2012 and 2013.

There will be no basic receipts from privatisation at the expense of the shares of the largest companies which have high investment attractiveness in the case that the RF Government adopts separate decisions on them, whilst receipts under the previous privatisation programme amounted to RUR 1 trillion in 2011–2013.

The new programme provides for the possibility that the President and the Government of the Russian Federation can adopt decisions on privatisation by decreasing the State's share in the charter capital of a company through the issue of additional shares and by contributing proceeds to the recapitalisation of joint stock companies with regard to their long term development and the investments required, as well as through the capital adequacy ratio (in relation to banks).

Considering the information from official sources, and following the results of discussion of the forecast, the Privatisation Plan for 2014–2016 by the RF Government as of 27 June 2013, at the time RUR 630bn of direct budgetary income, may be achieved during the three years (2014 – RUR 180bn, 2015 – RUR 140bn and 2016 – RUR 300bn), mainly from sale of the shares of joint stock companies which occupy leading positions in their respective industries, and, possibly, RUR 9bn from other sales. An additional RUR 380bn could be received as Rosneftgaz dividends¹ from the sale of Rosneft shares. Altogether federal budget receipts should realise about RUR 1 trillion 20bn².

The draft federal budget for 2014 and plans for 2015 and 2016 submitted to parliament by the Russian government provided for the use of assets received from the privatisation of federal ownership as a separate source of financing the federal deficit. In this respect the relevant federal law, as with a similar document which lapsed a year ago, did not contain any information about the specific value of the income from privatisation, either in the main body, nor in the annexes. Only the memorandum to the document considered the funds received from the privatisation of federal ownership and state borrowings as a separate source for financing the federal deficit.

In this context, in 2014–2016, it is planned to privatise the shareholdings of the largest companies which occupy leading positions in their respective industries. It is the Government of the Russian Federation that will determine the periods and methods of privatisation of these companies with regard to the market conditions and advice from leading investment consultants.

The memorandum to the bill of the federal budget for 2014–2016, as submitted to parliament, detailed the content of the forecast Plan (programme) for federal property privatisation and the core themes of federal property privatisation for 2014–2016, approved by the Order of the RF Government No. 1111-p. as of 1 July 2013. These actions will allow

¹ At that meeting, the finance minister of the government of the Russian Federation expressed doubts about the reality of obtaining such sums from the company.

² However, the direct addition of income through these channels has a total value of RUR 10bn less. This difference is more than in the single official statement in the new privatization programme: (value of privatization revenues at RUR 3bn, annually during 2014–2016.

for the attraction of funds to the federal budget in the amount of RUR 196.8bn – in 2014, RUR 158.5bn – in 2015 and RUR 99.9bn – in 2016 (*Table 3*).

Table 3

Federal budget estimated privatisation revenues 2011–2016, RUR bn

Source	2011	2012	2013	2014	2015	2016
Privatisation forecast plan (programme) and federal property privatisation fundamental objectives for 2011–2013	6.0	5.0	5.0			
BPFOs (budgetary policy fundamental objectives) for 2011 and target period for 2012 and 2013	298.0	276.1	309.4			
BPFOs for 2012 and target period for 2013 and 2014	298.0	276.1	309.4	300.0		
BPFOs for 2013 and target period for 2014 and 2015			380.0	475.0	385.0	
Estimated federal budget for 2013 and target period for 2014 and 2015 (memorandum)			427.7	330.8	595.1	
RF Government session records of 27 June 2013*				180.0	140.0	300.0
Federal budget basic parameters for 2014–2016 (RF Ministry of Finance projects)				230.8	445.1	250.0
Privatisation forecast plan (programme) and federal property privatisation fundamental objectives for 2013–2016				3.0	3.0	3.0
Federal budget draft law for 2014 and target period for 2015 and 2016 (memorandum)				196.8	158.5	99.9

* Excluding the revenues from privatisation transactions not classified as being the largest.

There is an evident decrease in the value of the forecast proceeds from the privatisation of public property in comparison with those specified in the memorandum with reference to the applicable federal law of 3 December 2012 No. 216-FZ On the federal budget for 2013 and for the target period of 2014 and 2015: in 2014 – by almost 40% (against RUR 330.8bn), in 2015 – by almost four times (against RUR 595.1bn). However, it is worth noting that in the publicly available versions of the aforementioned law (as amended in June and December 2013), there is no data on the magnitude of the funds from sale of shares and other federally owned forms of equity, and there is no distinction between federally owned property and the other sources of financing the budget deficit.

Within the new federal budget, the proceeds from privatisation play a subordinate role in financing its deficit. Thus, in 2014, the expected value of the privatisation revenues will amount to less than 1/3 of the funds which are supposed to be attracted in public borrowing, in 2015 – about 1/5 and in 2016 – approximately 1/10.

On the positive side the draft law submitted for the consideration of the Parliament on the budget for the next three years, among the items there are detailed projects on revenues from the use of state property. The most important role here is played by dividends on federal share packages. Thus, it is expected that in 2014 the proceeds from these dividends in the federal budget will amount to RUR 192.7bn, in 2015 to RUR 200.4bn, and in 2016 to RUR 761bn.

Such growth as is expected in 2016 would result from transfer to the federal budget of revenues in the form of dividends on Rosneftegaz shares as a result of selling 19.5% of shares minus one share of Rosneft (RUR 423.5bn) and from the supposed effect of the decision of the Government of the Russian Federation on the direction for payment dividends on shares owned by the state of at least 35% of the net value of the joint-stock companies, determined in accordance with the data of their consolidated financial statements (RUR 106.0bn). Other similar types of federal budget revenues from the use of state property through tangible assets (rental payments for land and property, and transfer of the profits of unitary enterprises) are additional.

To speak about the reality of achieving the declared target privatisation revenues for federal budget is quite difficult, because it depends both on the list of the assets supposedly

for sale and their value, which is associated with the evaluation procedures and with the situation in the securities market.

According to the Federal Property Management Agency, following the results of the sales during the three years of the 2011–2013 privatisation programme, RUR 25.67bn were subject to be transferred to the federal budget, including RUR 13,286.5m – in 2011, RUR 5,900m – in 2012, and RUR 6,471.9m – in 2013 (without taking into consideration the largest sales involving investment consultants), which amounts to 160% of the task established by the forecast privatisation plan. (If we use the values specified in the text of the programme as the basis for assessment of its performance: RUR 6bn for 2011, and RUR 5bn for each of 2012 and 2013, that is, in total, RUR 16bn - without taking into consideration the largest sales). This suggests performance above the target: in 2011 – more than 2.2 times (or by RUR 7,287m), in 2012 – by 18% (or by RUR 900m), in 2013 – by 29.4% (or by RUR 1,472m), and in total for the three years – by 60% (or by RUR 9.7bn).

At the same time, according to the Federal Budget Versus Actual Reports (on internal sources for financing the deficit) available on the Federal Treasury website, the funds from the sale of shares and from other forms of participation in the capital which is in federal ownership, amounted to RUR 126.2bn in 2011 (with an annual target of RUR 174.3bn, actually 74.41%), to RUR 43.9bn in 2012 (with an annual target of RUR 58.7bn, actually 74.72%), and to RUR 41.6bn in 2013 (according to preliminary data) (with an annual target of RUR 52bn, actually – 80%).

Altogether, over the three years of the preceding privatisation programme for 2011–2013, according to budgetary reporting, the federal budget received about RUR 371bn from sale of shares and from other forms of equity participation¹. This value, on the one hand, is many times higher than the estimated revenues which were in the 2011–2013 programme without taking into consideration the main proceeds from privatisation with respect to the shares of largest companies, which have high investment attractiveness. On the other hand, the proceeds to the federal budget from sale of shares in 2011–2013 has proved to be approximately 2.7 times less than the RUR 1 trillion estimate which was given in the preceding privatisation programme, taking into consideration the proceeds from the possible sale of shares of the largest companies in the case of particular decisions taken by the Government of the Russia Federation.

The mechanism of the budget process which has been developed in recent years, in which the actual text of the adopted budget law does not contain any indication of the budget revenues in relation to the privatisation, leaves a great deal of scope, to take unrestricted decisions in respect of the list of the assets to be privatised, and the timing and format of their sale.

Especially since the example of the preceding privatisation programme clearly indicated a greater probability of numerous changes and additions to the similar newly adopted document. In all, from the moment of approval of the forecast plan (programme) of privatisation of the federal property and the main areas of the privatisation of federal property for 2011–2013, pursuant to RF Government Directive of 27 November 2010, No. 2102-p,

¹ Including the funds got by the Central Bank of the Russian Federation from selling Sberbank's shares in 2012. Of course, with the consideration of the revenues from selling other assets (land and different property), the total value of privatisation revenues turn out to be higher. See the paragraph "Privatisation Policy Budgetary Efficiency" for further details.

about 50 corresponding regulatory acts were adopted, 15 of which were published in 2013; 24 – in 2012; 11 – in 2011 (and one more appeared at the latter end of 2010)¹.

Thus, RF Government's Directive of 18 April 2013 No. 627-p approved the changes in the privatisation programme for 2011–2013, provided for the inclusion of 54 joint-stock companies and 14 federal state unitary enterprises (FGUPs), engaging in business activities in the spheres of road infrastructure, transport, agriculture and other industries, as well as 149 other pieces of treasury property, which are immovable property (primarily, land plots with buildings and facilities located on them)².

After that, the total number of the assets subject to privatisation, which were specified in the programme, amounted to 298 FGUPs (in the initial version of the programme – 114 units which was an increase of 2.6 times), 1,428 open joint-stock companies (in the initial version – 809 units, an increase of 1.8 times), 43 closed joint-stock companies (in the initial version of the programme – 35 units, an increase of 1.2 times), 11 limited liability companies (in the first version – 10 units, an increase of 1.1 times), as well as 727 pieces of other property of the RF treasury (in the initial version – 73 units, an increase of 10 times). Furthermore, in accordance with the observations of the National Audit Office of the Russian Federation, the summary distribution of FGUPs and JSCs subject to privatisation in 2011–2013 has been refined, taking into consideration the changes made earlier in the privatisation programme, and the additions made in spring 2013.

From the practical side, the privatisation of 2013 was particularly remarkable for the six transactions with shares of the largest joint-stock companies made with the involvement of investment consultants pursuant to the decisions of the Government of the Russian Federation adopted in order to create conditions for attracting investments, to stimulate development of the stock market promotion, and modernisation and technological development of the economy, amounting to a total sum of RUR 286 bn.

Among them were:

- completion of a transaction for selling shares amounting to 55% of the share capital of OJSC Vanino Commercial Seaport (the dealmaker was CJSC VTB Capital) for RUR 15.5bn (the purchaser was Mechel-Trans LLC)³;
- Rosneftegaz selling 5.66% of Rosneft shares in favour of BP for a total sum of RUR 148.1bn, as part of the acquisition of shares in TNK-BP, as a result of which the monetary funds from the privatisation of Rosneft shares were placed on Rosneftegaz's books, the sole incorporator of which was the Russia Federation (the consultants for this transaction were Citi and Bank of America Merrill Lynch);
- the placing of an additional issue of shares of VTB Bank, amounting to RUR 102.5bn by public subscription, bringing the state's share of capital in the bank down

¹ To add to this, by the beginning of February 2014, for the period of approval of the new privatisation programme for 2014–2016, four regulatory acts appeared which amended it.

² Making technical changes and updating was also provided for with regard to the four OJSCs and another 11 pieces of property (with updating of the number of shares privatised, the names of the companies and the location of the pieces of immovable property). These pieces of federal property could have been of interest, first of all, for small and medium-sized business entities.

³ For further details of this privatisation transaction, which turned out essentially to be a scandal due to the quick resale by the purchaser of the government's stake (Mechel-Trans) of almost all the share to offshore companies, see 'The Russian Economy in 2012. Trends and Prospects' (Issue 34). M., IEP, p. 449–450. To add to this, in the preceding year Mechel suffered significant financial difficulties (falling capitalisation and high leverage), forcing it to appeal to state-owned banks for support.

- from 75.5% to 60.93% and the direction of borrowed funds for the support of bank recapitalisation (transaction organisers were VTB Capital, Citigroup, J.P. Morgan and Bank of America Merrill Lynch);
- the sale of shares amounting to 25.1% of the share capital of OJSC Territorial Generating Company No. 5 (TGK-5) (the dealmaker was VTB Capital) for RUR 1,080.4m (the purchaser was TGK-9);
 - the sale of shares amounting to 25.5% of the share capital of OJSC Sibir Airline Company (the dealmaker was OJSC Alfa Bank) for RUR 1,133.1m (the purchaser was CJSC S 7 Group);
 - the placing of ALROSA Share Company shares by means of public offer to a wide range of investors, in accordance with international standards (the dealmaker was the private unlimited company GOLDMAN SACHS (Russia), with the participation of G.P. Morgan Securities, Morgan Stanley & Co. International, VTB Capital, and Renaissance Securities (Cyprus) Limited as the underwriting banks).

This last-mentioned transaction deserves a more detailed consideration.

Late in October 2013, 7% of the shares of Alrosa AK, which were in federal ownership, were posted on the Moscow Stock Exchange, as well as 7% of shares which belonged to the Republic of Sakha (Yakutia), and 2% of quasi-treasury shares controlled by the company itself, with the purposes of ensuring a stabilisation mechanism to support the share price after the transaction. Thus, altogether, a 16% stake of ALROSA AK was placed on the Moscow Exchange.

The independent appraiser Ernst & Young – Appraisal and Consulting Services assessed the range of the market value of the ALROSA shares as between RUR 32.84 to RUR 38.21 per share. The corresponding report underwent an examination by the National Russian Non-Governmental Organisation, the “Russian Society of Appraisers”. The formation of the book application from investors was carried out in the course of a road show between 14 and 25 October 2013. This resulted in a placing price of RUR 35 per share, with the provision of a premium to the weighted average price for the last six months in the amount of 6.5%. The total purchase price amounted to RUR 41.3bn, including RUR 18bn for the 7% of the shares alienated from federal ownership.

The implemented public offering of ALROSA AK’s shares to a wide range of investors in accordance with international standards became: (1) the largest Russian public share placement in 2013; (2) the largest offering of local shares listed on the Moscow Exchange, throughout the history of the Russian securities market; (3) the first public offering of the shares of a Russian state company in the materials sector for the last seven years; and (4) the largest public offering of the shares of a mining company in the world, beginning from June 2011.

To add to this, after less than in a month, a shareholders’ agreement was signed, with regard to the shares of the company, which reflected the state’s strategic targets on the preservation of the controlling interest in the company in public ownership, as well as the interaction of the Russian federation and the Republic of Sakha (Yakutia) in corporate governance of ALROSA AK. The shareholders agreement was concluded for five years with an opportunity of automatic renewal.

Undertaking an overall assessment of the transactions, made in 2013, with the shares of the largest companies, we cannot pass over the fact that, as distinct from the two previous years, those transactions prevailed by volume and structure where the budget did

not obtain anything directly (an additional issue of the sale VTB shares in the Rosneft share package in the course of the transaction with TNK-BP), whereas, in 2011–2012, there was only one such transaction out of seven transactions (an additional issue of shares of the United Cereal Company (OZK) in 2012).

In 2014 the RF Government had taken decisions on selling INTER RAO YeES and Arkhangelsk Trawler Fleet's shares for a total of more than RUR 21bn, the arrangements for the sale of which were made in 2012–2013.

By its Directive of 16 January 2014 No. 22-r, the RF Government accepted the proposal of the Minekonomrazvitiya (the Ministry of Economic Development and Trade) of Russia, agreed upon with the Minenergo (the Ministry of Energy) of Russia, concerning the sale of the federally owned 13.76% of shares in INTER RAO UES in favour of Rosneftegaz. The transaction amounted to RUR 18.8bn.

This decision had been taken for the purposes of optimisation of the structure of the INTER RAO UES share capital, increasing the transparency of the company's management and decreasing the pressure on shares. This is an example of the implementation of the Decree of the President of the Russian Federation of 22 May 2012 No. 695, as well as of the norms of the preceding and of the effective privatisation programmes. (According to these, until the beginning of 2015, ROSNEFTEGAZ can act as an investor in relation to companies in the fuel and energy industry, the shares are scheduled for privatisation subject to the submission of the funding programme for these transactions, providing for the use of the dividends from the shares in companies which are fully owned by the aforementioned joint-stock company.

The transaction of the sale of the complete share package (100%) of the Arkhangelsk Trawler Fleet (the dealmaker was Gazprombank) for RUR 2.2bn can be used as an example of implementation of an unconventional approach within the privatisation process.

The peculiarity of the transaction lies in the special format of the interaction between the new owner (Virma LLC) and the regional authorities. There is an agreement between them, based on the voluntary conveyance of the title to one share to Arkhangelsk region. The key decisions, including the preservation of jobs and the registration of open joint-stock companies in the region in order to preserve the tax revenues received by the regional budget, are subject to agreement with the regional government, for which a seat on the Board of Directors is reserved.

The shareholder agreement between the Arkhangelsk region and Virma LLC is a unique example of the implementation of the post-privatisation control mechanism, allowing, *inter alia*, the balancing of the interests of the state represented by the Arkhangelsk region and those of the new owner with regard to the social obligations and improvements in business performance.

However it inevitably raises questions regarding possible conflicts of such tools with the more general legal norms, in particular, with corporate legislation (the role of the single share transferred to the regional authorities compared with the powers resulting from right to participate in control - "the golden share"), and with the adequacy of the concluded agreement for avoiding possible conflicts in the future, for example, in the case of Virma reselling all the share package of the Arkhangelsk Trawler Fleet, or a part thereof, to an outsider. This is in addition to the extent of taking into consideration all the negative experiences of investment tenders in the 1990s and the common practice of commercial tenders with social conditions,

which became common under the application as long ago as in the 2000s, of the, then effective, third privatisation law.

In 2013, the Russian Auction House (OJSC RAD) also joined in the sale of government stake. RAD, acting under the RF Government Directive of 31 January 2013 No.101-r and under the terms of the agency contract with Rosimushchestvo (the Federal Property Management Agency), is undertaking the sale of shares in 36 OJSCs which were part of the privatisation programme of the preceding year.

Altogether, in 2013, RAD successfully completed 15 sales, which resulted in RUR 1,967.8m for transfer to the federal budget, and this is comparable with the sum total of the transactions on the sale of the golden shares of TGK-5 and the Sibir Airline Company (RUR 2,213.5 bn) made with the assistance of investment consultants. RAD has planned the summing-up of 9 more sales for the 1st quarter of 2014. Among the transactions to be undertaken by the Russian Auction House from June, are the sale of the federal stakes in OJSC Ulyanovsk Automobile Plant (13.19%, RUR 850.31m), the Sakhalin Shipping Company (25.5%, RUR 405.77m), and Lenmetrogiprotrans (25.48%, RUR 266m).

As for the traditional privatisation tools, the largest transaction made with the use of these was the auction for the sale of the full (100%) government stake in Moskinap for RUR 935m held by Rosimushchestvo.

Altogether, in 2013, share packages (interests in their share capitals) of 148 companies were sold (without taking into consideration the two sales of shares made with the assistance of investment consultants), while the summing-up of the share sale of 55 other companies is planned for the 1st quarter of 2014, and the conditions of privatisation have already been adopted.

When these data are compared with the results of the previous years' privatisation programmes (*Table 4*), we may say that, in 2011–2013, during the period of the first 3-year privatisation programme, the number of share packages (interests), with 730 units being sold, increased by more than 1.8 times compared with the crisis period of 2008–2010 and was also comparable with the total value of the two years before the crisis (2006 and 2007), but was lower than in the mid-2000s, when, every year, more than 500 share packages were sold. The results of the privatisation programme in 2011–2013, with regard to the unitary enterprises look much more modest: the number of FGUPs in relation to which Rosimushchestvo issued directives concerning the conditions of their privatisation by means of reorganisation into OJSCs was 216 units and among them 182 OJSCs were registered: in 2011 – 46 units, in 2012 – 103 units, and in 2013 – 33 units), and this is approximately four times lower than the number in 2008–2010¹.

In spite of the significant number of cases of privatisation, the problems with the administration of the privatisation process are still relevant since not all the active assets included in the forecast plan of privatisation could be actually be put up for sale, because many businesses and unitary enterprises were in the process of bankruptcy, under reorganisation or liquidation and were therefore not economically active, and in some instances there was a lack of applications from potential participants in the appropriate procedures.

¹ It is possible that this difference was not so great, if we assume that a certain number of unitary enterprises were privatised by means of transforming into LLCs (limited liability companies) and ANOs (autonomous non-commercial organisations). However, there is no official information on this matter.

In total in 2011–2013 the shares of 730 companies (shares in charter capital) were sold, which was only half of the number included in the Programme of Privatisation (1,477 units) and about $\frac{3}{4}$ of the number of companies, which were subject to the terms of privatisation (975 units). In fact the shares of 573 companies were offered for sale again, and 282 of them were offered for sale more than twice, in other words through repeated auctions by means of public offer without announcement of the price.

Table 4

Dynamics of privatisation of state federal unitary enterprises and federal blocks of shares in 2000–2013

Period	The number of privatised enterprises (objects) of federal property (according to the Federal Property Management Agency, until 2004 – the Federal Ministry for State Property Management)	
	Privatised federal state unitary enterprises ^a , units	Sold blocks of shares of JSCs, units.
2000	2	320
2001	5	125 ^b
2002	102	112 ^b
2003	571 ^c	630
2004	525	596 ^d
2005	741	521
2006	...	356 ^e
2007	377	377
2008	213	209 ^b
2009	316+256 ^f	52 ^b
2010	62	134 ^b
2011	143	317 ^g /359 ^b
2012	47 ^g	265 ^h
2013	26	148 ^h

^a – all arrangements have been implemented and decisions on the terms of privatisation have been made;

^b – taking into account all blocks of shares which were announced to be ready for selling in the previous years;

^c – not including federal state unitary enterprises which were included as a contribution to the charter capital of JSC Russian Railways;

^d – taking into account 31 blocks of shares which were announced to be ready for selling in 2004 but where the results were reviewed in 2005;

^e – calculated value, based on data from the Report of the Federal Property Management Agency On the Privatisation of Federal Property in 2007 ;

^f – the number of federal state unitary enterprises which, according to the decision of the Ministry of Defence of the Russian Federation, were transformed into joint-stock companies, in addition to those enterprises which came under the same decision of the Federal Property Management Agency;

^g – calculated value, based on data from the Report of the Federal Property Management Agency on the implementation of the forecast plan (programme) of federal property privatisation in 2011-2013 regarding the total number of federal state unitary enterprises that, in 2011-2013, were subject to orders about the terms of privatisation, based on transformation into JSC (216 units) and separate data until 2011 and 2013

^h – not including sale of shares implemented with the help of investment advisers.

Source: www.mgi.ru; Materials for the meeting of the Government of the Russian Federation on the 17 March 2005 On Measures to Raise the Effectiveness of Federal Property Management. The report of the Federal Property Management Agency On the Privatisation of Federal Property in 2005. M., 2006; The report of the Federal Property Management Agency On the Privatisation of Federal property in 2007. M., 2008; The Federal Agency for State Property Management. Synthesis of activities for 2008. M., 2009; The report on implementation of the forecast plan (programme) of federal property privatisation for 2009, M., 2010; The report of the Ministry of Economic Development and Trade of the Russian Federation On the Results of Federal Property Privatisation in 2010; The report of the Ministry of Economic Development and Trade of the Russian Federation On the Results of Federal Property Privatisation in 2011; The report on the implementation of the forecast plan (programme) of federal property privatisation in 2011–2013.

In 2013 blocks of shares (shares of charter capitals) of 286 companies were actually put up for sale, while the shares of 148 of those societies were sold (shares of charter capital), which was about half of the number which were available for sale according to the stipulations on the terms of privatisation (301 units). A review of the results of share sales concerning 55 companies is scheduled for the first quarter of 2014. The unsold shares resulting from failed biddings on 221 JSCs were offered for sale again, including 130 which were offered not more than twice. The sales of shares (shares of charter capital) of 81 companies were declared as 'failed' in 2013.

Similar problems have also occurred during the sales of other types of property. So, during 2013 from 99 objects of immovable property put up for sale less than $\frac{1}{4}$ - 22 units (in 2011 - 3 units, in 2012 - 40 units) were sold. Bidding for 8 objects was not conducted. A review of the results of share sales concerning 69 other types of property is scheduled for the first quarter of 2014. According to the results of sales that took place in 2013, the sum of RUR 166.8m is subject to transfer into the federal budget, and for the 3-years 2011-2013 the total is - RUR 327.3m.

The formation of vertically integrated structures (VIS) has been of great importance for implementation of the privatisation programme. This has been especially true of the privatisation of unitary enterprises and of property of the Russian Treasury. So, out of 298 federal state unitary enterprises included in the Forecast Plan (programme) of privatisation of federal property for 2011-2013, 163 enterprises (or almost 55%) were subject to participation in the formation of holdings. From 522 objects of Russian Treasury property which were privatised in 2011-2013 only 65 units (or 12.5%) were sold, while the others became parts of the charter capitals of integrated structures. This process had weaker influence on the privatisation of blocks of shares (participation shares): out of 815 companies which had come under the process of privatisation, only 85 units (or 10.4%) were privatised by means of inclusion into charter capitals of parent companies of vertically integrated structures.

In total, in 2011-2013, as part of the process of enforcement of 48 Presidential Decrees of the Russian Federation and 7 decisions of the Government of the Russian Federation concerning the creation/extension of vertically integrated structures the measures of the Federal Agency for State Property Management resulted in the formation of 44 VIS. Of the relevant 41 Presidential Decrees of the Russian Federation and 3 Government decrees of the Russian Federation 34 VIS have been fully completed (or more than $\frac{3}{4}$ of the amount of those which came under the particular decisions of the state Government).

To the privatisation programme were added 163 federal state unitary enterprises, the shares of 98 OJSCs and 462 shares of other types of property which were all subject to inclusion into the charter capitals of Rosspirtprom, Russian Hippodromes, Russian Railways, UAC and the Federal Hydroelectric Generating Company. Nevertheless, for a variety of reasons the privatisation measures could not be implemented concerning 9 unitary enterprises and 13 OJSCs. That is why, de-facto, under the process of formation of the VIS, decisions were made about the terms of privatisation of 148 of 154 federal state unitary enterprises (96.1%) and of all the shares of the OJSCs (100%) which were possible subjects of privatisation (with approval of the transfer of titles and inclusion of shares of the OJSCs into the charter capital of the appropriate integrated structures), while orders on the terms of privatisation of 457 objects of other types of property (98.9%) have also been issued.

After a break which lasted for more than a year, last year saw a resumption of active improvements to privatisation law.

By means of three federal laws (in July and December, 2013) amendments and additions were made to Federal Law No. 178-FZ On the Privatisation of State and Municipal Property as of 21 December 2001.

As a result, the law possesses the following innovations:

- the list of property categories which do not come under the power of the law was supplemented with property transferred into the ownership of the Russian Scientific Fund as a material contribution of the Russian Federation (it now includes 16 categories);
- regulations for the special privatisation of objects of socio-cultural and municipal purposes came under radical amendments.

This last change deserves closer scrutiny. The universal norm, which is included in article 30, affords the opportunity for privatisation of facilities within the property complex of a unitary enterprise, but excluding a range of categories.

In the new version of the law the number of such exceptions no longer includes orphanages, children's homes and educational institutions intended to serve people particular settlements.

As far as an opportunity to change the designation of objects of social infrastructure for children is concerned, a reference to the order approved by Federal Law No. 124-FZ On the Fundamental Guarantees for the Rights of the Child in the Russian Federation of 24 July 1998 has appeared. The former maximum preservation term of designation of privatised institutions for socio-cultural purpose (health care, culture and sports) and for municipal purposes (5 years) was extended in connection to objects of social infrastructure for children by a factor of two – but for not more than 10 years.

With regard to the opportunity for privatisation of power grids, sources of heat energy, heat networks and centralised hot water systems the new version of the privatisation law (article 30) indicates that the abovementioned objects do not come under its restrictions if they are the main production assets of a unitary enterprise, in other words if the proceeds from sales of the products and services generated using these assets is higher than the proceeds from any other kind of activity implemented by the enterprise under its charter.

Concerning the regulation of opportunities for privatisation of specified categories of municipal infrastructure that cannot be shown to be major assets of a unitary enterprise, special article 30.1 has been included into the law; it allows privatisation under the terms of obligations on constructing, reconstructing and (or) modernisation (investment commitments) and with further commitments towards operation (operational commitments).

With the legal innovations it is important to notice that they are a part of actions aimed at lifting of the existing restrictions on privatisation. Evaluation of their effectiveness and consequences is rather difficult to undertake.

On the one hand, it is obvious that the great majority of assets related to children are institutions and that is why they do not come under the power of the privatisation law. On the other hand, within the ongoing campaign for decreasing the number of orphanages and enlargement of educational institutions, and taking into account information on the packing of those institutions, the new standards look very questionable from the perspective of morality and ethics.

As far as the relaxation of restrictions on privatisation of power grid facilities, sources of heat energy, heat networks, centralised hot water systems and separate objects of such systems is concerned, the following issue remains ongoing: to what extent are all negative

aspects of the experience of investment competition in the 90s and the consequences of the power sector reform in the 2000s being taken into account.

In connection with this fact, it is not surprising that the Investigation Committee of Russia (IC) has initiated a draft conferring additional powers on the law enforcement authorities for the implementation of control over privatisation. This implies inclusion into the criminal legislation of a special article 'Illegal Action within Privatisation of State and Municipal Property', introducing responsibility for the rigging of reports on asset evaluation, and the obligatory disclosure by claimants for state property, of their real owners and affiliated entities, with determination of the right for operational-search activity to make possible identity verification of the claimants and verification of provided documents¹. The last of these has become even more urgent in connection with the announcement regarding the official level of focus on 'de-offshorisation' of the Russian economy. Nevertheless it also concerns state companies, and the message from the President at the end of 2013 emphasised that fact in connection with the use of foreign jurisdiction during the implementation of the business transaction between Rosneft and TNK-BP. Nevertheless a preliminary review by the Expert Advisory Council (EAC) of the Federal Property Management Agency, for the draft on the Investigation Committee of the Russian Federation, on the privatisation of large state companies is of a more negative character and underlines the need for perfection and completeness of the already existing standards.

6.1.3. Presence of the State in the economy and structural politics

In 2013 major events in this area were connected to the fuel and energy industry. Foremost amongst these was the completion at the end in March of the acquisition by Rosneft of TNK-BP which had been the property of the British oil company BP and the consortium AAR, which had shared the company equally. It is important to remember in this connection that one of the elements of the transaction, besides a cash payment of \$16.64bn, was the transfer of 12.84% of Rosneft shares, which were on the company's account, to BP and the purchase of an additional 5.66% of shares of Rosneftegaz for \$4.87bn, which were on that company's account. As a result, the British company became the owner of almost 20% of Rosneft shares². In its turn the acquisition of TNK-BP made it possible for OJSC Rosneft to achieve leading positions in the fuel and energy sector and it created extra benefits for the shareholders of the company and contributed to the increase in its potential revenue and financial flow.

The forthcoming plans by Rosneft in the market of corporate control look rather ambitious. In the summer and autumn there was information about the possible acquisition of the oil assets of the Alliance business - group (a share in the Alliance Oil Company, Khabarovsk refinery and a share in the joint venture 'Petrol') and Domodedovo Airport (together with the Novoport holding). In the middle of the year by the purchase of 49% of the shares, Rosneft completed its acquisition of the gas company Itera, and at the end of the year Rosneft and Novatek signed the agreement on active assets exchange, provided for the exchange of the block of shares belonging to the oil company Severenergia, taking into account the participation of Gazpromneft, for the controlling interest in another gas project – Sibneftegaz.

¹ Not a private case. Interview with the representative of the Investigation Committee of the Russian Federation A. Bastrykin // The Russian News Paper, 15 January, 2014, № 6 (6278), pp. 1-2.

² The share of the consortium AAR in the capital of TNK-BP was repurchased for \$27.73bn.

In spring there was also information on the purchase by Rosneftegaz of 0.23% of shares of Gazprom which means it is possible, now, to speak about formal corporate control of the Government over the whole all-Russian gas monopoly even if in an indirect form. Until that moment it had directly possessed 38.37% of the shares, while another 10.74% of the shares belonged to Rosneftegaz, less than 0.9% had been under the control of RosGazifikatsiya, while the Federal Property Management Agency had a share of 74.55%. It is rather interesting that in the information on the structure of the share capital presented on the web site of Gazprom as at 31 December 2012 it was shown that the aggregate share of the government (including Rosneftegaz and RosGazifikatsiya) was 50.002%¹.

At the same time the Federal Anti-Monopoly Service blocked the purchase by Gazprom of the generating company Kvadra, controlled by the Oneksim group. Two years before that Gazprom had already failed in its attempt to purchase a large active asset in the power industry – of the company KES-Holding.

In the same spirit it is worth mentioning the purchase in spring of 2013 made by the bank VTB. For \$2.4bn it purchased the fourth largest (by the number of subscribers) cell phone operator in Russia, Tele2-Russia, from the holding Tele2 which comes under the control of the Swedish investment company Kinnevik. This transaction could be regarded as the first large-scaled acquisition in the sphere of mobile communications implemented by state companies and as a prerequisite for the possible emergence of a new mobile operator at a federal level in the case of a further sale of the active asset to Rostelecom. Supposedly, it is exactly this situation which has stirred up negative reactions from the existing cell phone operators, the so-called 'big three'.

Nevertheless, already by autumn of 2013 half of this active asset was re-sold to a consortium of investors led by the bank 'Russia' for RUR 40.4bn. As far as possible cooperation with Rostelecom is concerned, in the near future Tele2 is planning the creation of a joint venture with the Russian telecommunication holding, provided that the holding includes within the emerging mobile operator some relatively small mobile companies, the price for which is estimated at \$3.52bn. However there has still not been made any principal decision on the acquisition of the companies².

In 2013 the list of strategic enterprises and joint-stock companies underwent significant changes. Two unitary enterprises joined the list (Including Russian Post) but 7 OJSCs and 9 federal state unitary enterprises were excluded from it (including 3 enterprises subject to transformation into a joint-stock company in order to implement further transmission of the share to Rosato, 1 scientific research institution joining another one and also a liquidated Russian agency for international information RIA Novosti³).

It is also important to underline the changes flowing from the Decree of the President of the Russian Federation No. 874 of 2 December 2013 on improvements to space industry management. The document provides for bringing the federal block of shares of OJSCs the Moscow Research Institute of Space Instrument Engineering (Moscow) to the rate of 100% with a subsequent renaming as The United Rocket-Space Corporation, (URSC).

¹ www.lenta.ru, 1 April 2013, www.gazprom.ru.

² VTB sold half of Tele2 for RUR 40bn, www.lenta.ru, 5 December 2013.

³ Its property together with property of the subject of liquidation FGBU Russian State Radio Broadcasting Company Voice of Russia is transferred again to the emerging federal state unitary enterprise the International Information Community Russia Today. Those changes are a part of a wider set of measures for improvement of effectiveness of the state Mass Media activities concerning, inter alia, VGTRK, ITAR-TASS, The Russian Newspaper.

A further increase in its charter capital involves making it a part of the State as reimbursement for the additional issue of full (excluding one share) blocks of shares of the OJSCs, created on the basis of 9 converted into federal state unitary enterprises; blocks of shares of 13 OJSCs (including 2 minority packages) and also 100% of the shares, excluding one share, of the Rocket and Space Center Progress (the city of Samara) being under federal ownership, after preliminary inclusion in its capital of 100%, not including one share, of two other target enterprises the Moscow Institution of Thermal Engineering corporation, Echo (Moscow) and the Novator Technical Center (in the town of Mirny in the Archangelsky region).

At the same time the charter capital of the two last joint-stock companies will be rebuilt as payment of additional shares placed by them. One share of each OJSC created by means of the transformation of the abovementioned 9 federal state unitary enterprises is included into Echo, together with one share of 6 of the abovementioned 13 OJSCs and the Moscow Institution of Thermal Engineering and also one share of the Novator Technical Center into charter capital of which is added one share of Echo.

In addition blocking stock interests of 4 OJSCs are being contributed to the United Rocket-Space Corporation for their further inclusion in the charter capital of the State Missiles Center named after Academician V.P. Makeev (in the city of Miass in the Chelyabinsky district), the blocks of shares of 4 OJSC (1 blocking and 3 minority ones) – for their further inclusion in the charter capital of Information Satellite Systems named after Academician M.F. Reshetnev (in the city of Zheleznogorsk of Krasnodar region), blocks of shares of 5 OJSCs (2 controlling and 3 blocking) – their further inclusion in the charter capital of the Russian Corporation of Rocket-Space Device Engineering and Information Systems (Moscow) and a minority block of shares of 1 OJSC – for Space Monitoring Systems, Management - Information and Electromechanic complexes named after A.G. Iosifian (Moscow). Four specifically named OJSCs located in Moscow, Krasnodarsky krai and the Chelyabinsky district are included in the group which consists of 13 OJSCs; their shares are supposed to be used as a contribution to the United Rocket-Space Corporation. The blocking stock interests and two more OJSCs are subject to inclusion into the charter capital of the OJSC created on the basis of transformation of the Federal State Unitary Enterprise State Research and Production Space Center named after M.V. Khrunichev (Moscow).

Taking into consideration the large scale of the planned events which embrace more than 40 enterprises from the list of strategic organisations, only 1 enterprise and 7 OJSCs are excluded. So, concerning the rocket and space industry, a variant of implementation of restructuring has been chosen, this variant is similar to the one chosen for the aircraft and marine industries, where already, since 2006-2007 the national structures of the holdings have been active in the form of joint-stock companies (the United Aircraft Corporation (UAC) and the United Shipbuilding Corporation (USC)), although experience of their functioning during the last 6–7 years is rather ambiguous.

Precisely because of this, the President of the Russian Federation issued Decree of No.596 On the Long-Term State of Economic Policy (subclause 'b' of clause 2, concerning the privatisation and management of state property) as of 7 May 2012, which provided for implementation until 1 March 2013 for analysis of the performance of companies consolidated by the government, including the United Aircraft Corporation, the United Shipbuilding Corporation and Rostechtechnologies, in order to prepare suggestions for improvement to their administration, to ensure implementation of coherent strategies for their

development within the state development programmes for appropriate economic sectors; in order to gain leading positions in separate segments of the world markets for aircraft, shipping, information, communications and space technology.

Another important change concerning the energy sector is the permission to increase the charter capital of Russian Networks by means of an additional issue of shares with the increase in the threshold of government corporate control up to 61.7% (previously – 54.5%). There has been a small increase by 0.09% (from 79.55% to 79.64%) in the block of shares of the Federal Grid Company of Unified Energy System (FGC UES), subject to inclusion into the charter capital of Russian Networks.

Remember that after the completion of a long lasting process of restructuring of the energy sector and after the liquidation of RAO UES of Russia in the summer of 2008 the government turned out to be the owner of controlling interests of two infrastructure companies: FGC UES and the Interregional Grid Distribution Companies (IGDC). Decisions made in the second part of November 2012 provided for renaming the second of these as ‘Russian Networks’ with its inclusion into the charter capital of almost the whole federal block of shares of FGC UES as reimbursement for the Russian Networks’ offer of additional shares in connection with the increase in its charter capital, together with the maintenance of direct participation of the government in the capital of FGC UES on the value of not less than one share. The abovementioned amount of the federal block of shares in Russian Networks (61.7%) is fixed for the company and it is in the list of strategic joint-stock companies.

In total in 2013 the Federal Property Management Agency implemented events on the formation of 20 vertically integrated structures (VIS), and during that year the following measures were totally completed: implementation of 12 decrees of the President of the Russian Federation within the process of formation of 11 vertically integrated structures, including the Shipbuilding and Ship Repair Center, the Federal Hydroelectric Generating Company RusHydro, the concern Oceanpribor, Russian Networks, the concern Morinformsystem-Agat, Roskartography, The Scientific and Production Corporation, Uralvagonzavod named after F.E. Dzerzhinsky, the corporation Tactical Rocket Armament, the corporation The Moscow Institute of Heat Engineering, Rosgeology and the state corporation, Rostechologies.

After well-known events connected to the company Oboronservice occurred in autumn of 2012 new authorities of the Ministry of Defence of the Russian Federation directed their activities towards reconstruction of the holding. The director of the Property Relations Department of the defence corps D. Kurakin was told that from 9 subholdings, 100% of the shares, excluding one share of each, were included into the charter capital of Oboronservice, and in its new structures only 4 of them would remain: Slavyanka (maintenance, renewal and new construction of public utilities), Oboronenergo (maintenance of electrical equipment), Voentorg (food, tailoring and laundry service), Oboronstroi (military construction). The enterprises Remvooruzheniye, Spetsremont and Aviaremont should be handed in to the Ministry of Industry and Trade of the Russian Federation, Agroprom should be eliminated, and Krasnaya Zvezda should be subject to reform. Realisation of military assets is supposed to be outsourced, choosing sellers based on the results of competition¹.

¹ Ivanov M. Sergei Shoigu will leave the Oboronservice with the very minimum required, 01.11.2013; Ё-Online.

6.1.4. Public sector government issues

The legal and policy framework in the field of the management of economic entities included in the public sector remained unchanged until 2013.

At the end of the year the Law on unitary enterprises No. 161-FZ of 14 November 2002 experienced two amendments concerning reasons for the creation of state enterprises and the powers of the government as an owner of their property, which are of an editorial nature. From the point of view of content, a more important amendment was made in July 2013 and it completed the previous definition of a large transaction, as a transaction or several interrelated transactions connected to the purchasing, dispossession or the possibility of dispossession by a unitary enterprise, directly or indirectly, of property of which the value is more than 10% of the charter capital of the unitary enterprise or is 50,000 times the amount set by the federal law on the Minimum Wage for Labour, including the following phrase: ‘unless otherwise provided by federal law or adopted in accordance with their legal regulatory acts’.

After approval of the Government Resolution of the Russian Federation No. 990 On Regulations of Allocations of the Sovereign Wealth Funds (SWF) into the Securities of Russian Issuers Connected to Implementation of Self-Financing Infrastructure Projects, of 5 November 2013, it was determined that the effective Provisions on the management of the federally owned shares of joint-stock companies and the use of the special right for participation of the Russian Federation in the administration of joint-stock companies (golden shares) dated 3 December 2004 is not applicable to the case management of shares under federal ownership, purchased at the expense of the Sovereign Wealth Funds in accordance with the resolution.

As far as state companies’ management practice is concerned, the focus of attention was the dividend policy and issues of payments to their executives.

The year 2013 was the first substantial time frame within which the influence of the changes and additions to the former mechanism of payments of dividends for companies, with participation of government in their capital, in order to form the revenue of the federal budget should have become visible. The federal budget was approved more than 7 years ago by Government Order of the Russian Federation No. 774-p of 29 May 2006.

By means of a similar document No. 2083-p of 12 November 2012 amendments were made to the abovementioned document which provided for the direction of payments of dividends at the value of not less than 25% of the net profit of a joint-stock company (not including revenues received from the revaluation of financial investments) unless otherwise stated by Government acts (the former edition of the document included information about the definition of the minimum share of net profit of a joint-stock company directed towards the payments of dividends). Representatives of the government interests in joint-stock companies had to ensure the implementation of provisions which were stipulated by the Order in connection with their subsidiaries, while the authorities had to implement coordination and approval of the investment programmes of the subjects of natural monopolies, taking into consideration the terms provided in the amendments.

At the same time the new edition of the document does not include information about any necessity to use the rates of free (consolidated) financial statements in a joint-stock company that has subsidiaries when determining the amount of dividends; neither does it include information about the order of the Ministry of Economy and Development to develop and approve methodological recommendations on the determination of the state position, as a shareholder, concerning the question about the payment of dividends.

According to estimates by the Chief of the Management of Corporate Systems of the Federal Property Management Agency, V. Seerikova, taking into consideration the results of the annual meeting of shareholders in 2013, only a few state companies failed to fulfill the demand set by the Government about the minimum share of net profit of a joint-stock company directed for the payment of dividends.

Among the authorities of the companies with state presence, the reduction of government workforce representation still was going on. So, in the boards of directors of OJSCs included in the special list there was a reduction in members from 141 to 122 people while the number of professional directors was increased from 293 to 347 - more in other words, by over 18%¹.

The Federal Property Management Agency approved a list of essential competences for the members of auditing commissions, and the methodology for determination of the core assets of state companies.

Under development are methodological recommendations on the management of activities of Boards of Directors of such OJSCs; methodological recommendations on management of the activities of the Audit Committee of the Board of Directors; methodology of individual estimation of the members of joint-stock companies' boards of directors with state presence; and also methodological recommendations on the use of key indicators of effectiveness which can be used by state companies, unitary enterprises and also by companies, in the charter capital of which the total proportion of state presence is 50%.

The catalyst for the question about the payments for the authorities of state companies and golden parachutes turned out to be a situation which happened to one of the members of the authorities of Rostelecom, who received from the company more than RUR 200m for prescheduled termination of his employment contract. The information about such a big sum was made public and instigated a wave of negative judgments in the field of the close association of authorities and public organisations and stirred up claims from minority shareholders of the company.

As a result, the situation was followed by the decision of the Court which was issued at the request of the Federal Property Management Agency; according to the decision the appropriate clause of the decision of the Board of Directors of Rostelecom was formally invalidated. After the above-mentioned decision of the Court had come into force the shareholders of the company had the right to take the matter to Court to seek the seizure of financial assets from the manager in the case of his refusal voluntarily to refund the money to Rostelecom.

This case served as the basis for the introduction by the Ministry of Labor and Social Security into the Government of the Russian Federation of the bill on limits on the payments for top-managers upon separation from state companies and state corporations. In accordance with the bill, the minimum value of compensations is equal to three month's income, while the maximum value is six month's income. Financial compensation for unused annual leave is paid outside of the abovementioned restriction. In the case of termination of an employment contract under the agreement of both parties, the payment of any compensation to the above entities must not be implemented². Later the bill was laid before Parliament.

¹ www.rosim.ru, 19.12.2013.

² The Court found the golden parachute of the former leader of Rostelecom inadequate, lenta.ru, 5 December 2013; www.rosim.ru, 06 December 2013.

6.1.5. Budget effect of the government property policy in 2000–2013

In 2013, in contrast to several previous years, there was a decrease in budget revenues related to public property, and it was first observed in 2008-2009.

Remember that all federal revenues from property owned by the state can be divided into two groups. One group consists of the proceeds from the use of state property (renewable sources). The other group comprises receipts of one-time origin which may not be renewed due to the transfer of ownership from the state to other businesses and individuals after the sale including sale as part of the framework of privatisation (non-renewable sources).

Below in *Tables 5 and 6* are given the data on the income to the federal budget for 2000-2013 regarding the use of state property and selling of it only for a certain range of material objects¹.

Turning to the analysis of the preliminary results of the budgetary effect of the property policy of the state in 2013 in terms of renewable sources, firstly, it should be noted that there was a sharp (by more than 1/3 compared to 2012), fall in dividend income, the value of which was (RUR 134.8bn; however, this was greater than their total value for the first 2 years of post-crisis recovery (2010-2011). The transfer of part of their profits by unitary enterprises, by contrast, grew by almost 1/4 reaching RUR 6.2bn. Fiscal revenues from land rent remained almost at the same level as in 2012 (about RUR 7.7bn); but revenues from renting out federal property increased by 35%, which, however, corresponds only to the level of the early 2000s.²

¹ Outside the scope were left federal budget revenues received as payments for natural resources (including water biological, revenues from the use of forest resources and subsoil use), recovery of agricultural production losses associated with the withdrawal of agricultural land, as a result of financial transactions (income from budget investments (income on the balance of the federal budget and from the placement thereof, and, since 2006, also revenues from the management of the Stabilisation Fund of Russia (since 2009 - the Reserve Fund and National Welfare Fund), incomes from the amounts accumulated in course of the auctions for the sale of shares owned by the Russian Federation), interest received from budget loans within the country at the expense of the federal budget, interest on government loans (inflow of funds from foreign governments and their entities in the payment of interest on loans granted to the Russian Federation, the income funds from enterprises and organisations in the payment of interest and loan guarantees received by the Russian Federation from foreign governments and international financial institutions)), from the provision of paid services or the reimbursement of expenses of the state, transfer of profits of the Central Bank of the Russian Federation, some payments from state and municipal enterprises and organisations (patent fees and registration fees for the official registration of computer programs, databases and topographies of integrated circuits, and other incomes, which until 2004 inclusive, were part of the payments from government organisations (other than income from the activities of the Vietsovpetro joint venture since 2001 and the transfer of part of the profits of the FSUEs since 2002)), income from the implementation of production sharing agreements (PSAs), income from the disposal and sale of confiscated and other property appropriated to the state revenue (including that transformed into state property by inheritance or gift, or treasures), revenues from lotteries, other income from the use of the property and rights owned by the state (income from the disposition of rights to the results of intellectual activities (R & D and engineering works) of military, special and dual purpose, income from the disposition of rights to the results of scientific and technical activities owned by the Russian Federation, profits from the operation and use of the property of highways, the exclusive right of disposal of the Russian Federation to the intellectual property in the field of Geodesy and Cartography, fees for the use of highways by vehicles registered in other states, and other income from the use of property owned by the Russian Federation), as well as incomes from the permitted activities of organisations to the federal budget and receipts from the sale of state reserves of precious metals and gemstones.

² This value also includes the first allocated in budget reports of income from the rental of the property constituting the treasury of Russia (except for land) (about RUR1 bn).

The amount of income from land rent, as in the previous year, includes revenues from the payment for the land located in the rights-of-way of federally owned public roads of federal importance while the payment from the implementation of agreements on the establishment of easements in respect of land plots within the boundaries

Table 5

**Federal budget income from use of public property (renewable sources)
in 2000–2013 (million rubles)**

Year	Total	Dividend on shares (2000–2013) and income from other forms of participation in capital (2005–2013)	Rent for land owned by the state	Rental income from publicly owned property	Income from transfer of the profits remaining after payment of taxes and other obligatory payments of the Federal State Unitary Enterprises (FSUE)	Income from business of joint venture Vietsovetro
2000	23,244.5	5,676.5	-	5,880.7	-	11,687.3 ^a
2001	29,241.9	6,478.0	3,916.7 ^b	5,015.7 ^c	209.6 ^d	13,621.9
2002	36,362.4	10,402.3	3,588.1	8,073.2	910.0	13,388.8
2003	41,261.1	12,395.8	10,276.8 ^e		2,387.6	16,200.9
2004	50,249.9	17,228.2	908.1 ^f	12,374.5 ^g	2,539.6	17,199.5
2005	56,103.2	19,291.9	1,769.2 ^h	14,521.2 ⁱ	2,445.9	18,075.0
2006	69,173.4	25,181.8	3,508.0 ^h	16,809.9 ^j	2,556.0	21,117.7
2007	80,331.85	43,542.7	4,841.4 ^h	18,195.2 ^j	3,231.7	10,520.85
2008	76,266.7	53,155.9	6,042.8 ^h	14,587.7 ^j	2,480.3	-
2009	31,849.6	10,114.2	6,470.5 ^h	13,507.6 ^j	1,757.3	-
2010	69,728.8	45,163.8	7,451.7 ^h	12,349.2 ^j	4,764.1	-
2011	104,304.0	79,441.0	8,210.5 ^h	11,241.25 ⁱ	4,637.85	773.4
2012	22,8964.5	212,571.5	7,660.7 ^h	3,730.3 ⁱ	5,002.0	-
2013	153,775.55	134,831.8	7,700.5 ⁱ	4,035.2+1,012.25 ⁱ	6,195.8	-

^a – according to the RF Federal Property Management Agency, not itemised separately in the law on the federal budget for 2000, specified is the amount of payments from state-owned enterprises (RUR 9.8871bn) (without specific components);

^b – amount of rent (i) for agricultural lands and (ii) for the land of cities and settlements;

^c – amount of income from the rental of the property assigned to (i) scientific organisations, (ii) educational institutions, (iii) health care institutions, (iiii) public museums, public institutions of culture and art, (iiiii) archival institutions, (iiiii) Ministry of Defence of the Russian Federation, (iiiii) organisations of the Ministry of Railways of the Russian Federation, (iiiii) Organisations of scientific services of academies of sciences having a state status; and (iiiii) other income from renting out the property owned by the state;

^d – according to the the RF Federal Property Management Agency, not itemised separately in the law on the federal budget for 2000, the value coincided with the amount of other incomes in payments from the state and municipal organisations;

^e – the total amount of income from the rental of property owned by the state (without itemisation of land rent);

^f – amount of rent (i) for the land of cities and towns, and (ii) for land in federal ownership after the allocation of public ownership of land;

^g – amount of income from the rental of the property assigned to (i) scientific organisations, (ii) educational institutions, (iii) health care institutions, (iiii) public institutions of culture and art, (iiiii) public archival institutions, (iiiii) post offices of the federal postal service of the Russian Ministry of Communications and Informatisation, (iiiii) organisations of scientific services of academies of sciences having a state status and (iiiii) other income from rental of federally owned property;

^h – rents after the allocation of public ownership of land and money from sale of the right to lease agreements for land in federal ownership (except for lands of federal autonomous (2008-2011) and budget (2011) institutions);

ⁱ – income from renting out property located in the operational management of the federal authorities, and institutions established by them; and those under the economic management of FSUEs: placed under the operational control having state status (i) scientific institutions, (ii) scientific service institutions of the Russian Academy of Sciences and branch academies of sciences, (iii) educational institutions, (iiii) health facilities, (iiiii) agencies of the federal postal communication of the Federal communications Agency, (iiiii) public institutions of culture and art, (iiiii) public archival institutions; and (iiiii) other income from rental of property in the operational management of the federal authorities institutions established thereby; and the ones in

of rights-of-way of public roads of federal importance for the construction (reconstruction), repair and operation of the road services, construction, transfer, conversion and maintenance of utilities, installation and maintenance of advertising structures in the budget statements for 2013 was not itemised.

economic management of FSUEs¹ (for 2006-2009 without revenues from the permitted activities and use of federal property located outside the territory of the Russian Federation received abroad, which in previous years were not itemised at all²);

ⁱ – income from renting out property located in the operational management of the federal authorities and institutions established by them (except for autonomous and budget ones): placed under the operational control of having state status (i) scientific institutions, (ii) scientific service institutions of the Russian Academy of Science and branch academies of sciences, (iii) educational institutions, (iiii) health facilities, (iiiii) public institutions of culture and art, (iiiii) public archival institutions, (iiiii) located in the operational management of the Ministry of Defence and its subordinate institutions (2010) (iiiii) federally owned, by order of the functions implemented by the Office of Presidential Affairs (2010) and (iiiii) other income from renting out the property located in the operational management of the federal authorities and institutions established by them (excluding income from permitted activities and the use of federal property located outside the territory of the Russian Federation received abroad);

^k – rents after the allocation of public ownership of land and money from sale of the right to lease agreements for land in federal ownership (except for lands of federal budget and autonomous institutions) as well as (i) rent for lands located in a right-of-way of public roads of federal importance federally owned (2012-2013); and (ii) payments from the implementation of agreements on the establishment of easements in respect of lands within the boundaries right-of-way of public roads of federal importance for the construction (reconstruction), repair and operation of the road service, construction, transfer, conversion and maintenance of utilities, installation and maintenance of advertising structures (only in 2012);

^l – income from renting out property in the operational management of the federal authorities and institutions established by them (except for the budget and autonomous ones) placed under the operational control of having state status (i) scientific institutions, (ii) educational institutions, (iii) health facilities, (iiii) public institutions of culture and art, (iiiii) public archival institutions, (iiiii) other income from renting out the property in the operational management of the federal state-owned institutions, (iiiii) federal government agencies, the Bank of Russia and the management bodies of public extra-budgetary funds of the Russian Federation (excluding revenues from the use of federal property located outside the territory of the Russian Federation received abroad).

Source: laws on execution of federal budget for the years of 2000-2012; report on the federal budget as of 1 January 2014 (online), www.roskazna.ru; author's calculations.

As a result, dividends have provided for the overwhelming majority of federal income from renewable sources (about 88% versus 93% of a year earlier) while the share of other sources was more symbolic: land rent, - 5%; profit transferred by FSUEs, - 4%; property rent 3.3%.

Turning to an analysis of budget revenues from non-renewable sources it is necessary to recall that since 1999 the proceeds from the privatisation and sale of state property (shares, and in 2003-2007 land spots³) began to be treated as sources for financing the federal budget deficit (*Table 6*).

In 2013 federal budget revenues of a property nature from non-renewable sources fell by about 1/3 somewhat exceeding the level of 2005. The main contribution to this result caused a rapid (by an order of more 13.6 times) drop in revenues from land sales which amounted to only RUR 1.2bn against more than RUR 16.4bn a year earlier, which roughly corresponds to

¹ In 2008-2009 Federal state unitary enterprises as a source of income from rental of property in their economic management were not mentioned, and renting out the property located in the operational management of the federal authorities and institutions established by them excludes property of the federal autonomous institutions.

² according to the RF Federal Property Management Agency revenues from the use of federal property located abroad (in addition to the income on the shares of the Russian party of Vietsovetpetro) amounted to RUR 315m in 1999; and RUR 440m in 2000. Later, the FSUE Foreign property management company started to play a major role in the commercialisation of federal property abroad.

³ In 2003-2004 including for the sale of lease rights.

the values of 2008-2009. Also, revenues from various assets decreased by more than by 40%, while the proceeds from the sale of shares (RUR 41.6bn) decreased by only 5%.

Table 6

**Income of federal budget from privatisation and sale of property
(non-renewable sources) in 2000–2013, million rubles**

Year	Total	Sale of shares in federal ownership (2000–2013) and other forms of participation in capital (2005–2013) ^a	Sale of lands	Sale of other property
2000	27,167.8	26,983.5	-	184.3 ^b
2001	10,307.9	9,583.9	119.6 ^c	217.5+386.5+0.4(ITA) ^d
2002	10,448.9	8,255.9 ^e	1,967.0 ^f	226.0 ^g
2003	94,077.6	89,758.6	3,992.3 ^h	316.2+10.5 ⁱ
2004	70,548.1	65,726.9	3,259.3 ⁱ	197.3+1,364.6+0.04(ITA) ^k
2005	41,254.2	34,987.6	5,285.7 ^j	980.9 ^m
2006	24,726.4	17,567.9	5,874.2 ⁿ	1,284.3 ^o
2007	25,429.4	19,274.3	959.6 ^p	5,195.5 ^q
2008	12,395.0	6,665.2+29.6	1,202.0 ^r	4,498.2+0.025(ITA) ^s
2009	4,544.1	1,952.9	1,152.5 ^r	1,438.7 ^s
2010	18,677.6	14,914.4	1,376.2 ^r	2,387.0+0.039(ITA) ^s
2011	136,660.1	126,207.5	2,425.2 ^r	8,027.4 ^s
2012	80,978.7	43,862.9	16,443.8 ^r	20,671.7+0.338(ITA) ^s
2013	55,198.5	41,633.3	1,212.6	12,352.3+0.310

^a – relate to the sources of domestic federal budget deficit financing; the amount of RUR 29.6m in 2008 (according to the report on the federal budget as of 1 January 2009) attributed to federal budget revenues; but absent in the law on execution of the federal budget for 2008;

^b – proceeds from privatisation of organisations owned by the state attributable to internal sources of financing of the federal budget deficit;

^c – proceeds from sale of land and rights to lease lands owned by the state (with itemisation of those where privatised enterprises are located) attributable to federal budget revenues;

^d – amount of proceeds from (1) the sale of federally owned property attributable to internal sources of financing the federal budget deficit; (2) income (i) from sale of apartments, (ii) from sale of productive and nonproductive funds, vehicles, other equipment and other assets; as well as (3) proceeds from sale of intangible assets (ITA) attributable to federal budget revenues;

^e – including RUR 6m from sale of shares owned by the subjects of the Russian Federation;

^f – proceeds from sale of land and intangible assets the value of income from which was not allocated separately, attributable to federal budget revenues;

^g – proceeds from sale of property owned by the state (including RUR 1.5m from sale of property owned by the subjects of the Russian Federation) attributable to internal sources of financing the federal budget deficit;

^h – includes income: (1) from sale of land on which the immovable property, that before alienation was in the federal property, to be transferred to the federal budget; (2) from sale of other lands as well as from sale of rights to enter into contracts of lease; (3) from sale of lands after allocation of public ownership of land; as well as from sale of rights to contracts on lease thereof credited to the federal budget attributable to internal sources of financing the federal budget deficit;

ⁱ – amount of revenue (1) from sale of property in federal ownership attributed to internal sources of financing the federal budget deficit; and (2) proceeds from sale of intangible assets attributable to federal budget revenues;

^k – includes income: (1) from sale of land to the state ownership of the lands where the immovable property is located that before alienation was in federal ownership, credited to the federal budget; (2) from sale of other lands as well as from sale of rights to contract of lease thereof; (3) from sale of land after allocation of public ownership of land as well as from sale of rights to lease contracts, credited to the federal budget attributable to internal sources of financing the federal budget deficit;

^l – amount of revenues (1) from sale of property located in the federal property attributed to internal sources of financing the federal budget deficit; (2) income (i) from sale of apartments; (ii) from sale of equipment, vehicles and other assets to be credited to the federal budget; (iii) from sale of products of ships utilisation; (iiii) from sale of property of SUEs, institutions and military equipment; (iiiii) from sale of products of utilisation of weapons, military equipment and ammunition; (3) income from sale of intangible assets (ITA) attributable to federal budget revenues;

^m – includes proceeds: (1) from sale of land before allocation of public ownership of land where the immovable property is located that before alienation was in federal ownership; (2) from sale of lands that after allocation of public ownership of land to be transferred to the federal budget; (3) from sale of other lands owned by the state before allocation of public ownership of land and not intended for housing (last update applies only to 2006) attributable to financing the federal budget deficit;

ⁿ – revenues from sales of tangible and intangible assets (net of the federal budget from the disposal and sale of confiscated property and other property converted into the state revenue) include income (i) from sale of apartments; (ii) from sale of property of FSUEs; (iii) from sale of property located in the operational management of federal agencies; (iiii) from sale of military property; (iiiii) from sale of products of utilisation of weapons, military equipment and ammunition; (iiiii) from sale of other federally owned property; (iiiii) from sale of intangible assets attributable to federal budget revenues;

^o – revenues from sales of tangible and intangible assets (excluding incomes as a proportion of profitable products of state in the performance of production sharing agreements (PSAs) and the federal budget funds from disposal and sale of escheat, and other confiscated property converted into the state revenue) include income (i) from sale of apartments; (ii) from sale of property of FSUEs; (iii) from sale of property in operational management of federal agencies; (iiii) from sale of military property; (iiiii) from sale of products of utilisation of weapons, military equipment and ammunition; (iiiii) income from sale of other federally owned property attributable to federal budget revenues;

^p – proceeds from sale of lands after allocation of public ownership of land that were federally owned attributable to finance the federal budget deficit;

^q – revenues from sales of tangible and intangible assets (excluding income as a proportion of profitable products in performance of production sharing agreements (PSAs) and the federal budget from the disposal and sale of escheat, and other confiscated property converted into state revenue, funds from sale of sequester timber) include income (i) from sale of apartments; (ii) from sale of property of FSUEs; (iii) from sale of property located in operational management of federal agencies; (iiii) from sale of released movable and immovable property of the military and other federal executive bodies which involve military and service equal thereto; (iiiii) from sales of military products from the stock of the federal bodies of executive power in framework of military-technical cooperation; (iiiii) income from sale of other federally owned property attributable to federal income the budget;

^r – proceeds from sale of lands in federal ownership (except for lands of federal autonomous and budget (2011-2012) institutions) attributable to federal budget revenues;

^s – revenues from sale of tangible and intangible assets (excluding income as a proportion of profitable products in the performance of production sharing agreements (PSAs); the federal budget funds from disposal and sale of escheat, and other confiscated property converted into the state revenue; funds from sale of sequester timber (2008-2011); income from the release tangible assets of government reserves of special raw materials and fissile materials (in part of proceeds from sale; from the provision for temporary borrowing and other use) as well as, for 2012, funds from sale of wood obtained at conducting activities for protection, conservation, reforestation with state at placement of state order for performance thereof without sale of forest plantations for timber, and timber obtained using forests on forest lands in accordance with Articles 43-46 of the Forest Code; income from commodity interventions from federal intervention fund of agricultural products, raw materials and food; from release of tangible assets from state reserve; from engaging convicts in paid work (in terms of sales of finished products) from sales of special storage products)) include revenues: (i) from sale of apartments; (ii) from sale of property located in operational management of federal agencies (except autonomous and budget (2011-2013); (iii) from sale of movable and immovable released military and other property of the federal executive authorities which involve military and service equal thereto; (iiii) from sale of products of utilisation of weapons, military equipment and ammunition; (iiiii) from sale of military products from stock of the federal bodies of executive power in framework of military-technical cooperation (2008, and 2010-2013); (iiiii) from sale of products of utilisation of weapons and military equipment within federal target program "Industrial disposal of weapons and military equipment (2005-2010); (iiiii) incomes from sale of other federally owned property as well as income from sale of intangible assets (ITA) attributable to federal budget revenues.

Source: laws on execution of the federal budget for 2000-2012; report on the federal budget as of 1 January 2014 (online), www.roskazna.ru; author's calculations.

This source has provided more than 3/4 of the total revenues from non-renewable sources, against 54% a year earlier. The share of income from the sale of various assets and from land is 22.4% and 2.2%, respectively.

The aggregate amount of federal budget revenues from the privatisation (sale) and use of state property in 2013 (*Table 7*) decreased compared to the previous year by almost 1/3; and, taking into account the funds received by the Central Bank of Russia in 2012 from sale of the SberBank stock of shares, - by more than half. However, their amount (about RUR 209bn) was the third largest since the early 2000s after the maximum achieved in 2012 together with indicators for the year of 2011.

The ratio between non-renewable and renewable sources in the structure of total revenues from the privatisation (sale) and the use of state property in 2013 approximately corresponded to the values for 2012, excluding the proceeds from the sale of the SberBank stock of shares.

Taking into account the results of that transaction, when compared to 2012, the share of non-renewable sources in the structure of total revenues from the privatisation (sale) and the use of state property in 2013 fell by almost half (by 26.4%) when compared to the level of 2001; although exceeding the values for the year of 2010. The share of revenues from the use of public property, on the contrary, increased from almost 49% to 73.6% in 2012. The absolute value of this result is second only to the results for the end of 2012, exceeding the values for the year of 2011 by one and a half times, while revenues from the privatisation (sale) of assets are approximately 2.5 times less than in 2011, also losing indicators for the years of 2003-2004.

Table 7

**Structure of federal budget revenues of property nature
from different sources in 2000–2013**

Year	Total revenues from privatisation (sale) and use of state property		Revenues from privatisation (nonrenewable sources)		Revenues from use of state property (renewable sources)	
	Million rubles	% of total	Million rubles	% of total	Million rubles	% of total
2000	50,412.3	100.0	27,167.8	53.9	23,244.5	46.1
2001	39,549.8	100.0	10,307.9	26.1	29,241.9	73.9
2002	46,811.3	100.0	10,448.9	22.3	36,362.4	77.7
2003	135,338.7	100.0	94,77.6	69.5	41,261.1	30.5
2004	120,798.0	100.0	70,548.1	58.4	50,249.9	41.6
2005	97,357.4	100.0	41,254.2	42.4	56,103.2	57.6
2006	93,899.8	100.0	24,726.4	26.3	69,173.4	73.7
2007	105,761.25	100.0	25,429.4	24.0	80,331.85	76.0
2008	88,661.7	100.0	12,395.0	14.0	76,266.7	86.0
2009	36,393.7	100.0	4,544.1	12.5	31,849.6	87.5
2010	88,406.4	100.0	18,677.6	21.1	69,728.8	78.9
2011	240,964.1	100.0	136,660.1	56.7	104,304.0	43.3
2012	309,943.2/ 469,243.2*	100.0	80,978.7/ 240,278.7*	26.1/ 51.2*	228,964.5	73.9/ 48.8*
2013	208,974.05	100.0	55,198.5	26.4	153,775.55	73.6

* including funds received by the Central Bank of the Russian Federation from the sale of SberBank shares (RUR 159.3bn) that may somewhat overestimate the total share of non-renewable sources because these funds were not credited to the budget in full but net of their book value and the sum of the costs associated with the sale of shares. Accordingly, the share of renewable sources is probably understated a little.

Source: laws on execution of the federal budget for 2000-2012; report on the federal budget as of 1 January 2014 (online), www.roskazna.ru; author's calculations.

Basically, in 2013 economic policy in the sphere of privatisation and state property management was characterised by the same trends as in previous years. Completion of the first 3-year forecast plan (programme) of privatisation (2011-2013) has left its mark on the details of the privatisation process in the past year (the predominance of the largest transactions not directly related to funding the budget) and on the contents of the new forecast plan (programme) of privatisation for 2014-2016 (greater moderation and reasonableness

taking into account the conservation of state corporate control over a number of companies, the importance of which is beyond the ordinary course of business for the Russian economy).

With all this as problematic issues highlighted by the results of implementation of the privatisation programme of 2011-2013 one must specify the repeated corrections of the forecast plan (privatisation) which is in certain contradiction to the idea of transition from their annual approval to a longer planning horizon (3 years), as well as the lack of correlation of the privatisation mechanisms with the resolution of such tasks as the creation of conditions for attracting investment in the development of joint stock companies based on new technologies, the development and promotion of innovation on the part of private investors, the improvement of corporate governance, and the promotion of stock market development.

This year the state of affairs in the area analysed will be heavily dependent on the macroeconomic situation, which will affect both the volume of privatisation revenues and the revenues derived from the activities of the state as a business entity (primarily dividends). Additional factors requiring careful analysis in this regard are the possible solutions to regulate the tariffs of the natural monopolies, affecting, primarily, the public sector of the economy.

6.2. Industrial policy in Russia in 2000–2013: institutional features and key lessons

Conceptual and practical issues of the development of industrial policy have attracted, and continue to attract, the attention of experts and politicians. In the 2000s, especially after the world financial crisis, and in the period of remaining uncertainty over further developments, a discussion of best practices, reasons for the failure and the capabilities and features of a new industrial policy became quite popular in both developed and developing countries.

The subject of the formation and implementation of a state industrial policy in Russia has become particularly relevant in recent years as it has become obvious that an innovative model of development is needed. Additional impetus was provided to this theme by the recent discussions at the highest political level of issues related to Russian economic diversification, the increase in high-tech industries and the creation of high flying jobs in both the traditional and new sectors.

In this regard most of the focus of this article is on assessment of the experience in industrial policy implementation in Russia, and a determination of the key lessons including an analysis of two examples of industrial policy – the nano-industry and the automotive industry¹.

6.2.1. The industrial policy: terms and features, evolution of models and change in government attitude

Industrial policy has always attracted greater attention from decision-makers, the business elite and experts. There are many reasons to look at industrial policy, although they can be very different, ranging from an accentuated need to compensate for specific market failures and the initiation of certain structural changes to the relatively neutral coordination of different policies.

The many discussions conducted by the State on the implementation of industrial policy and the objective difficulties of assessing the actual effect of such policies on economic

¹ This paper is prepared on the basis of research conducted by the authors by the state order of the Russian Presidential Academy of National Economy and Public Administration in 2013.

development have resulted in uncertainty over the concept of industrial policy. In this regard we provide some basic definitions of industrial policy in our opinion:

(1) industrial policy in general is a set of State measures to support or avoid certain shifts in structure¹;

(2) industrial policy is an attempt by the State to promote the flow of resources to those sectors which are considered by the State as important for future economic growth²;

(3) industrial policy is aimed at specific sectors (and the companies being parts thereof) in order to achieve results which are considered by the State as effective for economy as a whole³.

With changing attitudes to industrial policy, its preferred forms and the definitions thereof have also been transformed. Currently the following definition is deemed to be operational for international institutions (OECD, UNIDO): *industrial policy is a State policy which is aimed at improving the business environment or the structure of economic activity in terms of sectors and technologies and, through intervention, it is expected to provide the best prospects for economic development and social benefit when compared to the absence of such intervention*⁴.

The following industrial policy attributes can be identified: activity and advancement; determination of priorities (or anti-priorities); reallocation of resources, rights, control between sectors, industries (formation of different rents); orientation towards long-term profit from the economy as a whole. A typical feature of an industrial economy is a system of objectives to change the economic structure, so that such priorities can be determined either from top (State) or from bottom (entrepreneur). It should be noted that industrial policy is not just support for the winners, but also about providing assistance to those lagging behind; it is not just a support for progressive structural changes in the economy but, on the contrary, about countering negative structural changes in the economy.

A key feature of industrial policy is that it combines different tools, including those which are generally typical of other functional policies (tax, customs, monetary, etc.) without any original tools of its own. This creates difficulties in distinguishing such terms as ‘industrial policy’, ‘structural policy’, ‘sectoral policy’ and ‘competitive growth policy’.

There are many different classifications of industrial policy: by nature of the priority – the sector, industry, market, or area of technology; by directivity – export expansion or import substitution; by the nature of the targeted objects – traditional and new business, large companies or small and medium-sized enterprises; by the sources of reallocated assets – budget, development institutes, business tools; by participants – Russian and foreign investors; by style of formation and implementation – state or national (partnership between governments, businesses, community), etc.

As to *industrial policy models* it should be noted that there are no firm views. Generally there are two models of industrial policy: *vertical* and *horizontal*.

¹ Price, C.V. (1981). *Industrial Policies in the European Community*. MacMillan for the Trade Policy Research Centre.

² Krugman, P., Obstfeld, M. (1991). *International Economics: Theory and Policy*. New York. HarperCollins Publishers.

³ Chang, H.J. (1994). *The Political Economy of Industrial Policy*. St Martins’s Press.

⁴ Pack, H., Saggi, K. (2006). Is there a case for industrial policy? A critical survey. *World Bank Research Observer*, 21 (2): 267–297; Warwick, K. (2013). *Beyond Industrial Policy: Emerging Issues and New Trends*. OECD Science, Technology and Industry Policy Papers, No. 2, OECD Publishing.

In general, the vertical policy provides support, rendered by the State to individual companies and (or) industries (picking winners), with selectivity of the measures being implemented. *The vertical model of industrial policy* is aimed at the development of certain sectors and the establishment of industrial priorities. It is characterised, most of all, by the problem of the identification of future winners, the active use of the mechanisms of direct support and the creation of special conditions through preferences and protectionism.

Horizontal policy is generally connected with structural changes in the industry (supporting research and development, deregulation, promotion of competition), but is indifferent to the measures implemented. *Horizontal industrial policy* relies mostly on multiple channels of influence, innovations, the formation of new sectors and companies, and is less oriented towards direct reallocation of rental income and more towards reduction in the barriers to growth.

With all the conventions of such comparisons, some experts are of the opinion that currently three models of industrial policy can be determined: vertical, horizontal and, finally, *industrial policy in an open economy*¹. The peculiar feature of this last model is that it creates the conditions for quasi-rents (to obtain which, companies have to apply their best efforts), a focus on maintaining communication between agents (matching winners) and extending the sphere of search networking. However this model does not solve the problem of how to achieve (accumulate) a critical level of changes.

Considering the *history of practical implementation* of industrial policies in different countries it should be noted that this type of policy has always been met with a mixed reception in different parts of the world, with periods of ‘enthusiasm’ replaced by periods of ‘disgrace’. From the perspective of the *evolution of perceptions of industrial policy in the world* and approaches to the implementation thereof² it seems appropriate to distinguish four stages (Table 8).

In the 50s – 60s many states saw their public policy priorities in industrialisation, the compensation of market failures, the protection of new emerging sectors and the potential for the public sector. In the 70s – 90s the existence of problems in the realisation of industrial policies became more obvious: governmental failures, distortion in the competitive sphere and the rent-oriented behaviour of agents could be witnessed. As a consequence, from the very beginning of the 80s there has been a domination by the ideology that includes such priorities as trade liberalisation, privatisation and direct foreign investments. Substantial attention has also been paid to the realisation of structural programmes.

Until the early 90s, active measures had been undertaken within the context of industrial policy. These related to the direct influence and support of “champions”. Amid globalisation, the development of TNCs and the reallocation of industrial factors in the 90s, there was a change in emphasis of industrial policy – it became more connected with the creation of the conditions necessary for capital reflow into separate sectors in order to improve the investment attractiveness of those sectors.

¹ Kuznetsov, Y., Sabel, C. (2011). *New Open Economy Industrial Policy: Making Choices without Picking Winners*. PREMnote, 161. The World Bank.

² Aiginger, K. (2007). *Industrial Policy: A Dying Breed or A Re-emerging Phoenix*. *Journal of Industry, Competition and Trade*, 7(3):297–323; Aghion, Ph., Boulanger, J., Cohen, E. (2011). *Rethinking Industrial Policy*. Bruegel Policy Brief, 04/2011; Naudé, W. (2010). *Industrial Policy: Old and New Issues*. UNU-WIDER Working Paper No. 106.

Table 8

Major stages in the evolution of perceptions of industrial policy in the world

Stage	Priorities of state policy	Distinctive features of industrial policy	Attitude towards industrial policy
The 50s – 60s	Industrialisation, import substitution, emerging public sector management	Tough, vertical policy, compensation of market failure, high level of selectivity	Fast increase in popularity of industrial policy in different states
The 70s – 90s	Trade liberalisation, privatisation, attraction of direct foreign investments, laissez-faire	Limited application, renunciation of tough instruments (protection of markets, support of national champions) in favour of mild ones (terms for capital reflow)	Governmental failures, distortion in business sphere, seizure, rent-oriented behaviour, globalisation, substantial doubts about the necessity to implement industrial policy
2000–2009	Reindustrialisation, development of stable innovation, perfection of national innovation systems	Mild, horizontal policy, compensation of system failures contribution to acceptance of knowledge, guarantee of dynamic benefits, guarantee of demonstration effects, self-disclosure	Market failures and government failures, ecology, Chinese and Indian factors, lagging factor, influence of evolutionary theory of growth, reconsideration of the government's role in the concept of industrial policy
2010 – Present	Protection of national sectors, guaranteed employment, search for new resources of sustainable growth	Technological industrial policy, cluster-based industrial policy, stimulation of interagent links, partnership support, accumulation of critical changes, design of competition- and innovation-friendly sectoral policy that can increase the quality of growth	Ideological crisis of the Washington Consensus, new post-crisis realism, strengthening and clarification of the government's role, search for new models of industrial policy, experimental construction of new industrial policy

The 2000s was a period of some reconsideration of the government's role, a balanced assessment of market and government failures and also a period of intensified attention towards stimulation of innovation and the development of national systems of innovation. During the first half of the 2000s, after a period of serious disappointment with the results of past industrial policy, it again gained governmental popularity including attention from the authorities within the EU. This was connected to several factors¹, in particular to the increased risk of deindustrialisation as a result of the displacement of production to the countries that could exploit retardation factors (low wages, the lack of strict environmental controls etc.), unfair competition and of weak economic growth in Europe. In this situation the typical market programmes (privatisation, deregulation) were already not leading to any significant results, especially when taking into consideration evolutionary growth theory, indicating that the significant factors of influence are education, interaction and the acceptance of knowledge; manifested through technological dynamism and the emergence of new technological industries.

Globalisation has weakened the potential of vertical industrial policy and its traditional instruments such as tariff-rates, subsidies and demands within local markets. At the same time there has been an increase in demand for a “new” industrial policy focused on the compensation of strategic “market failures” and moreover on supporting innovation and the development of education. During the acute phase of the world financial crisis (of 2008-2009) an actual expansion of the appliance of industrial policy instruments took place; at the same time as the implementation of protectionist and preferential methods were being reinforced.

¹ Aiginger, K. (2007). Industrial Policy: A Dying Breed or A Re-emerging Phoenix. *Journal of Industry, Competition and Trade*, 7(3):297–323.

On the whole, during the 2000s, there was an *active process of convergence of industrial policies and innovation policies*: the former became horizontal while the latter, by contrast, became vertical and specialised, with the latter also becoming the most important component of industrial policy. During the post-crisis period, with unstable world economic development and contradictory lessons from past crises, *industrial policy was hailed more as a systemic component for coordinating governmental policies*.

At all stages in the evolution of the perception of industrial policy a lot of attention has been paid to a comparison of the benefits and risks connected to the realisation of industrial policy¹. However all the arguments on one side, as a rule, have always managed to come across as no less weighty than those of the other and vice versa. It goes without saying that today there are already a great many examples of industrial policies which have been implemented in different countries at different times. Examples of the most successful industrial policies usually include countries such as Brazil, Finland, Japan and South Korea while the least successful attempts to implement the policy include the countries of tropical Africa and, to a certain degree, the countries of Latin America. However most conclusions and evaluations by policy experts of examples of the realisation of industrial policies differ significantly, and so it can be really difficult to understand the impact of industrial policy. As a consequence, a general analysis of industrial policy examples does not lead to unambiguous conclusions about its “value” or “harm” for economic development.

In general, *industrial policy is a very complicated instrument with attractive prospects but high levels of risk*. For the realisation of effective industrial policy, the ability of the state to implement “smart politics” is important. Furthermore a concerned reaction to independent assessments is important and a readiness publicly to admit mistakes and to draw necessary conclusions for future needs is considered even more so.

6.2.2. Russian industrial policy in the 2000s: conditions and specifications, factors of change, interest groups

A. Stages of formation and implementation of Russian industrial policy

In Russia, industrial policy has often been associated with vigorous and excessive state intervention in the economy, protecting the interests of particular large national companies, which is why it has been considered to be a particularly dangerous retreat from market reforms. Especially tough criticism of the industrial policy in Russia at the end of the 90s and the beginning of the 2000s was connected to an initial distrust of its effective implementation, taking into account the poor quality of the state system and the existence of many possible risks that there might have been hidden lobbying for the interests of different groups, a distortion of the results achieved and of “seized government”.

¹ B. Kuznetsov (2001). Is an industrial policy necessary for Russia? Report for the seminar Development Strategy of the Institute for Complex Strategic Research and Higher Business School of the MSU, Moscow; Rodrik, D. (2004). Industrial Policy for the Twenty-First Century. CEPR Discussion Paper No. 4767; Pack, H., Saggi, K. (2006). Is there a case for industrial policy? A critical survey. World Bank Research Observer, 21 (2): 267–297; Warwick, K. (2013). Beyond Industrial Policy: Emerging Issues and New Trends. OECD Science, Technology and Industry Policy Papers, No. 2, OECD Publishing; Aiginger, K. (2007). Industrial Policy: A Dying Breed or a Re-emerging Phoenix. Journal of Industry, Competition and Trade, 7(3):297–323.

The peculiarities of Russian industrial policy and its transformation over time were, first of all, determined by such basic factors as changing budget constraints, the dominant model of relations between government and business and the major challenges for future development (exhaustion of conditions essential for the previous model of growth). Based on these facts we can specify five major stages in the development of Russian industrial policy in the 2000s. (Table 9):

1. Policy of structural reconstruction – recovery growth – mild regulatory policy–prioritisation of institutional reforms (in 2000–2003);
2. Vertical sectoral policy – strengthening of the government’s role in the economy (in 2004–2007);
3. Industrial compensation policy – crisis – direct support and preferences (in 2008–2009);
4. Technological industrial policy – post-crisis development – prioritisation of improvement of the business climate (in 2010–2011);
5. Vertical and technological industrial policies – toughening of budget limits, social commitments – prioritisation of job-creation (since 2012).

Table 9

**Major stages of industrial policy in Russia
in the 2000s**

Период	Priorities	Peculiarities	Resources	Relationship model
2000–2003	Development of market institutions and structural reforms	Mild regulatory policy (types of taxes, natural monopolies` tariffs, exchange rates)	Regenerative growth, budgetary constraints	High level of personification, practice of meetings with big-business, business activity
2004–2008	Diversification, stimulation of innovation	Vertical industrial policy, long-term planning, creation of development institutions	Substantial budgetary resources	Bybuilding «vertical», government control, institutionalisation of access, increased numbers of organisations creating industrial policy (development institutions)
2008–2009	Guarantee of social stability	Vertical compensation policy, support for large organisations, preference for manual control	Harsh toughening of budgetary constraints	Assistance, in exchange for commitments between the government and large companies
2010–2011	Search for new sources of growth, innovation, modernisation, structural privatisation)	Technological industrial policy	A period of fiscal moderation, high uncertainty	Extension and competition for access, emerging of new players, intensification of competitive bidding
2012–...	Reindustrialisation, improvement of investment climate, assistance in development of new high-tech sectors	Industrial policy to create additional jobs	Toughening of budgetary constraints, limited growth	Development of new means of communications (ASI, Open Government)

Stage №1. Policy of structural reconstruction (In 2000–2003)

The early 2000s can definitely be called one of the most significant “windows of opportunity” both in Russian politics and in its industrial policy. The period opened with the development (until May, 2000) of one of the most informative conceptual documents of socio-economic development – the «Strategy of Development of the Russian Federation until 2010. (another, informal, title is the Gref Program). Even though the document was not officially accepted, many of its terms were nevertheless implemented. The main emphasis of this Program was the development of market institutions (equal conditions for competition,

deregulation, a reform of natural monopolies, a reform of the tax system, a reform of the system of power, a reform of administration etc.).

In the context of heated discussion about the choice between a strategy of liberalisation or the scenario of mobilisation of economic development in Russia, all suggestions of an industrial policy, even mild ones, were rejected during this period. This was determined by a string of additional circumstances:

- on the one hand, by the scarcity of recourses necessary for the launch of direct instruments of governmental support; on the other hand by the underdevelopment of market institutions, which explained the weak potential for the use of indirect regulatory instruments of industrial policy;
- by retention of the rather strong positions of big-business, including its political side (this was the reason why industrial policy was regarded by many experts as a serious risk of “a takeover” and as a risk of the strengthening of lobbying processes implemented by the business sphere on their own behalf).

In the context of industrial policy, the Gref Program, can include two major theses: (1) the main purpose of structural government policy is an increase in the proportion of industry sectors producing goods with a high degree of recycling and of the service sector; (2) based on the structure of the Russian economy, we can say that stimulation of exporting sectors to investment in modernisation and developing their potential is no less important than investment into the potential of other production sectors. Nevertheless, during the period of institutional reforms, the prioritised industrial policy on domestic aircraft engineering of the 90s continued unabated, which could be explained more by political factors and by the necessity for maintaining the export of armaments and military equipment.

In spite of the rejection of industrial policy, this period of time included at least one attempt at the reconstruction and implementation a new industrial policy that resulted from the fortuitously timed appearance of the development of the ICT sector in India. In February, 2001 the need was identified for the development of the Federal Target Programme “Electronic Russias (2002–2010)” and as early as the beginning of 2002, it had already been adopted.¹ The Programme was within the Center for Strategic Developments and involved unbiased experts and business representatives (to a certain degree the discussion format copied and extended the one that had been accepted during the development of the Gref Program).

At first the aim of the Programme was declared as the creation of conditions essential for developing and enhancing the efficiency of the economy, public administration and local self-governance, to be made possible through the adoption and mass distribution of information and communication technology; to ensure the rights for free search, receipt, transmission, production and dissemination of information and for expanded specialist training. It was *a rare example, for Russia, of horizontal industrial policy* oriented towards the development of the ICT sector through limitation of the effects of irrational administrative barriers and through the creation of conditions for additional demand. Nevertheless, since 2004 the Programme has changed direction - towards supporting the government in improving public sector efficiency.

A comparison of the initial version of the Federal Target Programme and its updated version of 2006 shows that some principal parts of the Programme have been excluded, in particular the part on the development of the information industry and the ICT sector. Such

¹ Approved by the Resolution of the Government of the Russian Federation No. 65 as of 28 January 2002.

strong metamorphoses of the Federal Target Programme “Electronic Russia” are partly connected to the fact that the urgent character of realisation of a “cash-strapped” industrial policy in 2004-2005 decreased significantly while the reduction of administrative barriers turned out to be a very “sticky” task that demanded a great deal of effort but was of little benefit for administrative purposes. The Ministry of Economic Development switched its attention to other more ambitious goals. A further reason was that, during the first stage of the Federal Target Programme, no strong consolidated interest group was created amongst participants in the ICT market (due to the typology of such markets – which generally consist of small companies), so the further modification of the Programme into an ordinary departmental programme of the Ministry of Communications and Mass Media was considered to be a natural and evolutionary process.

An integral feature of industrial policy (the decisions on which can be associated with industrial policy) at the beginning of the 2000s was the focus on extremely large companies and towards the position of the large owners. In connection with an intensive process of industrial integration and the formation of industrial holdings, the interests of major owners, who supported the ideas of industrial policy, were broadened. This was the reason why more attention was directed towards the creation of the necessary conditions for internal capital reflow. In October of 2001 the Russian Unity of Industrialists and Entrepreneurs initiated a discussion on scientific-industrial and investment policies. In December of the same year a Working Group “The Russian Unity of Industrialists and Entrepreneurs” was created; it was responsible for industrial and investment policies (later it was reorganised into the Committee of The Russian Unity of Industrialists and Entrepreneurs). In April of 2002 there was discussion of the project “The Concept of Russian Industrial Policy”; among the most important statements, the following points can be underlined: a transition from sectoral policy to a policy of support for competitive companies; prioritisation of the knowledge economy; transition from a governmental to a national industrial policy. Later, at the end of 2002, the Russian Unity of Industrialists and Entrepreneurs made a decision to renounce the concept of industrial policy (it was declared that such an approach was out of date) and to pursue the policy of developing a national, competitive economy. However, the idea of the necessity for “national champions” still remained quite popular.

Stage №2. Vertical sectoral policy (2004–2007)

The second stage was generally characterised by a significant strengthening of the role of the state in the economy and the move towards a vertical industrial policy. That transition was based upon the following factors and preconditions:

- creation of a vertical power structure, reduction in the power of influence of big business on government, target project-planning for structural changes in the economy;
- alleviation of budget restrictions, extension of the resource potential of the state;
- stabilisation of the business environment, the fulfilment of obligations, and, as a consequence, the opening-up of long-term project implementation opportunities.

From 2005 onwards, the state began to play a significantly more active role in implementing long-term planning instruments together with working out different development strategies, initially, sectoral strategies, and the formation of a complex of industry-specific FTPs (federal target programmes) for science and technology. In that period, special attention was paid to determining target development figures and to indicators of the efficiency and effectiveness of budgetary expenditure, as well as to extending private co-

financing. There was a significant shift towards implementing a *sectoral industrial policy*, including policy in respect of the sectors dominated by private companies: in 2007–2008 (before the crisis), seven sectoral development strategies were established: for the development of the metal industry, forestry, the chemical and petrochemical industry, shipbuilding, the vehicle construction industry, nuclear power engineering and the electronics industry.

In the absence of other instruments and tools, *the federal target programme*, which already existed and was subject to the applicable regulations and standards, became the main instrument. However, the agencies still mainly considered it as a means of “extracting” additional resources from the budget in order to deal with their current, rather than their strategic, issues. The obscure wording of the targets and, inconsistencies in both the expenditure and the expected results led to the low efficiency of this tool.

From 2006 onwards, there was a revitalisation of the work towards *creating vertically integrated institutions in the state sector*, in particular, in the MIC (military industrial complex), aircraft building and shipbuilding, the large institutions: the United Aircraft Corporation and the United Shipbuilding Corporation were founded, in 2006 and 2007, respectively. All this was related not only to solving the problems of how to decrease the administrative burden of managing many separate enterprises, but also a desire of the state and the sector ministries to extend the influence of their direct instruments over the development of particular industrial sectors.

In 2005–2007, there was a significant increase in the imbalance between the updated priorities of social and economic development (economic diversification and the transition to innovative development) and the state’s instruments for their completion. The brake on initiatives to improve the economic policy instrument, and the low efficiency of the then existing management tool, led to a shift away from improvement of the indirect instruments of reflation and the development of the institutional environment, to an expansion and strengthening of the mechanisms of direct state influence. Additionally, the unsatisfactory quality of the administrative system, the focus of the system on dealing with current issues, and problems with forming and implementing a system of measures to develop new sectors of the economy, introduced a need for the formation of additional measures for implementing state policy. Consequently, several decisions were made which were significantly outside the framework of the standard controls and which extended both the opportunities and the risks for the implementation of industrial policy. Among those decisions, were the *creation of the Investment Fund (2006)*, *the formation and capitalisation of development institutions (2007)*, and *the creation of state corporations (2007)*.

In 2007, there was a change of direction *towards an intensive formation of financial development institutions and an extension of their resource base* in the context of the policy decision¹ to use a part of the National Welfare Fund (approximately Rb 300bn) for the capitalisation of several development institutions (the Development Bank, the Investment Fund, the RVC (Russian Venture Company) and others). It stands to reason that there were multiple causes for the decision to capitalise the development institutions, but one of the probable causes was a desire to strike a certain compromise against the background of, on the one hand, growing pressure from the supporters of a significant increase in state investments in the economy, and, on the other hand, opposition to the increase in the level of public

¹The message of the President of the Russian Federation to the Federal Assembly of the Russian Federation as of 26 April 2007.

expenditure, from the supporters of macroeconomic stability¹. In this regard, the state's investment of a part of the accumulated funds into development institutions "tied" those funds into their further use for investment, without, however, meaning that it should lead to a sharp increase in public expenditure.

The most remarkable element of the industrial policy of 2007 was the *creation of large state corporations*. Two of these state corporations, Vneshekonombank and Rosnano were established as financial development institutions to compensate for "market failures"; two other state corporations, Rosatom and Rostekhnologii (Rostec) were established to restructure state property, consolidate state assets and to increase the competitive advantage of certain industrial sectors (the nuclear industry, MIC, the car industry and air transportation). The creation of these state corporations was significantly outside of the general principles of state control.

Vneshekonombank (Bank for Development) and Rosnano became two of the most important instruments for the implementation of industrial policy. However, if Rosnano was still close to horizontal policy – shaping the nanotechnology industry, technological priorities and the capitalisation of new high-tech companies, then *Vneshekonombank* was significantly closer to vertical policies. This follows, both from its focus on support for large projects (the cost of the projects it supported was not less than Rb 2bn), and from the system of the "key" sectoral priorities initially established for its activities (in particular, the space and aircraft industries, shipbuilding, the machine, wood, nuclear and electronics industries and the MIC). Thereafter, Vneshekonombank's priority list only expanded².

Without delving into the pros and cons of state corporations as tools of state industrial policy, please note that, materially, the introduction of this approach was an acknowledgement of the state's incapability or unwillingness to look for the best practice in public-private partnerships, and a concentration of structural policy within the public sector of the economy (with the growth of this sector). The latter caused a decrease in the state's interest in solving the problems of the investment climate.

Amid the majority of the other industrial policies, between 2004 and 2007 *there is quite an interesting example of an industry sector specific policy connected with the development of the automotive industry* – which we shall examine in more detail in the next section. Firstly, it was a relatively successful example; secondly, it was not related to the implementation of any budgetary programmes; and, thirdly, there was a special focus on attracting foreign investors and the creation of new companies.

Of course, *this period was not focused only on vertical industrial policy, because several important system measures were also taken, which were closer to horizontal industrial policy, although they were not the main ones at that stage. In 2004, the Kyoto protocol was ratified*, which contributed to the development of less resource-intensive and environmentally-cleaner manufacturing. In 2005, the UST (uniform social tax) rate was reduced, which was

¹ D. S. Ivanov, Yu. V. Simachev, M. G. Kuzyk (2012). Russian financial development institutes keep time? Economical Matters, No. 7. P. 4–29. Russian Financial System Institutes Development: Achievements and Problems http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2264360

² Thus, in November 2008 in the conditions of economic crisis burning out rapidly, to these priorities was added one more – the agricultural sector (Order of the Government of the Russian Federation No. 1697, as of 19 November 2008), and within a year additional technological priorities were determined for Vneshekonombank – strategic computer-aided technologies and software, information and communication systems, medical equipment and pharmaceuticals (Order of the Government of the Russian Federation No. 1783-p, as of 26 November 2009).

particularly important for the development of “the new economy” of relatively small, science-based companies. Finally, in 2006, the Strategy for the Development of Science and Innovation in the Russian Federation for the period until 2015 was approved¹, which evidences an increase in the significance of innovation for enhancing competitiveness.

The search for additional tools to implement horizontal innovative industrial policy began as early as at the end of the first stage and continued during the second stage. The most famous large scale experiment was the launch by the Minpromnauki (Russian Ministry of Industry, Science and Technology) in 2003 of *innovation projects on a national scale*. These got the unofficial title of “megaprojects”. The experiment involved the competitive selection of large modernisation and development projects for the manufacture of new innovative products by private companies, with support from the state. In exchange for the commitment to a significant (manifold) increase in the manufacture of new products, the state provided funds for meeting the costs of research and development and for putting the new products and technologies into production. By November 2006, 13 megaprojects worth a total of Rb 8.58bn were under way, however there was little further development of the megaproject experiment.

Another experiment in the sphere of industrial policy instruments was the introduction of the “special zones” mechanism (an attempt to repeat the successful experience of China). In July 2005, the Federal Law “On Special Economic Zones in the Russian Federation” was adopted, in accordance with which two types of SEZs (special economic zones) were determined – industrial production zones and technology development zones. However, due to contradictions between the governance processes and restrictions on the regulatory plan, these zones were not highly attractive for investors.

Stage №3. Antirecession compensatory industrial policy

This stage in the development of industrial policy in Russia is connected with the very severe economic crisis of late 2008 – 2009. On one hand, the crisis made the state turn from strategic to tactical objectives, including a transition to “manual control”, on the other hand, it made the state once again review its development priorities and the opportunities to finance a large-scale economic restructuring.

In that period, its industrial policy became especially selective², although some measures were implemented quite successfully, aimed at decreasing the administrative pressure on business. However, the majority of the measures then taken were connected with compensating for the recession in the most vulnerable sectors and with support for big strategic companies³. Among the main sectoral priorities of the industrial policy in that period were car and farm machinery building, the military-industrial complex, agriculture, the transportation industry and housing construction.

During the crisis, the activities of the development institutions were limited in terms of resources (for example, with regard to Rosnano) or re-focused on solving anti-recessionary problems (Vneshekonombank). There were several anti-recessionary measures, which were, although, a forced, but significant derogation from market economy principles, in particular,

¹Approved by the Inter-Departmental Commission for Science and Innovation Policy (Minutes No. 1 as of 15 February 2006).

²M. Yu. Gorst, A. V. Daniltsev, B. V. Kuznetsov, M. G. Kuzyk, Yu. V. Simachev, A. A. Yakovlev (2009). Assessment of crisis response measures to support the real economy. *Economic Matters*, No. 5. P. 21–46.

³Yu. Simachev, D. Ivanov, B. Kuznetsov, M. Korotkov, M. Kuzyk. (2012). State anti-crisis support for large and systemic companies: directions, features and the Russian experience. Science editor A. D. Rodygin. M.: Delo.

several measures connected with the substitution of private demand with public demand, with support for the continuation of the activities of operationally unprofitable enterprises, with protectionism towards certain sectors, with attempts at administrative price control and with the redistribution of losses and but lacking transparency in the reciprocal obligations of the state and the owners¹.

Note that the process of adoption of long-term sector strategies for development had been so well established in the practice of the state administration that it was retained during the period of the severe crisis, in particular, some additional sector strategies were adopted (on the development of the fisheries industry and of the pharmaceutical industry) in 2009.

The lessons from the crisis have been learned at the highest political level, and they have led to diverse consequences. On the one hand, as far back as in the first half of 2009, efforts were made to determine a package of measures aimed at stimulation of innovative development, to determine the directions of further reductions in state involvement in the economy. In June 2009, the first session of the Committee on Modernisation and Technological Development of the Economy of Russia took place, and this determined the strategic technology priorities: the energy economy and energy efficiency, nuclear technology, information technology, space technology and telecommunications, medicine and the pharmaceuticals industry, and nanotechnologies. On the other hand, the importance of the measures for “manual control” of the economy was remarkable.

Stage №4. Post-crisis policy learning and technological industrial policy (2010–2011)

The diversity and divergence of the lessons which the authorities had learned from the crisis *determined the specific nature and instability of the industrial policy ideology in the post-crisis stage (2010–2011).*

In the Guidelines for Action of the Government of the Russian Federation for the period until 2012, approved in November 2008², the next priorities were determined – this time they were in the high-tech and backbone industries. In spite of the fact that these priorities had been determined before the crisis, there was no reappraisal of their contents in the post-crisis era. The adoption of the next sectoral strategies of development still continued (mostly in a variety of engineering subsectors).

At the same time, *the state became more active in its search for and implementation of new instruments of horizontal policy*³, which included, as we see it, technological platforms, associated grants for stimulating partnerships between companies and universities, the development of innovative trends in the system of procurement for public use, the development and adoption of programmes of innovation-driven growth in big state companies, support for the formation of regional innovation clusters, etc. However, the critical barriers to increasing the effectiveness of many of those new instruments were the problem of their “seizure” by the traditional interest groups, the problem of the appearance of obstacles to the extension of best practice and the problem of restrictions on the accumulation of the “critical mass” needed for stable self-sustaining changes.

¹Yu. Simachev, M. Kuzyk. (2012). State anti-crisis support for Russian companies: assistance and limitations. Journal of New Economic Association No. 1. P. 100–125.

²Approved by the Order of the Government of the Russian Federation No. 1663-p as of 17 November 2008.

³Yu. Simachev, M. Kuzyk. (2013). Russian policy for innovations stimulation: evolution, achievements, problems and experience. Source: Russian economy in 2012. Tendencies and perspectives. Edition 34. M.: Gaidar Institute Press. P. 521–571.

In general, beginning from late 2009, *not only a declarative but also a practical strengthening of the technological and innovative direction of industrial policy* became more prominent and this was connected with a significant change in the global competitive environment, a global reappraisal of the role of the state in the economy, especially with regard to innovation, a critical appraisal of the results of the classical sectoral industrial policy and the fact that the “field” for such a policy in the modern context had become much smaller.

The shift from the vertical sectoral industrial policy to a technological industrial policy was, to a certain extent, associated with the search for new factors for the growth and extension of influence of various interest groups from the spheres of science, technology and education. In late 2011, after some lengthy refinement of the approvals procedures, the Strategy for Innovation and Development of the Russian Federation for the Period Until 2020 was at last adopted¹.

Stage №5. “Search” industrial policy

It is our belief that, beginning in 2012, a new stage in the development of the industrial policy of Russia opened. It happened because of a further understanding by that time of the upcoming tightening of the budgetary resources policy, together with the accumulation of major social commitments, and with the changing conditions for the implementation of Russia’s industrial policy after its accession to the WTO (World Trade Organisation).

The task of *searching for new sources of growth, including those based on different types of industrial policy* became especially significant in that period. Theses were developed about the need for a *reindustrialisation* of the Russian economy (which were to a large extent inspired by the example of Europe), the creation of new high-tech jobs and a massive improvement in the business climate. In January 2012, saw the first declaration at the highest political level of the necessity for an industrial policy² – amongst other priorities (it was stated that the priority list was open for additions and detailing) the named list included pharmaceuticals, high-tech chemistry, composite and non-metallic materials, the aircraft industry, information and communication technologies, nanotechnologies, nuclear industry and space.

In May 2012, amongst others, two principal long-range objectives were determined³: by 2018 to increase of the proportion of products from high-tech and knowledge-intensive industries in the gross domestic product by a factor of 1.3 in comparison with the level of 2011; the creation or modernisation of 25m high-level jobs by 2020. We have the impression that after that there was an effort by government to distribute the “share of responsibility” for fulfillment of the objectives and for ensuring regular monitoring of the current indicators between all the ministries and agencies on a voluntary basis. Discussion of state programmes, strategies and budgetary programmes was more oriented towards an appraisal of their contribution towards achieving the “basic” target.

In 2012–2013, a further component of the strategies for development was adopted – concerning the medical industry, the integrated power grid of Russia and the baby products industry. The transformation of the contents of industrial policy priorities continued, whilst, in the state programme, the “Development of Industry and Increase in Its Competitive

¹Order of the Government of the Russian Federation No. 2227-p as of 8 December 2011.

² V. Putin. We need new economy // Vedomosti, 30 January 2012.

³ Decree of the President of the Russian Federation No. 596 On Long Term State Economic Policy as of 7 May 2012

Advantage”¹, the number of priorities reached 14, and they were classified from a sectoral point of view in accordance with three market types – new markets; traditional industries, the products of which were oriented to user demand; and traditional industries where the products were geared towards investment demand. Furthermore, state programmes were also approved concerning the development of the aircraft industry, shipbuilding, the electronics and radio industry, pharmaceuticals and the medical industry, the atomic energy industrial complex and other sectors². In sum, *the notion of “priority” lost its initial value as an instrument for the concentration of efforts in specific directions.*

In that period, it probably became evident that there was a degree of crisis as a result of the implementation of the many approved sectoral development strategies. It was apparent that the state programmes had also not yielded the expected results, simply becoming an additional bureaucratic superstructure for the different FTPs and other mechanisms of federal budget expenditure.

In July 2013, action plans were adopted for development of the five sectors (industries) *in a new format – the format of road maps* (biotechnology and genetic engineering; information technology; engineering and industrial design; production of composite materials; optoelectronic technology and photonics). As a result one can see an emphasis on practical measures until 2018 with many target indicators for them. Please note that the adoption of road maps indicates the first *significant shift of attention of the state towards the development, initially, of, new and promising high-tech industries, as well as service industries.*

B. Demand for industrial policy and main interest groups

The following were explicitly (or, more often, implicitly) declared as the tasks for industrial policy:

(1) economic tasks

- ensuring long-term stable economic growth based on diversification of the economy;
- increasing the volume of exports of goods with high added value;
- the creation of new sectors of economy based on multidisciplinary technologies;

(2) social tasks

- creating additional jobs with the help of structural economic reforms;
- ensuring full-employment at the largest enterprises;
- solving employment problems in the regions, including the monotowns.

In spite of all the concerns related to the “introduction” of industrial policy, there were always new issues demanding a certain choices to be made by the state – for some priorities reducing or raising the tax burden, changes in customs duties; determining the conditions for accession to foreign economic regimes (the WTO and the Customs Union), transitional periods and compensation to domestic producers; emphases on saving some sectors during the period of the crisis; investment priorities with adequate resources, and expanding the role of the state as an investor (directly or through development institutions).

It may be noted that during the 2000s, with the many variations and manifestations of industrial policy, the strongest and the most acceptable argument for an industrial policy was

¹Order of the Government of the Russian Federation No. 1535-p, as of 29 August 2013

² List of State programmes of the Russian Federation (Order of the Government of the Russian Federation No. 1950-p, as of 11 November 2010)

the creation (and sometimes – saving) of jobs in the economy, in other words, *social tasks were and remain a definite priority*.

Meeting the challenges of industrial policy involves the redistribution of rents within the economy, which could then be used for:

- expanded dialogue with various interest groups, the expansion of support groups and the formation of new sources of development;
- the formation and consolidation of new, interest groups for modernisation;
- working with population’s request for justice – for the redirection of some of the rents (natural resource rent or monopoly rent) in order to solve social problems; and
- demonstrating the fulfillment of strategic tasks and of some political tasks, worthy of the power being wielded.

The aiming of industrial policy at bringing about a change in the distribution of rental income in the economy, added to the opportunities for appealing to long-term and potentially advantageous political tasks. Accordingly this defended the necessity for providing certain sectors with support and preferential treatment, and resulted in the high level of *attractiveness of this policy for different interest groups*.

For the period from 2000 to 2003, the discussion of industrial policy was apparently, more concerned with ensuring a change in the structure of the Russian economy, but *the driving force behind those discussions was, primarily, big business, the strongest consolidated industries*: metallurgy, the energy sector, mining industries and railway transport. In fact, it was a vertical industrial policy which was discussed, but that aspect appeared during discussion of the changes in functional policies – tax policy and customs policy. In the same period, businesses were mostly arguing with one another. One of the lines of those especially acute contradictions between big companies during that time was the service tariffs of subjects of natural monopolies, the necessity and conditions for accession to the WTO and the exchange rate policy of the Central Bank.

If in early 2000s, business was still relatively dominant in its interaction with the state, after that, state interest groups and their rivalry determined the development and “design” of industrial policy (Table 10). We see *four main interest groups* – “budgetary”, “structural”, “industry sector specific” and “science-and technology”. The peculiarity and advantage of such a classification is in the fact that such groups are always present, and they all have a positive agenda of social and economic development. Their positions and influence vary greatly, depending on changes to budgetary restrictions, with the level of social support for the population and with the lessons learned by the authorities during times of crisis, big and small.

Table 10

Conventional State interest groups projected onto industrial policy

(1) “Budgetary”	(2) “Structural”	(3) “Industry sector specific”	(4) “Science-and-technology”
Main positions of interest groups			
1	2	3	4
Ensuring macroeconomic stability	Diversification, development of new sectors	Ensuring social stability and control of the current situation and market prices	Ensuring transition towards an innovation-driven growth model
Neutrality of control, improvement of the investment climate	Extension of exports and incentives for high-techn production	Retention (strengthening) of direct influence on the development of certain industries and sectors which are “sensitive” for the population, and development of the economy in general	The “proposition of innovation” through logic, extension of cutting-edge aspects

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1	2	3	4
Restricted opportunities for the use of additional income for increasing current budget expenditure	Increase of expenditure for economic development, new programmes	Large investment programme implementation, ensuring significant progress in innovation	Increase in expenditure for science and education, forcing the state sector to cooperate
Restriction of new initiatives	Extension of PPP (private-public partnership), different agreements between business and state	Reform of large companies, integration, forming of "national champions"	Foundation of national laboratories, research universities, development of scientific and production partnerships
Attitude towards industrial policy			
In general – cautious, but hostile in the case of additional budgetary commitments	Positive towards horizontal policy, Cautious towards vertical policy	Neutral towards horizontal policy, Positive towards vertical policy	In general, positive, and in the case of technology industrial policy – especially positive
Strengthening of the position of interest groups			
In the case of tightening of budgetary restraints	In the case of a reduction in traditional sources of economic growth	In the case of social tension	Decrease in the competitive advantage of traditional products

In the period from 2004 to 2008, we can mark the following general shifts in the composition and positions of Russian interest groups:

- strengthening of state interest groups (due to the "vertical" and general strengthening of the state); reduction in the identity of the interest groups on the basis of their "origin", association with "security forces" and "technocrats" or by "thematic" trends;
- strengthening of the competition for distribution of resources between the power elites; increase in the role of rivalry between the controlling bodies of the interest groups (mutual grounds for claims – lobbying for the interests of certain business groups; and inappropriate use of funds);
- formation and strengthening of interest groups oriented towards research, education and technology; rapid development of interest groups representing the development institutions (general opposition to outside pressure, "self-regulation", "innovative elevator");
- strengthening of the positions of business associations, extension of their interaction with the state bodies for project development and the evaluation of the structural changes.

With the issues of implementation of industrial policy in Russia, there has always been "competition" between the vertical and horizontal policies (*Table 11*).

Table 11

Features of traditional (vertical) and new (horizontal) industrial policy

Traditional (vertical) policy	New (horizontal) policy
Industry sector specific priorities	Technological priorities
Existing sectors and industries	New industries and creative economy sector
Production	Services and production
Import substitution	Exports and new demand
Big and very big business	Newly developed small and medium-sized business
State sector and state development institutions	Private sector and foreign investors
Integrated structures and holdings	Science and technology networks, clusters and subcontracting chains
Existing interest groups	Search for new participants
Rent redistribution	Future changes to rent redistribution
Investments and public initiatives	Innovations and private initiatives
Sectoral development strategies, target budgetary programmes and "assembly" at sector level	Multiplicity of instruments, quasi-fiscal nature and "assembly" at company level
"Discretionary" decisions	Decision rules

The traditional (vertical) industrial policy generally attracts representatives of the state, especially where an industry sector specific interest group is involved. This shift in attention may be explained, amongst other things, by the following:

- the critical nature of issues of employment at large enterprises from the perspective of social stability;
- the ease of direct interaction and influence on the state sector from the perspective of the control of socially-sensitive prices;
- under conditions of scant mutual confidence between the state and business, the existence of reciprocal obligations, of the personalisation of big business and of enforcement opportunities provide advantages when focusing on big business;
- the consequences of decision making in the context of a vertical policy can be better modelled and assessed, and the effects appear with a smaller delay; and
- where the learning mechanisms are weakly-developed the propensity for discretionary decision-making is inevitable in the course of implementation and adjustment of the mechanisms of industrial policy.

In 2009–2011, there was some *extension of the access to and institutionalisation of new interaction channels, as new instruments appeared aimed at extension of the representation of new interest groups*. However, the process of progress towards a technological industrial policy was accompanied by the continued existence of principles of verticality in its formation, among which were the following:

(1) a focus on the interests of the major players, as a result of the expansion of their membership through the academic, scientific and technology sectors;

(2) weak competitiveness of the state institutions, in some cases features of monopolization of viewpoints on possible approaches and evaluation are observed;

(3) limited attention towards the demonstration effect and the transfer of best practices, an emphasis on the use of public (quasi-public) resources;

(4) a relative openness to proposals, but a closed approach to decision-making procedures and the appraisal of results; and

(5) personification, non-transparency of “exchanges” during redistribution, and the use of informal arrangements.

In the context of an underdeveloped system of “horizontal” assessment and the comparison of proposals from different interest groups, with a distribution of responsibility between different players this increased *the risks of inconsistency and opportunism in the formation and implementation of industrial policy*.

C. General assessment of characteristics and problems in the development and implementation of Russian industrial policy

Based on an analysis of the processes of formation and implementation of Russian industrial policy in the 2000s, we can draw the following general conclusions.

1. Russian industrial policy of the 2000s predominantly consisted of efforts to prevent negative structural changes and to compensate for the losses of domestic producers. This policy was largely related to attempts to use the technological advances obtained as far back as in Soviet times. Only in recent years are there signs of a proactive agenda when industrial policy began to turn to the promotion of progressive changes in the structure of the economy and to the development of new sectors, knowledge and skills. The innovation policy has also

changed, more and more prominence being given to the formation of new competencies and areas of expertise.

2. The system of priorities in Russian industrial policy has been continuously transformed. In most cases this has involved an extension of those priorities; in which regard the priorities have stopped fulfilling their meaningful function of encouraging concerted action of the state and business. The selection and shift of priorities occurred mainly outside of the broad dialogue between “society – state – business” and were more ad hoc.

Russian industrial policy is mainly connected with the domestic market, which raises the risks of protectionist barriers, the substitution of private demand with public demand aimed at supporting selected priorities of government and an ongoing multiplication of the problems and expenses connected with inappropriate startup solutions.

3. In 2004–2008, the process of renewal of interest groups was rather weak. That can be attributed, amongst other things, to the process of formation of “vertical of power” structures and the strong influence of traditional interest groups on the feedback channels. The access channels were poorly institutionalised, and access itself was strongly personalised.

The predominantly latent character of the industrial policy implemented by the state often led to discrepancies between the declared tasks and the real ones, and this extended the opportunities for rent-focused behavior and indirect lobbying for the interests of particular businesses and owners. The significant advantages for lobbying by the traditional interest groups reproduced the vertical model of industrial policy, combined with its low predictability and episodic nature.

4. Instrumental Russian industrial policy gravitated toward the allocation of funds, while the regulatory instruments were considered ineffective. The traditional direction of support within Russian industrial policy is the promotion of domestic demand, including the active use of FTPs and public procurement, the fixing of different quotas and preferences for certain groups of producers. The ideology of Russian industrial policy was materially attributable to the building of state capitalism, which was why there was also a niche for the instruments of consolidation of state ownership in that ideology.

5. The existence of rent from large natural resources allowed “defraying” of the costs of the contradictory industrial policy, where decisions were first made in favour of one interest group and then in favour of another. In comparison with horizontal policy, a vertical policy is less able to use a demonstration effect and its implementation requires a significantly larger volume of public expenditure. In view of the scantiness of budgetary resources and of the opportunities for their redistribution (a general reduction of budgetary mobility), there was increased demand for an effective industrial policy, a policy of using demonstration effects.

6. In recent years, the process expanding access began, but predominantly with regard to alternative proposals and, to a substantially lesser extent, with regard to decision making. Although the access for new interest groups is being extended, civilised competition between interest groups and between state institutions, remains limited.

In 2009–2011, there were signs of a transition from sectoral industrial policy to a technological industrial policy; however, Russian policy still retains signs of verticality. This predetermines ongoing fundamental risks in the implementation of the policy, including the risk of its “seizure” by factional interest groups. The process opens up access ahead of the transformation of the industrial policy from a vertical to a horizontal one. Where there is an underdeveloped system of “horizontal” comparison of the proposals from different interest groups and the distribution of responsibility between the different players, this raises the risk

of inconsistency and opportunism in the formation and implementation of such an industrial policy.

7. The insufficient quality of state institutions limits significantly the opportunities for an effective industrial policy to be pursued in Russia, both vertical and horizontal. The difficulties for Russian state institutions in implementing industrial policy are attributable, in particular, to the limited feedback channels; the skills-shift of state officials from the technocratic (industry-specific and scientific-and-technical) to economic ones (financial, management and institutional); and limits choice by virtue of the domination of traditional interest groups and the ineffectiveness of agreements.

8. A system for evaluation of the performance of industrial policy is virtually absent. The processes involved in its adoption are characterised by the non-transparency of the groups of potential beneficiaries and political bias in the appraisals. The procedures for identifying and disseminating best practice in implementation of industrial policy are quite limited.

6.2.3. Analysis of examples of the formation and implementation of industrial policy in development of the automotive and nanotechnology industries

To analyse the Russian practice of adoption and implementation of industrial policy, we have chosen two fundamentally different sectors which have become a state focus from the perspective of the significant efforts and resources used, which has allowed a consideration of the different approaches to adoption of the policy and its model.

The first sector – car-making – is assumed to be a low level medium-tech sector¹. It is characterised by a significant size, the existence of big and very-big companies and a permanently high level of interest from the state, not least because of the high social significance of those enterprises providing employment for a substantial part of the population, not only in population centres, but also in individual regions.

The second example is connected with the efforts which the state has made in recent years concerning the accelerated development of a new hightech area – the nanotechnology industry, which is based on the creation and commercialisation of nanotechnologies – a domain considered by the state as an area with the greatest priority. In that context, this direction is characterised not only by an increased focus from the state, but also by the large-scale expectations (declared in official documents) with regard to its influence on the economic structure, living standards of the population and national security.

A. Car manufacturing industrial policy

Industrial policy preconditions: automotive industry state and mechanisms of development

The implementation of the state policy in the automotive industry of Russia and emerging market countries is determined by very similar launch environment:

- growing demand for cars in the domestic market;
- the limited scale of national car plants in comparison with the international manufacturers;
- technological leadership of international car makers and limitations of technology transfer;

¹ See, for example, I. Frolov. 2010. Capabilities and problems of modernisation of Russian high technology complex. <<http://viktorvoksanaev.narod.ru/h14tt.pdf>> ; V. Spitsyn. 2010. Aspects of innovative development of high technology and medium technology sectors of Russia. <<http://sun.tsu.ru/mminfo/000063105/342/image/342-166.pdf>>.

- international restrictions on implementation of the state policy, including the WTO's trade-policy standards.

As the income of the population grows, *the demand for cars for personal use grows, too*. This demand may be additionally extended at the cost of customer lending. The prices of the cars purchased in emerging markets tend toward the figures of developed countries – the demand is switched to models identical to those of more mature markets. The growth of the economy as a whole also encourages the growth of road haulage and of passenger bus services. The sales growth in the vehicle markets of the developing countries consistently exceeds that of the developed markets. The international automotive companies obtain from 10 to 55% of their profits in the markets of the developing countries where they account for from 15 to 40% of the sales volume.

The modern technological conditions of the automotive industry are characterised by the *high cost of introduction of R&D (research and development) for the development of an own-product* (new platforms and models of cars, and new key components). These expenses are worth making only if a certain minimum production volume can be achieved, estimated at the level of 1million cars per year. Those car companies which do not exceed this bar do not get obtain the economies of scale of the high-volume market segments and are niche producers.

Therefore, we can see the intrinsic difficulties of the domestic producers in countries with developing economies. These companies, as a rule, do not achieve the production volumes necessary for a full-scale financing of R&D and the independent development of new car models.

Taking into consideration the spare capacity in their domestic markets, international car manufacturers prefer low-cost options for entry to the markets of developing countries – through imports or the organisation of assembly plants with low added value. A deeper *localisation of manufacturing* is performed with the purpose of cost reduction and access to markets defended by tariff barriers. In the first case, the most significant factors for the international car manufacturers are the investment climate and the long-term competitive advantage of production inside the country. In the second case, the creation of import-substituting production depends on the initial level of the tariff protection, the prospects for growth in demand on the internal market and on the behavior of competitors which are also considering localisation of their manufacturing.

In the context of the implementation of international trade agreements, the opportunities of developing countries with regard to tariff protection of their domestic markets are reduced, as the trade limitations which are connected with obligatory investments and localisation of manufacturing are abolished or eased. Under these conditions, where the interests of the state, domestic and international producers meet, there are the foundations for the formation of different types of **corporate alliances** for industrial cooperation. The role of the state policy is to choose an acceptable approach to integration into the global car market, which would ensure the growth of the competitive advantage of the domestic automotive companies or the achievement of other declared goals, taking into consideration the interests of the users of the products of vehicle manufacturing.

Systemisation of state policies

The importance of the automobile sector for the economy determines the diversity of the measures of providing state support. There are differences in the set of measures used by developed countries, where there are large domestic car manufacturers, which compete in the

global market, and by developing countries, which are creating their own national automotive industries. These differences are determined by the level of maturity of the market and the need for auto-mobilisation, as well as by the resources of the state to support the sector.

For *developing countries* with a large potential demand, the task of utmost importance is the localisation of the manufacturing of foreign models and the preservation of high levels of the trade barriers. For *developed countries*, the tasks of prime importance in the area of state policy in the automotive industry are the preservation of the international competitive advantage of production, including at through development and mastering the manufacturing of new innovative products whilst restructuring wasteful production. Developed countries show almost no use of tariff protection measures for their national markets because of the large gap in the quality of the products from international manufacturers and the manufacturers from developing countries.

There were also essential differences in the measures which were taken in automotive industry *before and during the 2008–2009 financial crisis*. The volume and nature of measures for the support of car manufacturers which were taken in the developed markets as part of their implementation of anti-recessionary measures, could have provoked a wave of criticism, if the measures had been taken in developing countries for the development of their national automotive manufacturing in the period before the crisis (there was violation of competitive conditions, the subsidising of domestic producers, etc.).

Table 12 shows the main measures aimed at state support of the automobile industry applied in Russia and abroad, classified by the types and purposes of their application.

A separate area of state policy, which is not specially considered herein, is the support for the development and implementation of fundamentally new types of power units for vehicles (electric and hybrid engines) and other deep innovations which demand large changes in the infrastructure (for example, the creation of a network of electric charging points), in the existing business models of the market participants and in consumer behaviour.

Table 12

Measures aimed at support of the development of the automotive industry by directions of control and instruments applied

Purpose	Measure Types					
	Budget expenses	State support of lending	Customs tariff	Taxes	Technical regulation	Other control measures
1	2	3	4	5	6	7
1. Stimulating Demand for Cars	- State subsidies in the case of trading in of an old car for a new one – so-called “scrappage schemes” (*) - Certain tax and levy recovery for buyers (*) - Public procurement of vehicles	- Temporary credit lines for financial intermediaries in automobile lending (*) - Interest rate subsidies for loans to purchase automotive equipment		Variation of tax rates: - For vehicles (included in the car’s price) - Transport fuel taxes - Taxes and fees related to car use (transport tax)	Prohibition or restrictions on certain vehicle types (obsolete engine types, left-/right-hand-drive models, etc.)	Certain measures aimed at restriction on or extension of the use of cars in cities (for example, small cars and electric cars)
2. Development of New Car Manufacturing Plants	- Production infrastructure and industrial site preparation - Grants for production development (*)	Loan financing for creation of new plants and products (*)	Customs tariffs cut for equipment and components	- Tax benefits/holidays for new plants - Accelerated amortisation		“Horizontal” incentives for the development of industrial production in general - Requirement for the development of related industries and suppliers
including localisation of manufacturing foreign car models and their components			The preferential tariffs are connected with production requirements, including local purchase (*)		Simplified requirements for product certification	Different additional requirements for newly created plants (**)
3. Export Support	Marketing and advertising support and trade fair activities	- Export crediting (suppliers and buyers) - Export risk insurance	Participation in trade negotiations on access to markets of other countries	Timely VAT recovery	Harmonisation of foreign and national certification standards	

1	2	3	4	5	6	7
4. Financial Stability of Manufacturers and a Competitive Environment	Financing of different production development programmes (*)	Temporary provision of loans to refinance the debt market (*)		Tax credit (*)		- Restrictions on foreign participation in capital - Approval of mergers and acquisitions - Controlled bankruptcy
5. Car Distribution			Rules for the imports of cars by high volume importers			- Permit for creation of a distributor network (in developing countries) - Management of the contracts of dealers and manufacturers (in developed countries)
6. Rise in level of technology	- R&D expenditures Co-Financing - Transfer and commercialisation of intellectual property created by means of state financing	Loans for R&D activities		Reduction in most significant taxes for R&D (for example, employment tax cuts)		Identify long term Technology development priorities prioritisation (foresight)
7. Environmental Requirements			Embargo on imports or increased import duties for automotive equipment which does not conform to the national standards	- Scrapage fees - Tax differentiation in accordance with the cars' emission classes		Requirements as to: - specific fuel consumption figures - high-pollution cars - certain car materials and components
8. Human resources and labour relations	- Changes to specialist training programmes in public educational institutions - Professional retraining in the case of business closure - Co-financing of retraining programmes					- Limit of the use of temporary employment - Trade unions' rights and prevalence

(*) Denotes anti-recessionary measures to support specific car makers in Russian and foreign markets in 2008–2009.

(**) Permitted geographical distribution of manufacturing volume, the content of technological operations, local production or the buying of certain components and parts, production technology transfers, new product development, staffing management, staff training and other requirements.

Application and results of industrial policy in the automotive industry

In the period beginning from 1998, we can see several stages in the development of state policy in the Russian automotive industry, which differ from each other in the sets of measures applied and in the main beneficiaries – the companies at which those measures were aimed.

1. The investment regimes for foreign car makers, which had been valid before 2006 (the “bonded store” regime) allowed for organising “light” assembly of foreign car models in Russia. That regime was used to organise initial assembly from prefabricated vehicle kits at plants in Kaliningrad (Avtotor) and Taganrog (TAGAZ). The first foreign car maker which independently organised car manufacturing in Russia after perestroika was Ford (at a plant in the town of Vsevolozhsk).

2. From 2005, customs duties for the import of second-hand cars were increased (including for imports by private individuals) simultaneously with the opening of an investment regime which allowed for a decrease in the duties for imported car components for organising local production facilities with a production volume of not less than 25,000 cars per year (the so-called “No. 1 Investment Programme” or “industrial assembly”). The required final level of localisation of production was, in practice, 30%. It is an extremely soft regime for the access of foreign car makers to the market, both by in production volume and by the localisation requirements

According to the Eurasian Economic Commission, as of July 2012, there are agreements with 31 companies, but only 18 of the enterprises had started car manufacture. Altogether,

within the limits of the industrial assembly regime, there are 178 agreements in the car manufacturing sphere and 74 in car component manufacturing.

3. In 2008–2009, during the global financial crisis, the measures for state support were reoriented towards ensuring the financial stability of the domestic car makers (primarily, AvtoVAZ), as well as supporting the demand for cars by support for lending to individuals and the public procurement of automotive equipment at a federal and regional levels. Those steps allowed retention of financial stability in the domestic automotive companies, including AvtoVAZ; however, the effectiveness of implementation of those measures is still doubtful.

The measures aimed at providing support for demand allowed mitigation but did not prevent recession of production in the industry. In 2010–2011, other measures aimed at supporting demand were also implemented, including the an experimental payment to the buyers of new cars for their old cars handed over for scrappage.

4. Within the framework of completion of the negotiations on the accession of Russia to the WTO in 2010, some important understandings were reached concerning exceptions to the agreement of restrictions on investment measures in trade for the industrial assembly regime in the automotive industry. That allowed the introduction of a modified regime of “industrial assembly” (the so-called “No. 2 Investment Programme”) with raised demands for localisation after project completion (both in the total contribution of Russia-manufactured car component – 60% instead of 30%, and additional requirements for the localisation of engine manufacturing) and in the scale of production scale (300,000–350,000 cars per year instead of 25,000 cars). As of 2011, four such agreements were concluded, three of which were those with associations of several car makers: the Volkswagen Group Rus; the Ford Motor Company, Ford Sollers Yelabuga and Sollers-KAMA; AvtoVAZ, Avtoframos, Nissan Manufacturing RUS, Obyedinennaya Avto Gruppa, KAMAZ and Mercedes Benz Trucks Vostok; GM-AvtoVAZ and General Motors Auto.

5. The new investment regime will operate in conjunction with other state support measures declared as part of the Strategy for Automotive Industry Development in the Russian Federation until 2020 and the state programme “Development of Industry and Increase in its Competitive Advantage” (the Automotive Industry Subprogramme).

In 2014, the main areas of expenditure will be support for employment at plants under conditions of a limited demand for car industry products¹, as well as for the partial compensation of the costs related to the implementation of the environmental standards Euro 4 and Euro 5. Furthermore, subsidies aimed at financing investment projects will be financed by loans and, preferential loans for individuals for the purchase of vehicles, in addition to covering the costs for transportation of cars from the Far East.

The Russian automotive industry is characterised by a significant concentration of production with relatively few companies, which, during the period in question had quite large differences in their strategies.

The most important of such differences in the strategies of the domestic car makers may be referenced to the product line of cars being manufactured and to the nature of the partnerships with foreign automotive companies. Depending on the initial conditions of their performance in the industry, the automotive companies could choose between a continuation of the manufacture of domestic cars, the assembly of foreign models with different depths of

¹ The Strategy for automobile industry development prior to 2010 and concept of the Strategy staff assistance approved thereafter determines formally the priorities for production restructuring and for increase in labour productivity while current announced measures are aimed at the maintenance of work positions available.

localisation and the manufacture and development of joint models, again, with different depths of integration of the technologies of the parties involved.

Table 13

Content and timings of state policies (beginning from 1998)

Policy programme	Period	Main stakeholders	Main policies
Investment Modes Before 2006	1998–2006	• Importers • “Offshore” car assemblers (Avtotor, TAGAZ) • “Pioneers” (Ford-Vsevolozhsk)	Bonded store regime
Investment Programme 1	2006–2011 (accession to the WTO)	• Car assemblers as partners of foreign companies (e.g. Sollers) • Foreign companies	Industrial car assembly regime with minimum requirements
Crisis Bailout Programme	2008–2009	• AvtoVAZ and other domestic car manufacturers • Foreign assembly plants	Support for demand Direct support for domestic automotive companies
Investment Programme 2	2010 – present day	• National consortia of companies (including consortia in partnership with large car manufacturers and manufacturers of car components)	Exclusive localisation standards, including for large car components
Other measures of state support compatible with the WTO requirements	2010 – present day	• Support of incumbent companies	Support for technical upgrading, fleet replacement and other measures

Foreign companies could choose between the import of finished cars or production startup in Russia, and in the case production startup – between independent organisation of manufacture at their own production facilities and the formation of alliances with Russian manufacturers. Foreign companies could also combine such production strategies.

During the stages of state policy in the automotive industry, referred to above, the profits and costs changed in connection with the implementation of the enumerated strategies of domestic and foreign car makers. Accordingly, the types of companies, which were principally interested in particular results of the implementation of state policy, changed.

Control over the then existing Russian car plants in the period from 2000 to 2008 was transferred to new owners. In 2000, the metals company Severstal and Bazovy Element Holding (which is the controlling shareholder of the United Company RUSAL) acquired control of the Ulyanovsk and Gorky Automobile Plants, respectively. The decisions might have been motivated by the unofficial support of the state with regard to diversification of production and by the necessity to develop the manufacturing sector. In 2005–2008, the state company Rostekhnologii obtained control of the AvtoVAZ plant, which was privately owned, and the KAMAZ plant, the controlling interest of which belonged to the federal and regional authorities.

There were the following “turning points” in the strategies of the Russian car companies, which were characterised by the different requirements of existing state policy, especially in the sphere of customs regulation:

- the decision to whether to develop domestic models or to transfer to the assembly of foreign models;
- the choice of which way to improve domestic models by borrowing technology from foreign suppliers; and
- the choice of foreign partners and agreements on possible technological cooperation with regard to new joint models.

According to experts, the UAZ/Sollers' strategy is mostly aimed at foreign model assembly and is being implemented in the niche market of off-roaders, which creates interest in small-scale industrial assembly regimes.

The companies GAZ and KAMAZ initially had a greater competitive advantage over imports in the niche markets for commercial vehicles than AvtoVAZ had in private cars. Implementation of technologies borrowed from foreign suppliers in these companies seems to be sufficient to guarantee a competitive advantage for their products in comparison with imported models. These companies could also be more interested in the localisation of manufacturing automotive components than in finished products.

Finally, in the light of the specific features of business competition in the car sector, where the returns of scale manifest themselves to a greater extent, the issue of getting a new process platform and beginning manufacture in association with a foreign partner was particularly important for AvtoVAZ. On this basis, AvtoVAZ should be interested in an industrial assembly regime which allows for the launch of large-scale manufacturing.

In general, the measures taken in Russia during the period from 2005 to 2010 which were aimed at encouraging foreign investment into the car industry failed to provide improvements in the trade balance for automotive products.

In 2000, the volume of imports and exports of automotive products in Russia was quite well-balanced, and the total trade turnover amounted to about \$2.1bn. By 2010, the volume of registered imports of automotive products had increased twentyfold, which was related to the increase of imports of both finished products and car components. By comparison, Russian automotive product exports are only about 9–12% of the import volumes (in Brazil and China the figure is 50–60%).

Reported data for 'The Automotive Industry Development Strategy for the period until 2020' also show that the steps taken to localise manufacturing did not make possible sufficient import substitution. From 2003 to 2008, the number of imported cars increased from 1.1m to 2.8m, while the localised production of car models increased from 200,000 to 600,000. Production of the traditional Russian models decreased by approximately 200,000 in the same period. Considering the difference in the prices for Russian cars in Russia and for cars imported into Russia, the share of imports is even greater in monetary terms in the Russian market.

As a result of the implementation of a policy of opening foreign assembly factories and a gradual localisation of manufacturing, Russia now occupies a position between the countries where the supply is formed by the production of foreign models and where the domestic producers are poorly developed (Brazil) and the countries which purposefully develop their car industries in cooperation with international automotive companies (India and China).

As a result, the current figures for Russian automotive products in the balance of foreign trade are not too promising: Russia is the fifth in the world by imports of automotive products (after the European Union, the USA, China and Canada), and it is not even among the top 15 large exporters of automotive products. Russia's 2011 automotive product export volume was smaller than that of the RSA (Republic of South Africa) or that of the UAE (United Arab Emirates).

It is expected that the new industrial assembly investment model will bring an opportunity for improving the trade balance in respect of automotive industry products by virtue of an increase in the proportion of added value by Russian enterprises.

To summarise it is important to comment on the following.

- The target-oriented image of the automotive industry in countries with developing economies is a replication of the experience of South Korea in 1970s-1980s when it was trying to create a competitive position in the world market as a car producer. From a country perspective the achievements of this goal would be characterised by a positive surplus in automotive industry products. Nevertheless, replication of South Korea's experience nowadays is difficult to implement due to the high level of competitiveness in the global automotive market and due to the existence of different institutional limitations, including the international trade agreements under the WTO.
- Developing countries use various opportunities for cooperation with world automotive producers: they may organise assembly plants for foreign models and the production of automotive parts within the country and do it at different levels of localisation, or they may establish mutual enterprises or purchase niche automotive producers in developed markets. Those strategies differ in the depth of technology transfer and in the contribution of the automotive industry to the added value.
- Active measures for stimulating foreign investments into the Russian automotive industry during the period from 2005-2010 did not provide any improvement in trade balance in the automotive industry. Between 2000 and 2011 the import of automotive products into Russia increased by 40 times in terms of value, while exports grew by only by 4 times. Nowadays Russia is the fifth largest importer of automotive products in the world, but it does not featured as a large international exporter state.
- In spite of the fact that import substitution is not represented in the Russian market, a corporative structure within the sector has been created and an investment regime has been introduced under the terms of the WTO. The regime provides for deeper cooperation between national and foreign automotive producers and is helping to increase the scale of production at new plants to allow it to reach the level of foreign counterparts and to broaden its domestic production of automotive parts.

B. Industrial policy on the development of the nanotechnology industry

The process of development and realisation of industrial policy in the development of the nanotechnology and nano-industry sectors in Russia began relatively recently. During the first half of the last decade the above issues regularly became the subject and point of discussions at the level of individual ministries and agencies and also within the Government of the Russian Federation. Certainly, the formation of the National Nanotechnology Initiative in the USA was a particular "trigger" for this process.

The process of formation of Russian government policy in the sphere of nanotechnology and nano-industry was started in 2006; the President of the Russian Federation acted as its initiator and active participant: the nanosystems industry has become one of the major directions of development for science technology and engineering. The list of crucial technologies includes nanotechnologies and nanomaterials, and the corresponding issues have been raised in presidential addresses to the Federal Assembly.

In the middle of 2006 the Government of the Russian Federation accepted the *Program for Working Coordination in The Spheres of Nanotechnologies and Nanomaterials*. This document, like almost all other documents else in this sphere, was distinguished by the magnitude of its targets which were not followed by any indicators of their achievement. The Program was not provided with its own "separate" budget support. It was only indicated that the budgets of target programmes and non-Programme activities could serve as its financial

resources. Funds allocated for the maintenance of institutions could also be used as a financial resource for the Program. Implementation deadlines were not determined either. On the whole, the document should be recognised to be excessively generalised and declarative; but nevertheless it included a number of steps which have become key elements of government policy in the sphere of nano-industrial development.

The publication in 2007 of the *Presidential Initiative “The Strategy of Nano-Industrial Development”* was, without doubt, the initial stage of active government policy in regard to this field. The “status” and the “ambitious character” of the document have emerged already at the level of the formulated aims and goals which concern not only the spheres of nanotechnology and nano-industry, but also the socio-economic developments in general. Just like the abovementioned coordination Program the Presidential Initiative lacked any target indicators and financial projections. But in spite of its some of its pretentiousness, this document has not become just one more composition of “catchwords and imaginings” of the government (from our point of view, its presidential status contributed to this): the Presidential Initiative has fixed the major instruments of government policy in the sphere of nanotechnologies; the necessity for the formation and development of the national nanotechnology network has been determined; and substantive areas to support its activities have been formulated. Looking ahead we can note that the Presidential Initiative has played a key role in the formation of government policy in the nanotechnology and nano-industrial spheres and it still remains essentially the only strategy document in the sphere of development of these sectors and branches which has been implemented almost in full, at least insofar as the formulated activities and instruments are concerned.

Perhaps the most important practical governmental step towards ensuring the development of nano-industry has been the establishment of the *Russian Corporation of Nanotechnologies* – the relevant law being passed in 2007. The high importance of this government corporation can be explained by its legal forms and targets which cross the borders of the “traditional” competence of major government sectors, and by the fact that the President of the Russian Federation and both chambers of the Federal Assembly were directly engaged in the formation of its Supervisory Council. At the same time, judging by its basic functions, this government corporation was a financial development institution of albeit with extended powers: its major functions were determined as the selection and support of three categories of project: Research and Development projects, a project which includes the introduction of nanotechnologies or the manufacture of such products together with projects on specialist training. We should underline that in 2010 this government corporation was transformed into a joint-stock company, but this transformation has not led to any significant changes in the profile of its activities. The only difference is that support for projects in the spheres of infrastructure and education has been handed to a specially established fund.

In August 2007 the Federal Target Program “*Development of the Infrastructure for Nano-Industry in the Russian Federation in 2008-2010*” was intended to support the formation of the essential infrastructure needed for the functioning of the National Nanotechnology Networks: the instrumentation and the information-analytical and methodological infrastructures of the nano-industry.

At the beginning of 2008 the composition of the basic documentation with regard to this sphere was enlarged by the state Program of *Development of the Infrastructure for Nano-Industry in the Russian Federation until 2015*. Unlike the Presidential Initiative that was, primarily, an “ideological” document; this Program was intended to become a practical basis

for the realisation of integral government policy on the development of nanotechnologies and the nano-industry. Judging by the content of the Program it had a purpose at a higher level than the Federal Target Program, departmental programmes and non-program arrangements. But in practice the Program has become no more than a “superstructure” because its status has not been officially confirmed. This was the reason why the Program did not have its “own” resources – its financial provision included only those funds which were allocated under other programs and support instruments. These aspects do not mean that this document is worthless from the point of view of the “construction” of government policy: in comparison with the Presidential Initiative the Program includes a concrete and operational determination of the major stages of nano-industry development, their targets and emphasis; the Program has documented, for the very first time, clear quantitative benchmarks for nano-industry development (even though some target figures seemed, at first, to be very difficult to achieve); finally the major participants in the development of nano-industry and the sum of all the relevant instruments of government policy have been determined.

In 2008 the process of formalisation of the *National Research Center*, the “*Kurchatovsky Institution*” began. This is the major element of the scientific research component of nano-industry and is the central link of the National Nanotechnology Network, on which rest such functions as the coordination of scientific activities on the implementation of the Presidential Initiative. In 2010 the process was “crowned” by the adoption of a special law that established that the National Research Center is the direct responsibility of the government, which was its founder, accepted its charter and represented the government. Coupled with the fact that the National Research Center is the main manager of budgetary funds it has obtained an extremely high status in the system of government.

Since 2011 intensity of implementation by the state of new practical steps in the sphere of nanotechnology and the development of nano-industry has decreased which is not unexpected since all the major instruments and measures stipulated by the Presidential Initiative had been implemented in one way or another. The activities which have since been undertaken are to a large extent technical.

The following *major interest groups* in the spheres of nanotechnologies and nano-industry in Russia can be identified:

The state. Since we are essentially talking about the creation of a new sector, the key player is actually the state. Its basic interests are quite clearly revealed by the targets of strategy and programme documents adopted in this field: an increase in the level of implemented research works and developments in the spheres of nanotechnologies and nano-industry; the entry of Russia into the list of world leaders in relevant field; the guarantee of successful commercialisation within Russia of the developing technologies and the creation of new high-tech manufacturing based on those technologies; a substantial increase in the amount of manufacture and export of particular products and at last an improvement in the structure of the Russian economy, the quality of life of the population and in national security. Furthermore, under increasingly stringent budgetary restraints, the aim of a rapid return on investments comes to the fore.

Scientific institutions. These are interested in obtaining funding for carrying out research and development, the evaluation of the material-technical base and the maintenance of current activities preferably on a regular basis. It is important to underline that this particular group (represented primarily by the Kurchatovsky Institute) was one of the originators of the government policy of support for the nano-industry in Russia. Which is why it is no surprise

that in practice the policy to a large extent ensures the realisation of the interests of a rather narrow circle of scientific organisations, primarily, the Kurchatovsky Institute).

Higher Education institutions. In addition to their requirements as scientific organisations, these institutions are also interested in target financing of specialist training in the spheres of nanotechnologies and nano-industry. This interest is partly realised within the educational projects and programmes implemented under the authority of “RUSNANO”.

Russian Business. Business is interested in the development of promising new products and technologies which are ready for commercialisation, and also in the availability of funding for their manufacture and market launch. Currently the supported projects embrace only an extremely small part of the potential “audience”.

Foreign Business. This is also interested in the commercial use of advanced Russian nanotechnologies, as is proved by the participation of foreign investors in venture capital funds founded by “RUSNANO”. Furthermore, some individual companies are showing interest in the creation of their own production areas within Russia and, generally, in the development of the Russian market.

Venture investors. These are interested in the appearance of a significant amount of new development with a substantial potential for commercial usage, but nowadays there are some problems with this in spite of the scale of government support.

The key role in ensuring the development of funding *supply* for nano-industry belongs with the financing of the government corporation “Rusnanotech” / OAO “RUSNANO”: in general, during the period being considered this instrument of support has obtained more than a half of the budget appropriations – about Rb 130bn; furthermore, “RUSNANO” has been given governments safeguards to the value of Rb 120bn. The annual amount of budget assignments for all other supported areas is about Rb 20bn, and one third of 120bn. has been assigned to the National Research Center, the “Kurchatovsky Institute” for the last years.

If we are speaking about the *results* of the policy being implemented by the government (Table 14), then we should say that recent years have witnessed a stable increase in domestic spending on research and developments in the sphere of nanotechnologies. There has also been some increase in the proportion of total expenditure on R&D; and it is obvious that the effect is, to a large degree, explained by large-scale government investment into the nano-industry.

Table 14

Factors in the development of the spheres of nanotechnologies and nano-industry

	2008	2009	2010	2011
1	2	3	4	5
Internal spending on research works and developments in the sphere of nanotechnologies, million Rub	11,026	15,113	21,284	26,086
The proportion of domestic spending on research works and developments in the sphere of nanotechnologies, of the total domestic expenditure for research and development, %	2.6	3.1	4.1	4.3
The amount of organisations implementing research works and developments in the sphere of nanotechnologies	463	465	480	485
The proportion of organisations implementing research work and development in the sphere of nanotechnologies, as a percentage of the total number of organisations implementing research work and development	12.6	13.2	13.7	13.2
The number of researchers implementing research work and development in the sphere of nanotechnologies	14,873	14,500	17,928	21,166
The proportion of researchers implementing research work and development in the sphere of nanotechnologies, as % of the total number of researchers	4.0	3.9	4.9	5.6

Cont'd

1	2	3	4	5
The value of innovative goods, works and services connected with nanotechnologies, million Rub	582	1,074	52,921	63,029
<i>Indicators of the Development Program for Nano-Industry in the Russian Federation until 2015</i>				
<i>Domestic spending on research works and the development promising directions in nano-industry, mln. rub</i>	<i>10,300</i>	<i>14,300</i>	<i>20,000</i>	<i>28,000</i>
<i>The number of researchers implementing research works and developments in the sphere of nano-industry</i>	<i>10,300</i>	<i>10,600</i>	<i>10,900</i>	<i>11,200</i>
<i>Sales of products of nano-industry, million Rub</i>	<i>20,000</i>	<i>80,000</i>	<i>155,000</i>	<i>240,000</i>

These figures can be regarded as evidence of development dynamics of the Russian nano-industry, but based on these it is difficult to judge how appropriate such resources dynamics and effort are for the industry. Some understanding can be gained by the comparison of these figures with similar indicators from the Program for Development of Nano-Industry: if the planned and actual values of the amount of spending on research work and development are fairly similar and the number of researchers is higher than the indicators shown, this means that the actual realisation of nanotechnological products is significantly higher (by several times) than the planned realisation.

So, the government policy implemented in the sphere of nano-industry has significantly more impact on the “input” characteristics (financing of the R&D, the number of researchers) than the results of product realisation. The significant obstacle on the path of development of the nano-industry is represented by an unavailability of a substantial number of developments for commercialisation, including very promising ones. As a result there is no stable “flow” of innovational projects; while the projects which are being realised are rare and do not lead to any significant economic effects.

C. Special features of used approaches, achieved results and problems

These examples allow us to distinguish two fundamentally different approaches to the realisation of industrial policy (Table 15). The situation with the automotive industry addresses the support of a large traditional sector with an inclination for attracting investments from leading foreign companies, the creation of new production areas with a larger degree of localisation. All these are combined with the support for national automotive manufacturers (primarily to retain jobs). Industrial policy in the sphere of nano-industry has the aim of guaranteeing the formation of a new globally-competitive high-tech sector, important for the national economy; the major policy directions here include creation of the necessary infrastructure (including financial), the guarantee of advanced promotion of the research work and developments, and at the same time, a rush to increase in the volume of manufacture of nanotechnology goods.

The instruments used by the government also varied significantly: the policy used for the automotive industry was based on the application of customs and tariff regulation, stimulating demand for the products of the national vehicle manufacturers (including, importantly, the Russian production areas of foreign companies) as well as assigning various budgetary funds to specific enterprises (primarily to AvtoVAZ). To support the nano-industry, a new large-scale development institution, RUSNANO, was founded; a special Federal Target Program was instigated to create the essential research and informational infrastructure; the National Research Center, with an appropriate profile, has been set up to provide government funding for research and development.

When talking about the results of these measures, it should be mentioned that the simultaneous attraction of several leading world automotive producers to Russia, their creation of stable alliances with Russian companies, the organisation of a string of new production facilities and, as a result, an improvement in the general culture of production and, last but not least, the significant progress of industrial development in separate regions are obvious signs of the successful support of the automotive industry. On the other hand, the policy, as implemented, has not provided any improvement in the balance of trade in automotive industry products, and has not led to any significant development of its own private research and development competences; besides which, the original players still operate in the market alongside the new, retaining their ‘competitiveness’ primarily through government support.

Table 15

Special features and outcomes of industrial policy

	Automotive industry	Nano-industry
The Sphere of Political Realisation	A traditional middle/ high-tech branch, rather large	An entirely new high-tech sector, with significant promise for the economy
The Beginning of Realisation	1998 (2006 – activation)	2007
Initiator interest group	Structural	Scientific-technological
Emphasis	• Attraction of foreign investments • Support for cooperation • Creation of new manufacturing, localisation • Import substitution • Promotion of employment	• Creation of infrastructure • Advanced promotion of research work and developments • Commercialisation, production of new high-tech goods
Political Type	Vertical	Horizontal with vertical elements
Key Instruments and Measures	• Customs regulation • Stimulation of demand • Financial support of existing manufacturers	• RDE «Kurchatovsky Institute» • RUSNANO • FTP «Development of Nano-Industry Infrastructure...» • Budget financing of R&D
Strong Sides, Success	• Foreign investments • Creation of new products • Cooperation of Russian and foreign manufacturers • Improvement of manufacturing culture	• A new institution of innovation stimulation • «Planned» increase in spending on R&D and the number of researchers • Launch of new high-tech products
Weak Sides, Problems	• weak influence on import substitution, deterioration of the balance of trade • Retention of ineffective companies • The lack of significant progress in development of research and constructor competences	• The limited amount of beneficiaries • Weak demonstrative effect • Deficit of new perspective projects • Orientation towards government support, scarce inflow of private resources • Relatively low rates of production growth

Industrial policy in the sphere of the *nano-industries* has created conditions for the creation of a large and active functioning institution for the support of innovation, which can pay attention, not only to project financing, but also to infrastructural development and the development of educational programmes; and thanks to large-scale government investments “as planned” the indicators of the value of R&D are rising; there are some examples of the launch of new industries and the development of new products and technologies. At the same time the circle of beneficiaries from such support is quite small and progress is piecemeal in nature and therefore does not provide significant demonstrative effect; the actual production volumes of nanotechnological products are still far from those which were expected. Moreover, in contrast to the policy measures used to support the automotive industry, the measures in support of nano-industry have not brought a significant inflow of private investment. At the same time the major players and interest groups are focused on the receipt

and use of government recourses. All these factors lead to the inevitable question of whether the achieved local successes have been worth the invested governmental funds.

6.2.4. Some general lessons of industrial policy implementation in Russia

There have been many attempts to implement industrial policy in Russia in one way or another. It's most likely that such an approach will remain: industrial policy is inevitably attractive for politicians as an understandable and clear mechanism of communication with society, as an instrument for the reallocation of rents and for interaction with economic interest groups. Basically this instrument can be useful from the perspective of the "packaging" into 'industrial policy' of the "standard" measures used to improve the investment climate, and for the optimisation of governments regulations and aggregation of different policies directed towards fairly clear and measurable goals.

In this connection it is quite useful to identify *some lessons for the future* based on the existing but diverse manifestations of industrial policy. We shall try not only to point out existing faults, but also to identify causal relationships for the sustained repetition of certain imbalances in the formation and realisation of industrial policy.

Lesson 1. A negative attitude towards particular alternative policies, or the activities of government in specific spheres should not be "taboos" preventing us from studying the appropriate issues. The fact that for a long time in Russia it has been as if there were no "kind of" industrial policy and this has led to the quality, formation and implementation of industrial policy and the culture of its research have remained at a rather low level.

In any case, there is no government policy which is entirely neutral in its effect on different business groups, sectors and markets. So it is a matter of choice, whether it is appropriate to use the heterogeneity of influence purposefully or not. Nevertheless it is necessary to understand the reasons for this heterogeneity and to assess the real beneficiaries in the group during the implementation of particular measures.

Lesson 2. World experience has evidenced that the requirements for industrial policy and its opportunities (especially instrumental ones) change significantly with time. Such policies in each country and at a given time need new ideas and solutions; it is extremely difficult to replicate the success of the industrial policies of various countries.

In this connection ex-post assessments of industrial policies are valuable from the perspective of determining not only the necessary ("right") content and direction, but, to a greater extent the principles on which the policy should be formed, controlled and refined. For industrial policy in particular, both "politics" and proficient state management are of special importance (these are the methods for the creation and exercise of policy).

Lesson 3. It is usually that the most important element of industrial policy is a system of priorities, yet, in Russia no system of clear and reasoned priorities has been established. We cannot but agree from this that branch and sectoral priorities have changed and been supplemented many times, as a result, not fulfilling any consolidation role in the efforts of government and business. Such isolation from the system of priorities of real economic policy and the lack of at least some attempts by the government to understand and estimate progress

in the realisation of one or another priority has significantly undermined the trust of strategic investors and of society in every further “serving” of government priorities.

However we do not believe that it is necessary to make special efforts to define priorities or even regard it as an urgent step.

We can notice that each new cycle of enhanced attention to industrial policy in Russia usually begins with a discussion of priorities, and here, on the whole, is also where it ends. Priorities have been perceived by the majority of players as a kind of “rubricator of directions” within which public money can be required. Politically it is rather difficult to limit the sprawl of process priorities – it is hard to deny the priority of a particular sector, especially under the widespread perception that major governmental resources should be spent within the framework of priorities.

Practice shows that a transition from industrial to technological priorities will not change the situation beyond recognition – there are some “sacred” priorities in the field of science and technology, at the same time other interest groups emerge with pledges which are even longer and more difficult to verify.

Lesson 4. *A significant problem is the attempt to maximise all the advantages of industrial policy but only at the level of the national economy.* The majority of Russian industrial policy initiatives have focuses on the domestic market which means that structural changes, primarily through import substitution have been implied. This greatly increased the risk of protectionist barriers being set up, limitation of competition, replacement of private demand with governmental ones for the support of selected priorities and as a result a multiplication of problems and costs of inappropriate starting decisions.

However on a global basis, the most successful industrial policy examples are focused on the conquering export markets. Let us underline the fact that globalisation does not diminish, but on the contrary, increases, the significance of the need for a policy of building global chains of value formation, and the extension of modern competences, of choosing strategic partners and forming a range of technological alliances. Taking into account Russian’s accession to the WTO there is a need for different “leaner” and more effective instruments for supporting exports.

There is also a serious problem of *correctly assessing the accumulated scientific and technological potential and identifying appropriate ways to apply it.* The relevant assessments and perceptions are often overstated, taking into consideration the fact that they are based on perceptions which were relevant 20-30 years ago and on the supposition that business demands for technology have not really changed. The aim of using the legacy of past decades has become a political problem, blocking some new approaches and the development of cross-border technological cooperation. Note that in the development of the automotive industry it was easier for the government to orientate towards world brands and the attraction of foreign investors as a consequence of the lack of a strong private car industry, combined with a public perception of the low competitiveness of the quality of the domestically produced cars.

In our view, under current conditions the implementation of industrial policy without the participation of foreign partners (financial and technological) and without definite and sufficient conditions for the free entry and withdrawal of major players, is doomed only to simulate achievement, to have strong informational asymmetry and to form antagonist images of what is actually happening in society and in public governance.

Lesson 5. Industrial policy which does not *rely on the supply of demonstrative effects, competition between companies and investors and on independent objective assessment is, on the whole, possible but inefficient.* An emphasis on the primary usage of state resources heightens the risk of rent-oriented behaviour and limits the possibility of adequate evaluation. There are usually not enough resources to support all the priorities and initiatives and, as a result, reasons appear for “limited responsibility” together with requests for the assignment of additional resources in order to achieve better results (in the future).

The implementation of industrial policy detached from institutional changes, especially in the organisation of individual sectors, results in both significant limitation of the possible positive results and high risks of excessive distortions in the market environment. *For successful realisation of industrial policy it is fundamentally important to have a high quality institutional environment and positive dynamics of change.* Note that an independent factor may also be the expectations of some business change. This largely determines the scale of demonstrative effects.

Lesson 6. A significant obstacle to improving the efficiency of industrial policy is the limited access for new interest groups to participate in the development and evaluation of the results achieved. While the government is trying to form new instruments and to use new factors and interest groups in development, the traditional interest groups quickly “capture” these new instruments and contribute to their adjustment for their own purposes.

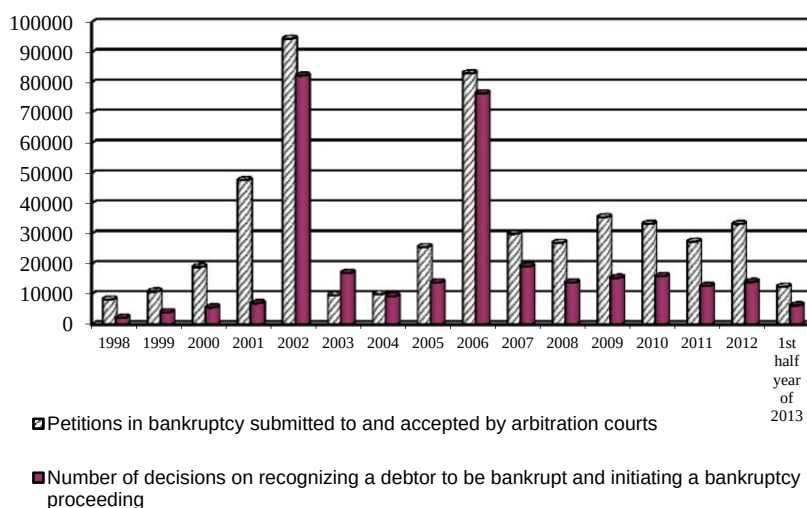
An analysis of individual cases of Russian industrial policy has shown that the stability of changes and movements is critically dependent on the *rapid formation of new interest groups* (or reorientation of existing groups towards modernisation). The consolidation of new interest groups is more likely in emerging sectors, where the traditional groups are not yet strong enough to carry out the “seizure” of industrial policy instruments. However the government often unintentionally prevents the creation of new interest groups and the accumulation of a “critical mass” when it engages new charismatic representatives of such groups into the organs of the state.

In conclusion, it is important to underline that ideological bias and categorical judgments on industrial policy, and a lack of pragmatism and questioning are significant obstacles on the way to ensuring the relevance and improved rationality of such policy. Both globally, and in Russia, there has been an increase in the number of prerequisites (or ‘risks’ – depending on your point of view) for the implementation of industrial policy its the current stage of development – in a period of deep transformation of perceptions about the 90s and the role of government in economic development. In this connection *critical and verifiable exchange of reasoned assessments and opinions concerning the issue of how industrial policy should be implemented, and what results can be achieved, are really fundamental; but most importantly, what should not be undertaken during implementation of the policy.*

6.3. Bankruptcies in 2012-2013: Growth in the Number of Bankruptcies of Financial Institutions and Individual Entrepreneurs and the Introduction of New Regulations

6.3.1. The Dynamics of Bankruptcies in 2012-2013

The overall situation in the field of bankruptcy over the period under consideration was characterized by a considerable rise, in 2012, in the number of bankruptcies and the number of petitions in bankruptcy submitted to and accepted by arbitration courts. Compared to 2011, the number of submitted petitions in bankruptcy rose by 22.4%, to 40,864. At the same time, the number of petitions in bankruptcy accepted by courts of justice increased by 21.2%, to 33,236. However, in the first half-year of 2013, the number of petitions in bankruptcy submitted to and accepted by courts of justice dropped by 25.4% and 21.1% respectively on the same period of the previous year. A similar trend was observed in the annual number of decisions on recognizing a debtor to be bankrupt and initiating a bankruptcy proceeding: having grown in 2012 by 10% in year-on-year terms, in Q1 2013 their number dropped by 11.1%, compared with the same period of 2012 (*Fig. 1*).

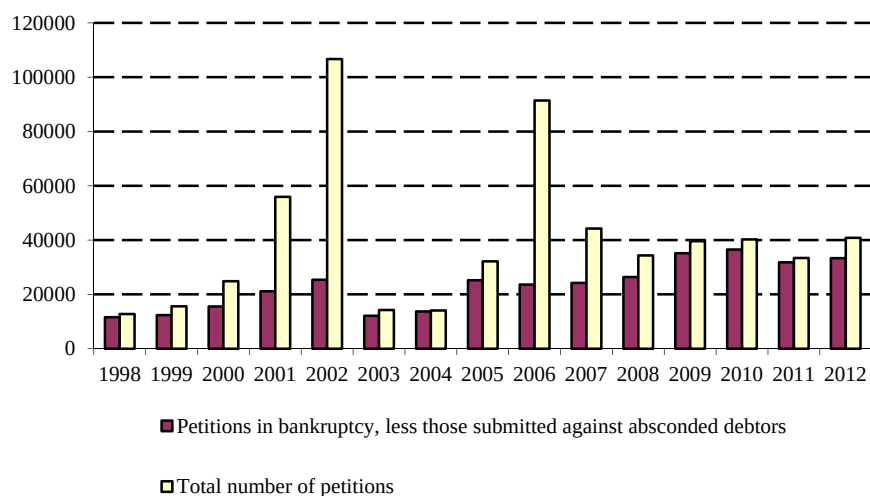


Sources: Statements prepared by the Supreme Arbitration Court of the Russian Federation concerning the consideration, by the arbitration courts of subjects of the Russian Federation, of insolvency (bankruptcy) cases in the period 1998–2013.

Fig. 1. Changes in the Number of Decisions on Bankruptcy Petitions over the Period 1998–2013

Similar opposite changes were observed in:

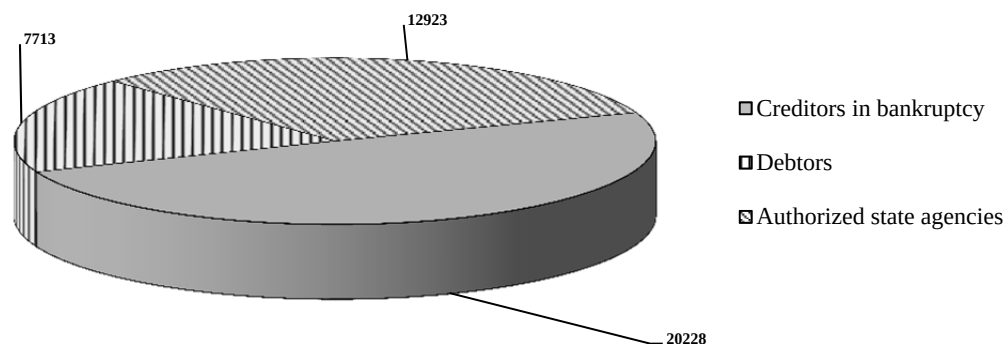
- the number of completed insolvency (bankruptcy) proceedings: in 2012, it rose by 15.4% on 2011; in the first half-year of 2013, it dropped by 21.2% on the same period of the previous year;
- the number of applications, disputes, complaints and petitions considered by courts of justice: in 2012 it rose by 17% on 2011; in the first half-year of 2013 it dropped by 11.2% on the same period of the previous year (*Fig. 2*).



Sources: Statements concerning the consideration, by the arbitration courts of subjects of the Russian Federation, of insolvency (bankruptcy) cases over relevant periods; analytical notes to the statistical reports on the operation of the arbitration courts of the Russian Federation over relevant periods, prepared by the Supreme Arbitration Court of the Russian Federation.

Fig. 2. The Number of Petitions for Recognizing a Debtor to Be Bankrupt Submitted in 1998–2012

The structure of petitions in bankruptcy filed with courts of justice in 2012 is shown in *Fig. 3*.



Source: Analytical Note for 2012 prepared by the Supreme Arbitration Court of the Russian Federation.

Fig. 3. The Structure of Petitions in Insolvency (bankruptcy) Filed with Courts of Justice

It can be seen that, in 2012, almost one half of petitions that a debtor should be recognized to be bankrupt were submitted to courts of justice by creditors in bankruptcy (49% or 20,228 petitions).

The proportion of petitions in insolvency (bankruptcy) submitted by debtors dropped from 22% in 2011 (7,273 petitions) to 19% in 2012 (7,713 petitions). In 2012, the share of petitions that a debtor should be recognized to be bankrupt, submitted by authorized state agencies (mainly tax agencies) amounted to 32% (12,923 petitions vs. 10,477 petitions in 2011). In 2012, the number of petitions in bankruptcy submitted with regard to financial and credit institutions increased almost twofold (2011 – 58 petitions; 2012 – 109 petitions). The number

of petitions in bankruptcy submitted with regard to agricultural producers went up by 11%, most likely due to the slackening of state support in the corresponding market segments.

In 2012, the number of petitions in bankruptcy submitted with regard to individual entrepreneurs rose by one third (+31%) (2011 – 4,761 petitions; 2012 – 6,248 petitions). It seems that the main factor behind this growth in the number of petitions in bankruptcy was Resolution of the Plenary Session of the Supreme Arbitration Court of the Russian Federation, of 30 June 2011, No 51, ‘On Judicial Practices in Bankruptcy Cases of Individual Entrepreneurs’. This Resolution has unambiguously established that a petition to recognize a debtor individual entrepreneur to be bankrupt should be accepted for consideration by a court of justice if the amount claimed against him is no less than Rb 10,000. Previously, there was a split of opinion over that issue, because the RF Civil Code stipulated that ‘the rules of the present Code which regulate the activity of juridical persons that are commercial organizations shall apply respectively to the entrepreneurial activity of citizens effectuated without the formation of a juridical person [...]’, which meant that the amount claimed against a debtor individual entrepreneur should be no less than Rb 100,000. However, the Civil Code has a reservation in this respect: ‘[...] unless it arises otherwise from a law, other legal acts, or the essence of a legal relation’ (Article 23.3 of the RF Civil Code). It was precisely this reservation that was used by the Supreme Arbitration Court to substantiate its position over that issue.

The most noteworthy trends observed in recent years were as follows: firstly, there was a rise in the number of court-approved amicable agreements and the resulting growth in the number of terminations of bankruptcy proceedings. Over the course of the period 2008-2012, the number of such cases increased by 4.4 times (from 126 in 2008 to 563 in 2012). It should be said that, in 2012, the number of amicable agreements hit an eleven-year high, thus proving the effectiveness of changes introduced to the corresponding part of bankruptcy regulation. One of the major factors behind the growth in the number of concluded amicable agreements was the introduction, in 2010, of a number of amendments to tax legislation, which increased the possibilities of paying the tax arrears in installments, of getting tax deferrals, and of writing off hopeless payables.

Secondly, there was a drop in the number of bankruptcies of state unitary enterprises. Over the period 2008-2012, it fell by more than 2.3 times (from 176 to 76).

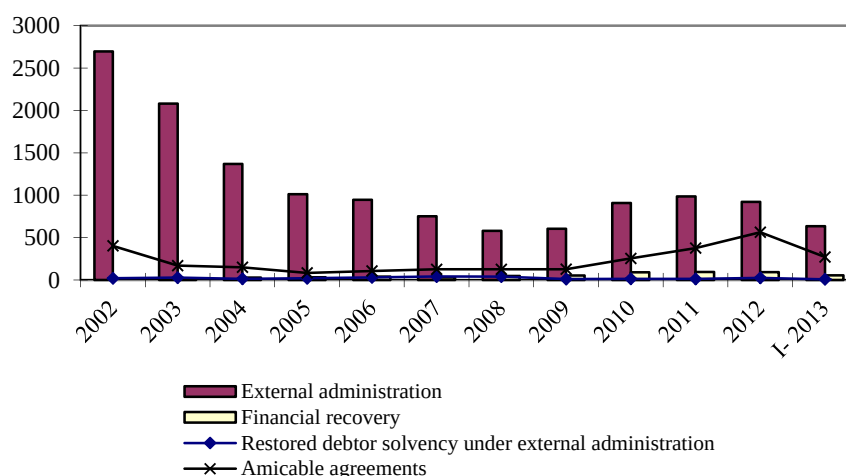
Thirdly, the period 2011-2013 saw a continuation of the upward trend displayed by the number of statements disputing the transactions carried out by a debtor (which grew from 5,090 in 2011 to 8,406 in 2012). In the first half-year of 2013, the number of such statements increased by 30% compared with the same period of 2012. The persistence of this upward trend proves, among other things, the effectiveness of the mechanism, introduced in April 2009, for challenging suspicious transactions, ‘transactions which result in preferential satisfaction of claims of one creditor over other creditors’ claims’, etc. (Articles 61.1-61.9 of the Federal Law ‘On Insolvency (Bankruptcy)’¹).

Over the course of that period, the number of claims for cost recovery in bankruptcy cases also continued to grow.

Fourthly, there was a continuation of the drop in the number of cases where external administration was effected. In 2012, the number of such cases went down by 6.5% on the

¹ For more details, see Apevalova E.A. *Bankruptcies in 2009-2011: Their Dynamics and Trends*. MIEP. ‘The Economic and Political Situation in Russia’, October 2011.

previous year, while in the first half-year of 2013 it dropped by 16.8% compared with the same period of 2012 (*Fig. 4*).



Source: Statements concerning the consideration, by the arbitration courts of subjects of the Russian Federation, of insolvency (bankruptcy) cases over the periods 2006 – 2010, 2008– 2011, 2009–2012, and first half year of 2013.

Fig. 4. Changes in the Number of Cases of Effected External Administration, Financial Recoveries, Restoration of Debtor Solvency, and Concluded Amicable Agreements over the Period 2002 – First Half Year 2013

Cases when a company under external administration restores its solvency or when it repays its debts in the course of financial recovery are few and far between, and their number continues to decline.

In 2012, arbitration courts considered a total of 1,724 petitions containing requests that a commissioner in bankruptcy should be dismissed, which represented a rise on 2011 by more than 7% (in 2011 – 1,552 petitions). Arbitration courts explain the growth in the number of filed petitions by the recommendations issued by the Presidium of the Supreme Arbitration Court of the Russian Federation (RF SAC) in the form of an information letter as of 22 May 2012, No 150 'An Overview of the Practices of Arbitration Courts in Dealing with Disputes Involving Dismissals of Commissioners in Bankruptcy'. In that letter, the RF SAC's Presidium has pointed out, in particular, that 'the absence of proof in confirmation of the precise amount of incurred losses, as well as the actual absence of losses shall not be an impediment for dismissing a commissioner in bankruptcy, if the possibility of incurring such losses as a result of violations committed by him has been established'; 'A commissioner in bankruptcy may be dismissed for having incurred unjustified expenses ...', etc.

As a result of the introduction of special norms concerning bankruptcy of construction companies, arbitration courts in 2012 considered a total of 31,625 such petitions, their share in the overall number of considered applications, complaints and petitions amounting to 13.2%. The year 2012 also saw a rise in the number of petitions to the effect that the parties exercising control over a debtor should be brought to subsidiary responsibility (from 1,032 in 2011 to 1,177 in 2012).

Besides, there is also growth in the number of petitions belonging to another category - concerning the redemption of claims presented to a debtor. Thus, in 2011, arbitration courts

considered a total of 739 petitions stating an intention to redeem claims presented in respect of mandatory payments, and in 2012 – a total of 1,032 such petitions, of which 793 (or 77%) were resolved to petitioners' satisfaction.

By way of summing up the results of the period of 2012–2013, we may point to the following relatively significant trends in bankruptcy procedures:

- absence of any marked trends in the movement of the number of bankruptcies;
- decline of the number of bankruptcies of state unitary enterprises;
- rising numbers of bankruptcies of financial and credit institutions, as well as individual entrepreneurs;
- existence of efficient mechanisms for disputing the transactions concluded by a debtor and for concluding amicable agreements;
- persisting inefficiency of external management and financial recovery procedures;
- preservation of a pro-creditor bankruptcy procedure model in this country.

6.3.2. Bankruptcy Legislation in 2012 – 2013: Special Norms for Special Societies

December 2013 saw a continuation of the **trend**, which had emerged in 2007, **towards making the bankruptcy procedures established for certain categories of entities so complicated as to render their bankruptcy virtually impossible** (Federal Law No 379-FZ, of 21 December 2013 'On the Introduction of Alterations to Some Legislative Acts of the Russian Federation'). This time, specialized societies and housing mortgage agents were added to this particular category. Specialized societies may be set up in the form of a financial society or a society created for the purpose of project financing. The creation of these new legal forms is envisaged in Article 15.1 of the Federal Law of 22 April 1996, No 39-FZ 'On the Securities Market'. The goals of a specialized financial society and its core activity consist essentially in the acquisition of monetary claims and the right to present claims to debtors in respect of their monies owned against credit contracts, loan agreements, and other liabilities¹.

The goals and core activity of a specialized society created for the purpose of project financing is to provide funding for a long-term investment project (launched for a period of no less than three years) by means of acquiring the monetary claims that will arise in connection with the realization of property created as a result of that project's implementation; by means of rendering services, producing goods and (or) carrying out work by way of using the property created as a result of that project's implementation; by means of acquiring other property necessary for that project's implementation or related to its implementation; and by means of issuing bonds secured by pledging monetary claims and other property (Item 2 of Article 15.1 of the Federal Law 'On the Securities Market').

Specialized societies are vested with a number of powers, including the right to issue bonds secured by a pledge. The only plenipotentiary representative of such societies can be their asset managers. The functions of the asset manager of a specialized society may be performed by a manager, the asset manager of an investment fund, mutual fund, private pension fund or other organization established as an economic society, on condition that the

¹ Including, among other things, the rights that may arise in the future in connection with the already existing liabilities or future liabilities, as a result of acquisition of other property related to the monetary claims being acquired, including the rights arising under lease contracts and tenancy contracts, and the issuance of bonds secured by a pledge of monetary claims.

said organization is entered by the Bank of Russia in the register of organizations empowered to act as asset managers of specialized societies.

A petition in bankruptcy against a specialized society may be filed only by a representative of the holders of its bonds in accordance with the law on securities and on the basis of the decision of a general bondholder meeting. In this connection, the specialized society's creditor may not petition a court to the effect that the said society should be recognized to be bankrupt, if the realization of such a right has been restricted by the relevant contract. Similar restrictions are applied to the right of a specialized society's director to file a petition in bankruptcy.

In other words, what one can observe here is the *restriction of the right of creditors in bankruptcy, challenging of the existing competition norms, and an attempt to provide an administrative solution to the problem posed by the inefficient performance of certain state-owned legal entities.*

In an event of bankruptcy of a specialized society, the introduction of an observation procedure, financial recovery and external management are not allowed. The information concerning the recognition of a specialized society to be bankrupt and the initiation of proceedings in bankruptcy is entered into the Single State Register of Bankruptcies, but *without being published in an official information source.*

Competition mechanisms are not relied upon in connection with the sale of property used as a pledge to secure bonds, either. The procedure and conditions for the bidding, as well as the starting selling price of property used as a pledge to secure bonds are to be established by a representative of the bondholders, and only in absence of such a representative or absence of a relevant bondholder decision – by the commissioner in bankruptcy. Besides, it is envisaged that property may be transferred by one specialized society to another specialized society, the latter assuming all the liabilities of the issuer of bonds.

The issues relating to bankruptcy of a housing mortgage agent are dealt with in a similar manner. It seems that the main goal is to protect the rights of some of the investors - the issuers of bonds. In this connection, the actual sources of funding - judging by the recent amendments to the RF Civil Code whereby a new type of bank account (a nominal account) was introduced - may remain unknown. The introduction of a new form of a legal entity endowed with special rights closely resembles the practice of creating public corporations, resorted to a few years ago.

Also in December 2013, new Federal Law No 410-FZ, of 28 December 2013 'On the Introduction of Alterations to the Federal Law "On Private Pension Funds"' was adopted, whereby a special bankruptcy procedure was introduced for these funds as well. The following specific features were established:

1. Additional grounds for applying measures designed to prevent bankruptcy of pension funds participating in mandatory pension insurance plans. Among these, for example, is failure to fulfill the obligation to repay the amount of pension reserves and (or) pension savings to those insured persons who are entitled to special pension payments; insufficiency of mandatory pension insurance reserves and property needed for ensuring proper functioning of a pension fund in accordance with its charter, etc.¹

¹ For further details, see Subitems 1-3, Item 1 of Article 187.2 of the Federal Law 'On Insolvency (Bankruptcy)', as amended by Federal Law of 28 December 2013, No 410 'On the Introduction of Alterations to the Federal Law "On Private Pension Funds" and Some Legislative Acts of the Russian Federation'.

If such grounds arise, the pension fund should be obliged to duly notify of their emergence the controlling body, and submit to the controlling body a plan for recovering its solvency, on condition that there are no indicia of bankruptcy.

2. Specific procedures for the appointment and operation of the provisional administration of a private pension fund participating in mandatory pension insurance plans.

3. The composition of current payments executed by a private pension fund.

4. Specific features of bankruptcy procedures are established with regard to private pension funds participating in mandatory pension insurance plans.

Thus, for example, the bankruptcy procedures applied to a private pension fund participating in mandatory pension insurance plans do not include the mechanisms of observation, financial recovery, external management and amicable agreements.

5. Specific features of proceedings in bankruptcy. These should last for a period of one year, and may be extended beyond that period on request of a participant in the proceedings in bankruptcy.

6. Specific procedures for bringing to responsibility the persons exercising control over a private pension fund participating in mandatory pension insurance plans.

The innovations introduced in respect of special protection of pension savings appear to be justified and are distinctly oriented to social protection measures. However, any conclusions as to their effectiveness may be drawn only after a time lapse sufficient for an adequate evaluation of their practical implementation.

In the field of general norms regulating insolvency issues the trend that had emerged in 2009 - **the toughening and more detailed elaboration of the procedure for bringing to responsibility the persons exercising control over a debtor** - has continued. While 2009 the definition of persons exercising control over a debtor was introduced, their procedural rights in bankruptcy proceedings determined, and the procedure for considering the petitions for bringing to responsibility the persons exercising control over a debtor established, in June 2013 (by Federal Law No 134-FZ, of 28 June 2013 'On the Introduction of Alterations to Some Legislative Acts of the Russian Federation in the Part of Prevention of Unlawful Financial Operations') the presumption of a debtor's bankruptcy as a result of an act of failure to act on the part of the persons exercising control over the debtor was established in the following cases:

- damage caused to the property rights of creditors as a result of a transaction concluded by the person exercising control over the relevant debtor, or concluded for the benefit of that person, or approved by that person;
- if the relevant accounting documents do not contain the necessary information on the objects entered into the records, or if that information is distorted, as a result of which the effectuation of proceedings in bankruptcy becomes more complicated. In such a case, the person responsible for the organization of accounting record-keeping should be brought to responsibility.

Besides, it is determined that the limits of subsidiary responsibility of the persons exercising control over a debtor are extended to:

- claims entered into the register of creditors;
- claims presented after the register has been closed;
- claims in respect of current payments that remained unredeemed due to insufficiency of debtor estate.

However, the scope of responsibility should be diminished if it can be proved that the damage inflicted on creditors due to any failures on the part of the person exercising control is less than the amount of claims presented to that person, which will have to be satisfied.

Another noteworthy trend is **the lower level of independence granted to a commissioner in bankruptcy**. Thus, for example, a commissioner in bankruptcy is now obliged to valuate relevant property for the purpose of selling the bankrupt company in response to a petition filed by creditors or tax agencies.

In addition, **proceedings in bankruptcy have become more open** because, from July 2012 onwards, the report on property valuation and inventory results must be entered into the Single State Register of Bankruptcies.

In December 2012¹ and July 2013², **more detailed regulation was introduced in the field of bankruptcy procedures applied to construction companies**. In particular, the new amendments establish the order in which the claims presented by the bank that has issued a surety should be satisfied; the timelines for the implementation of some measures envisaged in the framework of bankruptcy procedures applied to a construction company are changed, and so on. Thus, for example, the period for a commissioner in bankruptcy to file a petition that the claims of the participants in a construction project should be satisfied by means of transferring to them the construction company's rights to the unfinished building has been extended to 6 months (previously - 2 months). Besides, the mandatory amount to be paid by the participants in a construction project in an event of transfer of the unfinished building to them has been reduced by half – from 20 to 10% (Item 5 of Article 201.10 of the Federal Law 'On Insolvency (Bankruptcy)'), if the construction company lacks the resources to make the necessary current payments and to satisfy the claims presented by first and second priority creditors.

In July 2013 it was determined that the control functions over the bankruptcy procedures applied to financial institutions - the category which also includes insurance companies, private pension fund, etc.³ should be exercised by the Bank of Russia. The Deposit Insurance Agency exercises the powers of a liquidator of financial institutions, and also acts as a commissioner in bankruptcy in cases when such functions are envisaged by the law on public corporations. The Bank of Russia approves the list of persons to be included in the provisional administration, appoints the head of the provisional administration, etc.

In July 2013, the RF Government submitted to the State Duma draft law No 316848-6, whereby it is envisaged that proceedings in bankruptcy may be initiated by a company's employees, or even by its former employees. The necessary precondition for the initiation of initiated on these grounds is the presence of wages in arrears over a period of more than 3 months. If arrears of wages arise due to financial problems, the employer himself is obliged to file a petition in bankruptcy.

Besides, the new amendments have altered the procedure for satisfying the claims relating to wages in arrears in an event of bankruptcy. These are second priority claims, and are to be satisfied consecutively, one by one, in accordance with a calendar-based schedule. So, if the bankrupt debtor's estate is insufficient, the claims of some employees, although of the same

¹ Federal Law No 294-FZ, of 30 December 2012 'On the Introduction of Alterations to Some Legislative Acts of the Russian Federation'.

² Federal Law No 189-FZ, of 2 July 2013, 'On the Introduction of Alterations to the Federal Law 'On Insolvency (Bankruptcy)''.

³ For more details, see Article 180 of the Federal Law 'On Insolvency (Bankruptcy)'.

priority as those due to be satisfied at an earlier date, may remain unsatisfied. In order to eliminate the possibility of such situations, the claims of all the employees will at first be satisfied in amounts up to Rb 30,000. The amount of wages in arrears in excess of Rb 30,000 will then be paid in accordance with a calendar-based schedule – first those due to be paid at an earlier date, and then those due to be paid at a later date¹. The draft law was passed in the first reading in the autumn of 2013.

On the whole, it can be concluded that the pro-creditor orientation of bankruptcy procedures has become stronger, and that special measures have been introduced to prevent some entities - specialized societies, private pension funds, etc. (as defined by the State) from going bankrupt.

6.4. Financial Markets: Government Regulation vs Self-regulation

From 1 September 2013, the Federal Law 'On the Introduction of Alterations to Some Legislative Acts of the Russian Federation in Connection with the Delegation to the Central Bank of the Russian Federation of the Powers for Regulation, Control and Supervision in the Sphere of Financial Markets'² has entered into force, whereby the RF Central Bank (the Bank of Russia) is to be endowed with the powers of a federal body of executive authority over financial markets, which previously were exercised by the Federal Financial Markets Service (FFMS of Russia). As a result of integration of the Federal Financial Markets Service into the Bank of Russia, a special structural subdivision has been created - the Bank of Russia Financial Markets Service.

Although from a formal point of view the RF Central Bank is not a government body, its official functions essentially belong to the sphere of government authority, because the execution of these functions implies certain law enforcement measures, and so to a certain degree it can be viewed as a government regulator. So, what does this transfer of powers mean for those spheres of the economy that were previously subject to regulation by the Federal Financial Markets Service of Russia?

For non-bank financial institutions, one of the 'symbols' of the stronger influence exerted by the government regulator has become the draft federal law 'On Self-regulatory Organizations (SROs) in the Sphere of Financial Markets'³ submitted by the Bank of Russia in 2013.⁴

On the one hand, the aim of the new draft federal law is to provide solution to the problem posed by the absence of uniform regulation rules in the field of self-regulation on financial markets, because the activity of self-regulatory organizations (SROs) in each financial market segment is regulated by the specific law issued with regard to that segment, or is not regulated

¹ List of important documents at the stage of their approval. - *Glavnaia kniga* [General Ledger], 2013, No 16.- www.consultant.ru

² Federal Law of 23 July 2013, No 251-FZ 'On the Introduction of Alterations to Some Legislative Acts of the Russian Federation in Connection with the Delegation to the Central Bank of the Russian Federation of the Powers for Regulation, Control and Supervision in the Sphere of Financial Markets' // *Sobranie zakonodatel'stva RF* [Collection of Laws of the Russian Federation], 29 July 2013, No 30 (Part I), Article 4084.

³ See http://www.minfin.ru/common/upload/library/2013/12/main/FZ_o_SRO.pdf. As amended on 13 November 2013.

⁴ See Polezhaeva N. A. *Pravovoe regulirovanie deiatel'nosti samoreguliruemyykh uchastnikov rynka tsennykh bumag* [Legal Regulation of the Operation of Self-regulatory Organizations of Professional Participants of the Securities Market] Self-Regulatory Organizations of Professional Securities Market Participants: Membership Features// *Zakon i pravo* [Law and Justice] – 2013. – No 8. – P. 50–52. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2380625

by any legislative acts at all. On the other hand, the draft federal law's goals are declared to be as follows: to make more prominent the role of SROs in the activity of financial market participants; and to make more effective the interaction between SROs and the regulator¹.

At the meeting held on 28 November 2013, in the course of discussion on the issues of creating an international financial center in Moscow and improving the investment climate in the Russian Federation, RF Prime Minister Dmitry Medvedev spoke of the necessity to observe proper balance between the interests of participants in the self-regulation process and those of the regulator, where 'a more prominent role may and must be played by professional associations'².

Indeed, any further expansion of the powers of the government regulator over self-regulatory organizations may have a negative effect on their performance, if SROs should be deprived of at least one of the components of self-regulation, namely the right to elaborate and establish the standards and rules of professional (entrepreneurial) activity and to exercise control over compliance with said standards and rules³. However, it is precisely this trend - instead of a trend towards increasing the role of self-regulatory organizations and making more effective their interaction with the regulator - that manifests itself in the draft federal law prepared by the RF Central Bank.

Similarly to the general law on SROs adopted in 2007⁴, the new draft federal law puts forth only the general principles of financial market self-regulation, with no regard for the specificities of each type of self-regulatory organization.

It should be noted that the general law on SROs had initially been elaborated exclusively as a law on self-regulatory organizations operating on financial markets. However, it was not properly coordinated with the Bank of Russia and the FFMS of Russia, and so was not applicable to part of the existing financial markets⁵.

One of the innovations to be introduced by the draft federal law, which makes questionable the freedom of SROs, relates to expanding the sphere of legislative regulation of the standards and rules applicable to self-regulatory organizations, and expanding the corresponding powers of the regulator as well (Article 4, 5, 6).

In accordance with the draft federal law prepared by the RF Central Bank, the self-regulatory organizations operating on financial markets will be obliged to develop and adopt mandatory internal standards of SROs, and also to develop, approve and coordinate with the Bank of Russia mandatory uniform basic standards for each type of SRO.

In order to be granted the status of a SRO, a not-for-profit organization will be obliged to adopt the basic standards previously coordinated with the RF Central Bank. Besides, those standards may also become mandatory for all financial organizations of a certain type, irrespective of the fact of their membership in a SRO.

The Bank of Russia is planning to be able both to establish the lists of internal and basic standard (to be developed and adopted by self-regulatory organizations in a mandatory

¹ See <http://regulation.gov.ru/index.html>.

² See <http://government.ru/>.

³ See Item 1 of Article 2 of Federal Law of 1 December 2007, No 315-FZ 'On Self-regulatory Organizations' // *Sobranie zakonodatel'stva RF* [Collection of Laws of the Russian Federation], 3 December 2007, No 49, Article 6076.

⁴ Federal Law of 1 December 2007, No 315-FZ 'On Self-regulatory Organizations'.

⁵ See V. S. Pleskachevsky's speech at 3rd All-Russian Forum of Self-regulatory Organizations, entitled 'Self-regulation in Russia: Experiences and Prospects for Development' held in the framework of *Russian Business Week 2013* (organized by the Russian Union of Industrialists and Entrepreneurs (RSPP)), 19 March 2013.

procedure) and to determine the scope, content and forms of the relations between public organizations requiring regulation. These standards must be compatible not only with Russian legislation, but also with the normative acts issued by the Bank of Russia (while the requirements stipulated therein are as yet unknown).

The existing legislative norms applied specifically to each sector¹ usually overlook the issue of the regulator's participation in the elaboration and enforcement of these standards and rules, leaving them within the discretion of the self-regulatory organizations.

In this connection it should be noted that the participants in the self-regulation process are usually more willing to comply with the requirements established by their own organizations rather than with the standards and rules imposed on them from above. Thus, for example, the self-regulation model that was applied in the US securities market prior to 2007, relied on two major self-regulatory organizations: the New York Stock Exchange (NYSE) and the National Association of Securities Dealers, Inc. (NASD).

The former organization was created on the initiative of market participants, who also established the standards and rules for their operation. The NYSE's members were anxious to uphold their organization's reputation, and so their services were in great demand among holders of securities and other clients. The NASD, on the contrary, was created with the active assistance of the US Administration (Maloney Act of 1938), and its members did not participate in the elaboration of standards and rules. The relevant standards and rules were agreed upon between the self-regulatory organization's board and the government regulator, and represented in the main references to normative acts issued by the regulator. So, the NASD did not enjoy one of the main advantages of self-regulation – the possibility for its members to take part in the development of standards and rules, conducive to ensuring a high level of professional requirements.

If the provisions stipulated in the draft federal law put forth by the RF Central Bank are implemented into actual practice, SROs may find themselves in a situation similar to that faced by the NASD, further complicated by the fact that the government regulator will probably also participate in the decision-making concerning the appointment of heads of self-regulatory organizations (of which more will be said later).

The second innovation to be introduced by the draft federal law developed by the Bank of Russia may be detrimental to the interests of SROs in the sphere of financial markets - and consequently, to their members' interest - has to do with imposing constraints on the supervisory functions exercised by SROs. At present, the constitutional (or charter)

¹ Federal Law of 22 April 1996, No 39-FZ 'On the Securities Market' // *Sobranie zakonodatel'stva RF* [Collection of Laws of the Russian Federation], No 17, 22 April 1996, Article 1918; Federal Law of 29 November 2001, No 156-FZ 'On Investment Funds' // *Sobranie zakonodatel'stva RF* [Collection of Laws of the Russian Federation], 3 December 2001, No 49, Article 4562; Federal Law of 7 May 1998, No 75-FZ 'On Non-state Pension Funds' // *Sobranie zakonodatel'stva RF* [Collection of Laws of the Russian Federation], No 19, 11 May 1998, Article 2071; Law of the Russian Federation of 27 November 1992, No 4015-1 'On the Organization of Insurance Business in the Russian Federation' // *Rossiiskaia gazeta* [The Russian Newspaper], No 6, 12 January 1993; Federal Law of 2 July 2010, No 151-FZ 'On Microfinancial Activity and Microfinancial Organizations' // *Sobranie zakonodatel'stva RF* [Collection of Laws of the Russian Federation], 5 July 2010, No 27, Article 3435; Federal Law of 18 July 2009, No 190-FZ 'On Credit Cooperation' // *Sobranie zakonodatel'stva RF* [Collection of Laws of the Russian Federation], 20 July 2009, No 29, Article 3627; Federal Law of 30 December 2004, No 215-FZ 'On Housing Saving Cooperatives' // *Sobranie zakonodatel'stva RF* [Collection of Laws of the Russian Federation], 3 January 2005, No 1 (part 1), Article 41; Federal Law of 8 December 1995, No 193-FZ 'On Agricultural Cooperation' // *Sobranie zakonodatel'stva RF* [Collection of Laws of the Russian Federation], 11 December 1995, No 50, Article 4870.

documents of some self-regulatory organizations contain provisions concerning supervision over the operation of their members¹.

The RF Central Bank has specified that SROs may supervise the activity of their members only on condition that the corresponding powers have been delegated to them by the Bank of Russia (Article 7). In this connection, the procedure for the delegation of such powers, as well as the procedure and grounds for the termination of such powers are to be established by the RF Central Bank individually for each type of self-regulatory organizations (all organizations of the same type may only be granted an identical set of powers). The delegation to SROs of supervisory powers does not entail the loss of such powers on the part of the Bank of Russia.

Besides, the following functions are also performed by a self-regulatory organization in an event of being endowed with the relevant special powers by the Bank of Russia: receipt of reporting documents from members of SRO; attestation of their heads, their members and their personnel; participation as observers, via representatives, in the audits of their members conducted by the RF Central Bank and government bodies.

Thus, the RF Central Bank is building a new system for regulating the operation of SROs on financial markets, with the regulator's active participation. It is noteworthy that the extent of that participation is to be determined by the regulator itself - a circumstance that may have a negative effect on the realization of the interests of self-regulatory organizations and their members, because no guarantees are envisaged in the draft federal law that the Bank of Russia will actually grant SROs full access to the procedure of development and implementation of their professional standards and rules, or to supervision over their enforcement.

In contrast to the currently applied model of self-regulation in the sphere of financial markets, which is based on the principle of a voluntary association, the draft federal law proposed by the RF Central Bank establishes that membership in a SRO should be mandatory (Article 9). At the same time, licensing is not abolished, although it actually makes sense only if membership in a self-regulatory organization is voluntary.

According to the draft federal law submitted by the Bank of Russia, the following types of self-regulatory organizations may be created in the sphere of financial markets (Article 3): (1) self-regulatory broker organizations; (2) dealers; (3) managers; (4) depositories; (5) registrars; (6) joint-stock investment funds and asset managers of investment funds, mutual funds and non-governmental pension funds; (7) specialized depositories; (8) non-governmental pension funds; (9) insurance companies, insurance brokers, mutual insurance companies; (10) micro-financial organizations; (11) credit consumer co-ops; (12) housing saving co-ops; (13) credit history bureaus; (14) actuaries; (15) rating agencies; (16) agricultural credit consumer co-ops.

At present, membership in a self-regulatory organization is mandatory only for agricultural credit consumer co-ops² and credit co-ops, with the exception of second-tier credit co-ops³.

The introduction of the principle of mandatory membership can be motivated by the interests of holders of securities and other clients of financial organizations, because it helps

¹ See Subitem 'e' of Item 2.1 of the Charter of the Russian National Association of Securities Market Participants (NAUFOR); paragraph 4 of Item 2.2 of the Charter of the Professional Association of Registrars, Transfer Agents and Depositories (PARTAD).

² Item 3 of 7 Article 31 of Federal Law of 8 December 1995, No 193-FZ 'On Agricultural Cooperation' // *Sobranie zakonodatel'stva RF* [Collection of Laws of the Russian Federation], 11 December 1995, No 50, Article 4870.

³ Item 3 of Article 35 of Federal Law of 18 July 2009, No 190-FZ 'On Credit Cooperation' // *Sobranie zakonodatel'stva RF* [Collection of Laws of the Russian Federation], 20 July 2009, No 29, Article 3627.

in establishing additional control over the activity of SROs. However, the mandatory double control (licensing and self-regulation) coupled with broader powers granted to the government regulator is by no means a guarantee of the best possible protection of clients' interests.

It seems that what clients are concerned with is by no means limited to the protection of their interests: their main priority, in fact, is to secure their profits. The presence in the market of several SROs based on the principle of voluntary membership makes them compete between themselves, improve their performance standards and rules for attracting clients, while their clients have opportunities for making a choice between several financial organizations – members of one or other self-regulatory organization.

The draft federal law put forth by the RF Central Bank also establishes that a SRO of a certain type must have, among its members, no less than 30% of financial organizations operating in a given field. Associated members¹ cannot be included in the total number of members sufficient for the creation of a self-regulatory organization.

According to the new draft federal law, any financial organization may be a member of only one SRO of a certain type. If a financial organization operates in several different fields, it may become a member of several self-regulatory organizations at once, or of one self-regulatory organization uniting several types of SROs. In the latter case, a self-regulatory organization may be created on condition that the number of its members operating in each given field amounts to no less than 30% of the total number of financial organizations it unites. Consequently, it may unite no more than three SROs of each type.

At present, under the general rule, in order to gain the status of a self-regulatory organization, a not-for-profit organization must unite no less than 100 professional entities (or no less than 25 subjects of entrepreneurial activity) of a certain type, in not otherwise specified by the existing federal laws². The prevailing legislation whereby the activity of those SROs on financial markets is regulated, which are not subject to the 2007 general law on self-regulatory organizations (SROs of funds and the organizations which, by agreements with funds, keep their pension saving accounts; asset managers; housing saving co-ops), sets no floor for the number of their members. One exception is the SROs of professional securities market participants (no less than 10 members). So, no restrictions are imposed on the number of self-regulatory organizations.

Besides, the Bank of Russia intends to establish the procedure for ensuring that heads of SROs comply with the requirements to their professional qualifications. The Bank of Russia is also going to reserve the right to approve or reject the proposed candidacy of a SPO's head (Article 26).

At present, the head of a self-regulatory organization is appointed to that post or dismissed from it by decision of that organization's responsible body.

One more important provision stipulated in the draft federal law is that the heads of SROs (or other persons representing their interests) and the boards of SROs represented by their chairpersons, which may be elected by the self-regulatory organizations from among their heads, may represent the interests of these SRO at the Bank of Russia, but only with the right of an advisory vote.

¹ For more details on associated membership, see Article 10 of the draft federal law prepared by the Bank of Russia.

² Subitem 1 of Item 3, Article 3 of Federal Law of 1 December 2007, No 315-FZ 'On Self-regulatory Organizations'.

However, the rights and responsibilities of the said representatives at the Bank of Russia, including their right to act on the issues relating to the core activity of each self-regulatory organization, are to be determined by the Bank of Russia (Article 32).

One of the main functions of a SRO is to represent the interests of its members in their relations with federal bodies of state authority, bodies of state authority of RF subjects, and bodies of local self-government. The participation of the government regulator in appointing the representatives of organizations subordinated to them - in this case heads of self-regulatory organizations - may be contrary to the interests of those organizations.

By way of summing up, it can be said that, in this phase of development, the replacement of one regulator by another has had no influence on the procedures applied in regulating the activity of SROs on financial markets. Market participants still retain a considerable degree of independence in regulating their own activity. Nevertheless, if the provisions stipulated in the draft federal law "On Self-regulatory Organizations in the Sphere of Financial Markets" put forth by the Bank of Russia are adopted and implemented in actual practice, the influence exerted by the government regulator will become stronger, and the burden imposed on financial market participants (financial organizations) - heavier. Moreover, there is a possibility that the very idea of a SRO may vanish as a result of such alterations, although the formal status of these organizations will be preserved.

6.5. The Real Estate Market in the Russian Federation

6.5.1. The Land Plots Market

According to data released by the Federal Service for State Registration, Cadastre and Cartography (*Rosreestr*), the total land area in the ownership of RF individuals continues to be on the decline, amounting as of 1 January 2013 to 118.3 million hectares (m ha), or 6.9% of the total land surface in the Russian Federation, vs. 119.5m ha (7.0%) in 2012 (*Table 16*). By contrast, the land area in the ownership of legal entities has been on the rise, increasing over the course of last year by 1.2m ha to 14.7m ha, or 0.9% of the total land surface in the RF. Of these lands, 755.7 thousand ha is represented by participatory shares, formerly in the right of common ownership, purchased by legal entities from individuals. The total area of land plots in state or municipal ownership increased only slightly – by 0.7m ha (*Table 16*).

Table 16

The Structure of the Russian Federation's Land Area, by Form of Ownership

Form of ownership	01.01.2010		01.01.2011		01.01.2012		01.01.2013	
	m ha	%	m ha	%	m ha	%	m ha	%
In state and municipal ownership	1,576.3	92.2	1,576.4	92.2	1,576.7	92.2	1,576.8	92.2
In the ownership of individuals, including:	123.2	7.2	121.4	7.1	119.6	7.0	118.3	6.9
Land shares of individuals	104.3	6.1	100.8	5.9	97.6	5.7	94.9	5.6
In the ownership of legal entities	10.3	0.6	12.1	0.7	13.5	0.8	14.7	0.9
In private ownership, total	133.5	7.8	133.4	7.8	133.1	7.8	133.0	7.8

Source: The State (National) Report On the State and Use of Lands in the Russian Federation in 2012.

As of 1 January 2013, the bulk of Russia's privatized land remained in common share ownership, including unclaimed land shares. In 15 RF subjects, the share of privatized land as of 1 January 2013 amounted to 40% or more of their total land fund. These are situated, in the main, in the south or southwest of Russia. In 11 RF subjects, the share of privatized land was

less than 1%. Only the Southern Federal District managed to climb above the 40% privatization threshold (*Table 17*).

Table 17

The Rate of Land Privatization, by RF Federal District, as of 1 January 2013

RF federal districts	Total land area, m ha	Land owned by individuals, m ha	Land owned by legal entities, m ha	Privatization of land by individuals, as % of total	Privatization of land by legal entities, as % of total	Place with regard to amount of land owned by individuals
Russian Federation	1,709.8	118.3	14,720.2	6.9	0.9	
Southern Federal District	42.1	18.2	1.4	43.2	3.4	I
Central Federal District	65.0	19.8	4.9	30.4	7.5	II
Volga Federal District	103.7	31.2	4.6	30.1	4.4	III
North Caucasian Federal District	17.0	4.2	0.4	24.9	2.6	IV
Siberian Federal District	514.5	29.5	1.7	5.7	0.3	V
Urals Federal District	181.8	9.0	0.8	4.9	0.4	VI
North Western Federal District	168.7	4.2	0.6	2.5	0.4	VII
Far Eastern Federal District	616.9	2.1	0.3	0.3	0.1	VIII

Source: The State (National) Report On the State and Use of Lands in the Russian Federation in 2012.

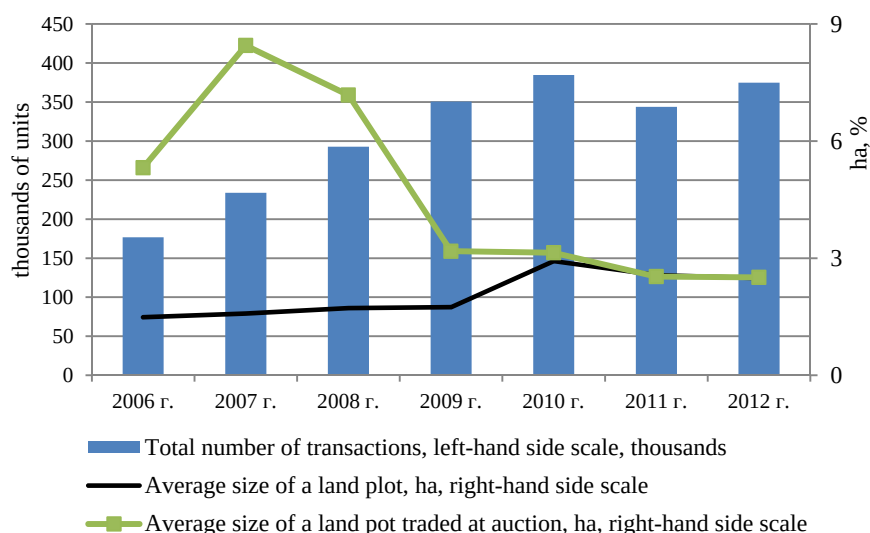
In the Russian Federation, the bulk of land involved in market turnover is represented by land plots in state and municipal ownership, which are offered for lease. As of 1 January 2013, the deals of lease amounted to 59.1% of the total number of land transactions, and to 77.2% in terms of land area. The number of lease agreements increased on 2011 from 3.3m (159.4m ha) to 3.4m (156.9m ha). The total number of land plots brought into turnover as of 1 January 2013, including leased land plots in state and municipal ownership, was 5.8m, their total area - 203.4m ha.

Specifically, over the course of 2012 a total of 2.8m transactions with land plots were concluded (their total land area amounting to 60.9m ha); of these, 39.3m ha was taken up by private land, in respect of which individuals and legal entities closed 2.0m deals, which represents a rise on 2011 by 48.6% in terms of land area, and by 21.1% in terms of number of transactions. The share of transactions with private land plots in 2012 exceeded that of transactions involving state and municipal land, and amounted to 64.6% in terms of land area and to 70.5% in terms of number of transactions. This type of land takes up 29.6% of the entire amount of land in private ownership. The share of private land plots brought into turnover varies from 2.7% (0.1m ha) in the North Caucasian Federal District to 49.1% (15.3m ha) in the Siberian Federal District.

In 2012, the number of sales of state and municipal lands increased on 2011 by 9.0% to 0.4m, while the land area sold increased by 5.5% – to 0.9m ha, and the average size of a sold land plot shrank by 3.2% – to 2.5 ha (*Fig. 5*). The number of transactions involving state and municipal land sales at auctions increased on 2011 by 18.3% (from 29.3 thousand to 34.7 thousand plots), while the amount of sold land increased by 17.3% (from 74.2m ha to 87.0m ha), and the average area of a land plot sold at an auction shrank by 0.85% – to 2.51 ha (*Fig. 5*).

In 2012, the share of state and municipal land sales at auctions amounted to 9.3% of the total volume of sales of land in state and municipal ownership, both in terms of the number of transactions and the land area sold. Individuals and legal entities purchased at auctions a total of 34.7 thousand state and municipal land plots. The bulk of land plots sold at auctions are situated in inhabited localities, and the majority of these plots will be used by the buyers for

individual housing and *dacha* construction (17,171 land plots with the total area of 5,419.0 ha), as well as for gardening, vegetable gardening and animal husbandry, or for conducting personal subsidiary economy (6,509 land plots with the total area of 1,732.7 ha) (Table 18). In most cases, the price of land sold at auctions is higher than the buyout price for land in state and municipal ownership based on the established land price norms.



Source: The State (National) Report On the State and Use of Lands in the Russian Federation in 2012.

Fig. 5. The Dynamics of Sales of State and Municipal Lands, 2006-2012

Table 18

Total Sales at Auctions, in 2012, of State and Municipal Land in the Russian Federation,

	inside inhabited localities			outside of inhabited localities		
	number of transactions, units	total area, ha	price per m ² , Rb	number of transactions, units	total area, ha	price per m ² , Rb
To individuals, for the purposes of:						
individual housing or dacha construction	17,171	5,419.0	347.2	1,542	1,138.4	82.7
conducting personal subsidiary economy, gardening, vegetable gardening, and animal husbandry	6,509	1,732.7	52.6	610	278.5	52.4
other purposes	4,411	1,700.3	560.7	362	2,622.4	39.0
To legal entities (except agricultural organizations):						
to be used for industrial or other special purposes	558	588.1	222.3	167	1,355.9	53.3
for other purposes	1,342	5,356.3	493.8	113	822.3	18.5
To peasant (or farmer) households, agricultural companies and other organizations for the purposes of agricultural production	146	1,679.5	33.7	1775	64,288.0	7.7
Total	30,137	16,475.9	X	4,569	70,505.4	X

Source: The State (National) Report On the State and Use of Lands in the Russian Federation in 2012.

The average price of land plots situated in inhabited localities and designated for individual housing or *dacha* construction in 2012 increased 2.5 times on 2011 across the Russian Federation, while that of land plots situated outside of inhabited localities went up 4.6 times.

The price of land plots designated for conducting personal subsidiary economy, gardening, vegetable gardening, and animal husbandry inside inhabited localities rose 2.3 times, and that of land plots situated outside of inhabited localities increased by 58.1% (*Table 19*).

Table 19

The Average Per Square Meter Prices, in Rubles, of State and Municipal Land Plots Sold to Individuals and Legal Entities in the Russian Federation in 2012, and Their Change on 2011, %

RF federal districts	To individuals and their associations, for the purposes of:				To legal entities, in order to be used for industrial or other special purposes		To peasant (or farmer) households and agricultural organizations	
	individual housing or dacha construction		conducting personal subsidiary economy, gardening, vegetable gardening, and animal husbandry					
	inside inhabited localities	outside of inhabited localities	inside inhabited localities	outside of inhabited localities	inside inhabited localities	outside of inhabited localities	inside inhabited localities	outside of inhabited localities
Russian Federation	136.1	19.8	28.3	12.9	131.5	35.1	4.0	17.8
percent change	147.7	360.3	132.8	58.1	4.3	-46.1	-79.1	376.7
Central Federal District	58.7	74.1	38.3	10.9	186.1	21.2	7.0	3.4
percent change	-28.4	3,412.3	83.1	-30.2	-3.5	-87.7	-90.4	33.2
North Western Federal District	539.0	29.5	72.0	16.1	77.7	47.9	8.9	4.6
percent change	705.3	210.8	334.5	25.5	-21.8	53.1	218.7	645.9
Southern Federal District	159.1	3.6	52.9	21.5	309.4	150.3	5.3	122.5
percent change	1,376.8	–	783.8	2,287.8	273.6	121.8	75.7	11,564.8
North Caucasian Federal District	133.9	–	3.0	4.5	209.4	6.8	1.8	2.8
percent change	42.9	–	19.8	1465.5	188.5	-73.1	0.0	164.2
Volga Federal District	48.9	24.7	19.6	25.0	101.6	21.9	3.0	2.8
percent change	5.7	30.4	61.2	183.5	-40.8	-71.6	11.0	44.9
Urals Federal District	28.3	0.2	13.0	1.9	49.5	13.5	2.6	5.4
percent change	18.1	-92.4	-14.0	-56.3	-74.1	-82.0	413.7	790.2
Siberian Federal District	54.0	3.0	8.2	10.6	71.2	14.7	1.6	0.4
percent change	11.6	116.9	4.7	3.2	-49.9	-64.7	-96.4	-98.3
Far Eastern Federal District	67.0	3.9	19.3	12.8	47.0	4.5	1.9	0.8
percent change	-0.7	38,500.0	19.6	4.1	-14.8	-85.2	-91.9	23.4

Source: The State (National) Report On the State and Use of Lands in the Russian Federation in 2012 and the State (National) Report On the State and Use of Lands in the Russian Federation in 2012.

As of 1 January 2013, the average lease payment for land plots used for housing and *dacha* construction, situated in inhabited localities, rose 2.5 times on 2011 – to Rb 3.3 per square meter, and that for land plots used for conducting personal subsidiary economy rose 6.4 times - to Rb 14.5 per square meter. Over the same period of time, the average lease payment for land plots used for housing and *dacha* construction and situated outside of inhabited localities increased 2.4 times, and that for land plots used for conducting personal subsidiary economy and vegetable gardening dropped by 69% (*Table 20*).

In 2012, the number of transactions involving purchase and sale of land plots in private ownership was 1.1m (*Fig. 6*), while the total area of land subject to those transactions was 20.9m ha. By comparison with 2011, the number of transactions increased by 24.4%, while

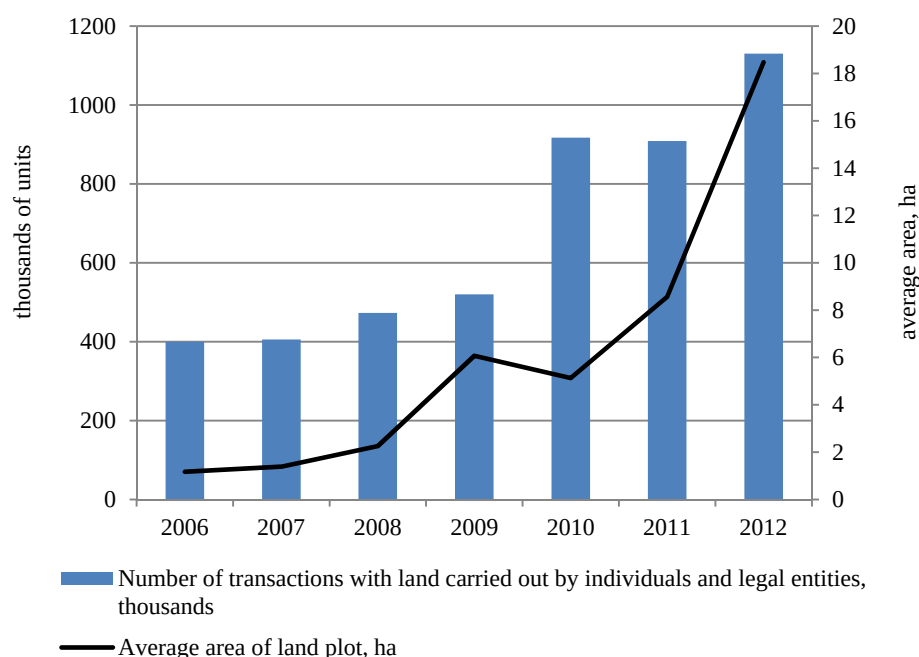
the total area of land subject to those transactions rose by 168.2%. The average area of a land plot grew by 115.6% to 18.5 ha.

Table 20

**The Average Per Square Meter Lease Payments, in Rubles,
for the Use of State and Municipal Lands in the Russian Federation**

Individual leasers and their associations using leased land plots for the purposes of:	2009		2010		2011		2012	
	inside inhabited localities	outside of inhabited localities	inside inhabited localities	outside of inhabited localities	inside inhabited localities	outside of inhabited localities	inside inhabited localities	outside of inhabited localities
housing and <i>dacha</i> construction	13.4	1.3	17.3	0.9	13.4	0.8	33.3	1.8
conducting personal subsidiary economy, gardening, and vegetable gardening	1.5	0.2	2.0	1.1	2.3	7.0	14.5	2.2

Source: The State (National) Report On the State and Use of Lands in the Russian Federation in 2012.



Source: The State (National) Report On the State and Use of Lands in the Russian Federation in 2012.

Fig. 6. The Dynamics of Sale and Purchase Transactions with Privately Owned Land Plots Concluded by Individuals and Legal Entities, 2006-2012

Land mortgages accounted for 7.6% of a total of nearly two millions of transactions with privately owned land plots concluded in 2012, which represented a 0.86 pp. rise on 2011 (Table 21). In 2012, the highest share of land mortgages in the structure of land transactions was observed in the North Caucasian Federal District (11.8%), the lowest share (similarly to 2011) – in the Urals Federal District (4.8%). The leader in the number of land mortgages concluded in 2012 was the Central Federal District.

Table 21

**The Number of Transactions with Privately Owned Land Plots Concluded
in the Russian Federation in 2012**

RF federal districts	Land sale	Gift	Inheritance	Pledge	Total number of transactions	Pledge transactions, as a percentage of the total number of transactions, %	
						2012	2011
Russian Federation	1,130,449	218,811	460,247	148,932	1,958,439	7.6	6.7
Central Federal District	324,752	69,487	152,859	38,881	585,979	6.6	5.0
North Western Federal District	72,876	19,314	33,276	6,359	131,825	4.8	5.5
Southern Federal District	186,645	23,181	64,414	30,130	304,370	9.9	6.1
North Caucasian Federal District	49,173	8,664	15,361	9,809	83,007	11.8	10.9
Volga Federal District	228,178	55,775	113,523	31,930	429,406	7.4	8.2
Urals Federal District	106,604	9,599	26,445	7,181	149,829	4.8	2.6
Siberian Federal District	137,849	26,946	41,176	21,750	227,721	9.6	12.6
Far Eastern Federal District	24,372	5,845	13,193	2,892	46,302	6.3	4.8

Source: The State (National) Report On the State and Use of Lands in the Russian Federation in 2012.

In 2012, the ratio between the total area of pledged land plots and the total area of land in the ownership of individuals and organizations fluctuated from 0.3% in the North Caucasian Federal District to 4.1% in the Central Federal District. This index, in 2012, for the Russian Federation as a whole amounted to 1.8%, which represents a drop by 0.83 pp. on 2011. Most of the pledged land plots were land plots designated for agricultural use. In 2011, the proportion of mortgaged land designated for agricultural use to the total area of pledged land decreased by 3.26 pp. - to 82.8% (*Table 22*).

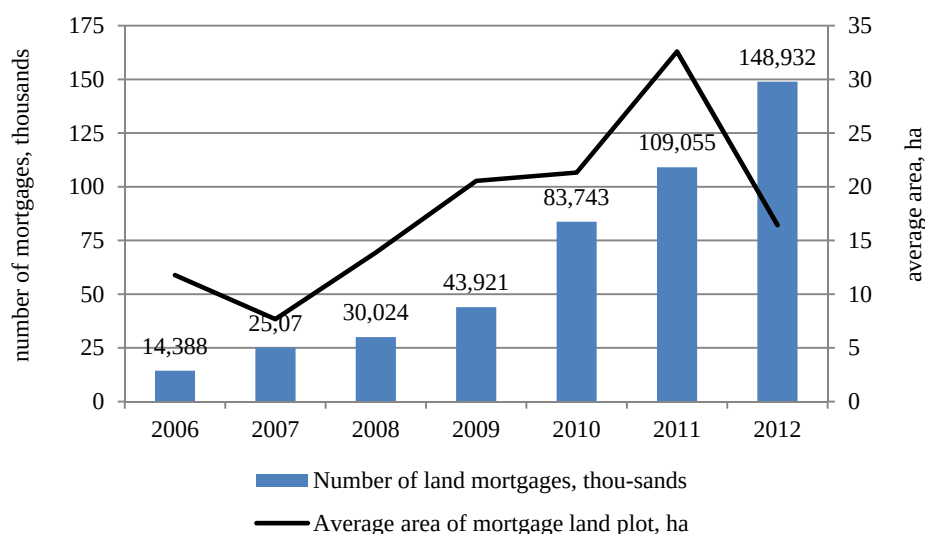
Table 22

**A General Characteristic of Pledges of Land in the Russian Federation,
As of 1 January 2013**

RF federal districts	Land owned by individuals and legal entities	Of which in the state of being pledged		Including mortgages of land designated for agricultural use	
	2012	2012	2011	2012	2011
	m ha	%	%	%	%
Russian Federation	133.0	1.8	2.7	82.8	79.5
Central Federal District	24.7	4.1	10.0	89.7	96.4
North Western Federal District	4.9	0.9	0.8	71.9	53.4
Southern Federal District	19.6	1.2	0.4	82.1	59.8
North Caucasian Federal District	4.7	0.3	0.3	63.8	88.1
Volga Federal District	35.8	1.9	1.7	95.4	95.9
Urals Federal District	9.8	0.9	0.8	60.6	18.4
Siberian Federal District	31.2	1.1	0.8	45.3	64.3
Far Eastern Federal District	2.4	0.6	0.8	65.1	61.1

Source: The State (National) Report On the State and Use of Lands in the Russian Federation in 2012.

The year 2012 saw a total of 148,932 pledge transactions with land plots (or mortgages), which represents a 36.6% rise on 2011 (*Fig. 7*). At the same time, the total area of pledged land amounted to 2.4m ha, which is by 31.1% less than in 2011. In 2012, the average area of a pledged land plot amounted to 16.4 ha, which represents a decline by half on 2011.



Source: The State (National) Report On the State and Use of Lands in the Russian Federation in 2012.

Fig. 7. The Dynamics of Pledges of Land Plots
by Individuals and Legal Entities

According to *Rosreestr*, in early 2013, a total of 7.8m families held land plots designated for individual housing construction, their total area amounting to approximately 1m ha. Of these land plots, 31% were held by right of inheritable possession for life (already null and void), by right of permanent (or infinite) use, or by right of temporary use of land in state ownership (Table 23).

Table 23

**The Structure of the Ownership of Lands Granted
for Individual Housing Construction**

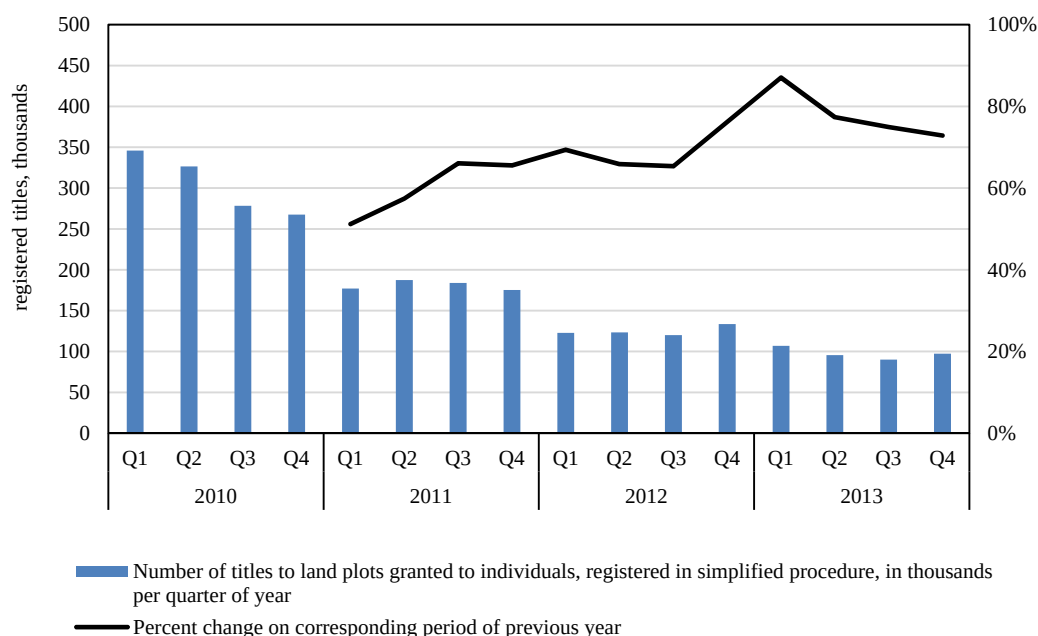
	2011		2012	
	thousands of ha	%	thousands of ha	%
in private ownership	514.3	55.3	546.2	56.7
in state and municipal ownership including:				
in permanent (or infinite) use	206.2	22.2	202.7	21
under lease	110.8	11.9	119.1	12.3
in free-of-charge temporary use (or temporary use)	2.2	0.2	3.5	0.4
in inheritable possession for life	56.2	6	54.8	5.7
without right to land being formalized	41.1	4.4	37.5	3.9
Total	930.8	100	963.8	100

Source: The State (National) Report On the State and Use of Lands in the Russian Federation in 2012.

According to data released by *Rosreestr*, the positive effect of the ‘*dacha* amnesty’ – the simplified procedure for individuals to register their titles to land plots granted to them prior to the enactment of the RF Land Code for conducting personal subsidiary economy, *dacha* construction, gardening, vegetable gardening, individual garage construction or housing construction – has become less visible (Fig. 8). Over 2013, a total of 389.8 thousand land acts were registered in the framework of the ‘*dacha* amnesty’, which represents a drop by 22.0% on 2012.

At the same time, according to *Rosreestr*, quite often it happens so that the liquidation or reorganization of an organization holding a land plot is not followed by a proper registration of the altered right to land. As of 1 January 2013, the holders of rights to a total of 16.9m ha

of agricultural land, which is still kept on state cadastre records, have been stricken off the corresponding registers of legal entities and individual rights holders. In other words, the rights still exist, while the holders of those rights have disappeared – thus giving rise to all sorts of related legal and tax collisions. The total area of this type of land shrank on 2011 by 34.2 thousand ha.



Source: data released by Rosreestr.

Fig. 8. The Dynamics of Registration, in the Simplified Procedure, of Titles to Land Plots Granted to Individuals

The highest numbers of individuals holding land plots designated for housing construction as of 1 January 2013 were recorded in Krasnodar Krai (448.1 thousand), in Moscow Oblast (412.0 thousand), in Kemerovo Oblast (313.2 thousand), in Sverdlovsk Oblast (283.8 thousand), in Irkutsk Oblast (255.6 thousand), and Voronezh Oblast (200.6 thousand), in Stavropol Krai (209.9 thousand), in the Republic of Bashkortostan (201.1 thousand), in Volgograd Oblast (182.8 thousand), the Chechen Republic (178.8 thousand), the Republic of Tatarstan (176.7 thousand), and Saratov Oblast (175.2 thousand).

According to data released by Rosreestr, the number of registrations of individual right of ownership to a land plots as of 1 January 2014 amounted to almost 6 million, which represented a 4.1% increase on 1 January 2013. The same index for the registered rights of legal entities to land plots, on the contrary, declined by 8.7%, amounting as of the same date to 277.4 thousand. The rate of lease of land plots by individuals (85.6 thousand acts) over the same period of time increased by 2.1%, and the same index for the lease of land by legal entities rose 2.1 times, to 67.5 thousand.

By comparison with 2012, over the four quarters of 2013 the number of registered mortgages of land plots by individuals increased by 29.6%, to 550.8 thousand, while the same index for legal entities increased by 17.21%, to 163.7 thousand.

The results of State cadastre land valuation, represented as the cadastre value of a land plot in accordance with the norms stipulated in the Tax Code of the Russian Federation (the RF TC), are applied as tax base for levying land tax. The actual amount of land tax is determined by the land tax rate, estimated as a percentage of a land plot's tax base (its cadastre value) in accordance with legal acts issued by the representative bodies of municipal formations. According to *Rosreestr*, the majority of representative bodies of municipal formations have decided that the rates of land tax in the territories under their jurisdiction should be set at their ceiling stipulated in the RF TC (as a percentage of a land plot's cadastre value).

As evident from data released by the Federal Tax Service of Russia (RF FTS), in 2012 the amount of collected land tax, as estimated on the basis of the cadastre value of land plots, was Rb 141.0bn, which represents a rise of 15.4% on the corresponding period of 2011 (Rb 122.2bn).

According to *Rosreestr's* experts, the data on land transactions indeed reflect the main trends in the development of Russia's land market; however, errors in the estimated values of some of the relevant indices may be as high as 20%. The principal cause of such errors, in the opinion of experts, is the lack of proper legal and normative regulation of information exchange in the field of registration of rights to land plots and land transactions at the level of municipal formations.

However, to adequately promote the development of market land turnover mechanisms, it is not sufficient to simply organize an exchange of information at the administrative level. It is also necessary to ensure transparency of information on land transactions for all market participants. The key role in that field has been played, over the past 25 years, by the system of State registration of rights to real estate (currently represented by *Rosreestr*), whose records have accumulated detailed information on real estate deals resulting in alteration or transfer of titles to land. However, while *Rosstat* releases timely updates of housing market prices at frequent intervals (in fact, independently of *Rosreestr*), the averaged statistics of transactions with land plots, including information on land prices, can be found only in the Government (National) Report 'On the State and Use of Land in the Russian Federation', which is prepared and released on an annual basis. *Rosreestr's* quarterly reports contain only data on the number of completed registration acts, with no mention of transaction prices or any description of the objects of completed transactions. Meanwhile, the number of registration acts does not always reflect the actual number of completed transaction and objects of those transactions.

The price component of land turnover is strongly influenced by two factors. Firstly, as follows from data published in the Government (National) Report, only 10% of state and municipal land is sold at auctions; the rest, including the huge area of leased land, is handled in accordance with the established government norms. The other factor is the introduction of the cadastre value index, whose purpose essentially is to reflect the realities of the as yet non-existent land market.

Besides, there is a methodological gap between the pricing procedures applied to residential housing units (or buildings) and to land plots. It results in a distortion (primarily in an urban setting) of the existing housing market pricing mechanism, when the value of a housing unit is determined not so much by the construction costs involved in its creation, as its location. If the sale of housing units is subject to market mechanisms, while the relevant land plots designated for housing construction are obtained via barter deals or granted in

accordance with government norms, the land rent that could have been part of state or municipal budget revenue will instead be seized by construction companies.

In spite of all these difficulties, in 2012 the turnover of one-third (or 29.6%) of private land was higher than that of state and municipal land; its share in the total land turnover for that year amounted to 64.6% in terms of area of land, and to 70.5% in terms of number of transactions.

6.5.2. The Dynamics of Residential Housing Commissioning

The situation in Russia's residential housing market over the past year was largely determined by the near-stagnation macroeconomic situation and the current phase of market development, which resulted in a multi-vectored movement of prices in the housing markets of different cities, because in most of them the period of post-crisis recovery was already over¹, while some cities were still struggling with the consequences of the crisis.

In 2013 the housing construction sector, for a third year in a row since the end of the financial and economic crisis, displayed a rising residential housing commissioning rate (a rise of 5.6% on 2012).

Over the course of 2013, 912.1 thousand apartments with the total floor area of 69.4m square meters were commissioned (*Table 24*); it is noteworthy that the housing commissioning rate was on the rise over the first three quarters, and then in Q4, contrary to the traditional trend of many years, it demonstrated a slight drop on its previous year's index.

Table 24

The Commissioning of Residential Housing in Russia in 1999-2013

Year	Total floor area, in millions of square meters	Rate of growth, %	
		on previous year	on 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	167.0
2007	61.2	120.9	202.0
2008	64.1	104.7	211.5
2009	59.9	93.4	197.7
2010	58.4	97.5	192.7
2011	62.3	106.6	205.6
2012	65.7	104.7	216.8
2013	69.4	105.6	229.9

Sources: *Rossiiskii statisticheskii ezhegodnik*. 2007 [Russia: Statistical Yearbook 2007]: M., Rosstat, 2007. P. 507; *Rossiiskii statisticheskii ezhegodnik*. 2011 [Russia: Statistical Yearbook 2011]: M., Rosstat, 2011. P. 461; *O zhilishchnom stroitel'stve v 2013* [On Housing Construction in 2013] www.gks.ru; the authors' calculations.

In 2013, the share of individual housing construction in the total area of completed residential housing units in Russia as a whole amounted to 43.8%, which roughly corresponds to last year's index. In a number of regions (Altai, Tyva, Dagestan, Kabardino-Balkaria, Karachay-Cherkessia and Chechnya, Belgorod Oblast and Tambov Oblast), the share

¹ Sternik G. M. Zakonomernosti poslekrizisnogo vosstanovleniia rynka zhilia gorodov Rossii [The Typical Features of Post-crisis Housing Market Recovery in Russia's Cities // *Finansovyi Zhurnal* [Financial Journal]. 2013. No 1. P. 103–112.

individual housing construction amounted to more than 70% of newly commissioned residential space.

The positive dynamics of housing construction was observed in the majority of Russia's regions, including almost all regions where the volume of newly commissioned residential space exceeded 1 million square meters (*Table 25*).

Table 25

**The Dynamics of Housing Commissioning in Russia's Regions in 2012
(Ranked by Housing Commissioning Rate)**

Region	Hosing commissioning rate, as percentage of 2012
Perm Krai	121.6
Voronezh Oblast	121.3
Samara Oblast	117.2
Leningrad Oblast	112.5
Novosibirsk Oblast	108.2
Rostov Oblast	107.5
Bashkortostan	106.9
Belgorod Oblast	106.6
Dagestan	106.5
Saratov Oblast	106.4
Chelyabinsk Oblast	106.3
Krasnoyarsk Krai	105.2
Tyumen Oblast (including its autonomous okrugs)	104.6
Moscow Oblast	104.2
Moscow	102.7
Nizhny Novgorod Oblast	101.9
Kemerovo Oblast	100.5
St. Petersburg	100.3
Tatarstan	100.0
Sverdlovsk Oblast	93.2
Krasnodar Krai	90.2
Stavropol Krai	84.9

Source: *O zhilishchnom stroitel'stve v 2013* [On Housing Construction in 2013], www.gks.ru.

As suggested in *Table 25*, a dynamics of housing commissioning considerably above the RF average (more than 8%) was recorded in Perm Krai, Voronezh Oblast, Samara Oblast, Leningrad Oblast, Tyumen Oblast ¹, and Novosibirsk Oblast. At the same time, the volumes of residential housing construction in Kemerovo Oblast and St. Petersburg grew by less than 0.5%, while Tatarstan was experiencing stagnation. In Sverdlovsk Oblast, Stavropol Krai and Krasnodar Krai housing construction volumes dropped.

A very significant drop in the volume of housing construction, by more than 10%, was registered in Krasnodar Krai - a trend that may continue well beyond the 2014 Winter Olympics in Sochi, because housing prices may collapse in an event of a market offer of a large number of housing units over a very short period of time. The investors in the Olympic construction projects have built a total of approximately 12 thousand apartments, to be temporarily occupied by the organizers, volunteers and technical staff employed during the Olympic Games. Once the Olympic Games are over, the investors will want to generate revenue covering their initially incurred costs, and also derive some profit.

The local authorities have made a preliminary declaration that approximately 3.5 thousand people currently on the waiting list will be granted new housing units after the Olympic Games are over. Another thousand of apartments was to be leased, for the period of their

¹ The territory of Tyumen Oblast (without Khanty-Mansi Autonomous Okrug and Yamalo-Nenets Autonomous Okrug) where the volume of newly commissioned residential space exceeds 1 million square meters.

employment, to the staff of local public healthcare institutions and educational establishments. This will result in a significantly increased burden on the local budget, even if the investors should grant a certain discount for the authorities.

However, even if all these plans are successfully implemented in actual practice, it is still not clear what will ultimately happen to the bulk of the newly created real estate complexes. There exists a possibility to influence investor behavior and the movement of housing prices by means of regulating the process of turning hotels into residential complexes; in this connection, investors will have to carry out a comprehensive feasibility study in order to determine whether it will be more profitable to continue to run these properties as hotels, or to sell them as ongoing concerns¹.

Moscow Oblast has retained its first-place position among Russian regions, in terms of the absolute volume of housing commissioning. The city of Moscow, in spite of the rather modest growth rate displayed by this index (2.7%), came third after Moscow Oblast and Kuban. The share of the Moscow region (Moscow Oblast and the city of Moscow) in Russia's aggregate residential housing construction volume remained at approximately the same level – approximately 14.5%. Most of that percentage was accounted for by Moscow Oblast (9.9%), while the rest of it – by Moscow proper (4.5%).

Out of a total of 3.1m square meters of housing commissioned in Moscow in 2013 (vs. 2.57m square meters in 2012), 1.93m square meters was built in the territory of 'Old' Moscow, which is below the corresponding indices for the previous years (in 2010 – 1.97m square meters; in 2011 – 2.11m square meters, in 2012 – 2.15m square meters). 'New Moscow' accounted for 1.17m square meters of newly commissioned housing projects (or more than 1/3 of the newly commissioned residential space across the city's entire territory within its new boundaries).

Over the course of 2013, a total of 35.3 thousand housing mortgage loan agreements were registered in Moscow (a 2.3% increase) and 21.3 thousand participatory share construction agreement (PSCA) (an 11.3% drop) (according to data released by *Rosreestr*). The possible reason for the declining activity on Moscow's primary housing market in 2013 can be buyer outflow from the city towards Moscow Oblast where prices are definitely lower, as well as the ongoing contraction in housing supply resulting from the declining housing construction volume in Old Moscow after the suspension of previously issued construction permits and revision of investment contracts.

A significant change displayed by recent *Rosreestr*'s reports has been the creation of a single pool of data on purchase and sale transactions and exchange transactions, of which a total of 145.8 thousand were registered in 2013 (vs. 94.4 thousand purchase and sale transactions in 2012). If we apply the growth rate index of 9% (derived in 2013 for the entire pool of data) separately to the category of purchase and sale transactions, it may be assumed that the total number of such transactions completed on the housing market was approximately 103 thousand.

The emphasis on transport infrastructure development, which has been declared to be one of Moscow government's priorities, makes bleaker the prospects for future expansion of housing construction projects, especially with regard to projects designed to provide low-cost social housing to families on waiting lists.

¹ *Kvadratnye metry v Sochi budut prodavat' postepenno* [The Square Meters in Sochi Will Be Sold Gradually] // *Nezavisimaia gazeta* [The Independent Newspaper]. 13 December 2013.

Under Moscow's targeted investment program, over the period 2013–2015 the city will augment its housing fund by 1.87m square meters of newly commissioned residential floor space, of which 1.4m square meters will be designated for the free-of-charge resettlement of residents of 'temporary' 5-storey walkups with a planned 25-year life (to be demolished) into new residential buildings, while 470 thousand square meters will be granted to families on the housing improvement' waiting lists (which, when broken up by the existing social norm of 18 square meters of residential floor space per person, will mean that a total of approximately 8,700 families will get new apartments, or 2,900 families per annum. These apartments, newly built at the city's expense, will be distributed via two channels: 'social' lease with the possibility of subsequent privatization, and sale on installments (the market price of an apartment thus sold usually exceeds its actual selling price several times over). Over the period 2011–2012, 25–40% of apartments were distributed under 'social lease' agreements. If this rate is to be taken as baseline, in 2013–2015 this type of housing will be granted to 725–1,160 families per annum (in 2012, 1,500 families received their new apartments free of charge).

In conditions of slow progress of the existing waiting lists, the authorities are necessarily trying to find other solutions to the housing shortage problem, based on providing the needy with means to independently obtain a new apartment.

One of the available methods is to grant to them a subsidy for purchasing an apartment, calculated depending on the length of time that a given family has been kept on the waiting list. As a rule, towards the middle of each year the annual amount of money earmarked for housing subsidies is already distributed among the applicants. In 2012, the annual limit was set at Rb 10.6bn. Another method envisages leasing an apartment under a temporary lease agreement, with revision of the amount of lease payment on an annual basis. The residential buildings included in these lease plans are called 'dotation free', because their residents receive no dotations to cover the cost of housing and utilities¹.

The main problem areas in the housing market in 2013, as before, were the low volume of newly commissioned residential space and the situation with regard to housing mortgage lending.

In spite of the somewhat increased scale of new housing construction projects over the past 3 years, the actual volume of newly commissioned residential space remains far below the per annum target of 1 square meter per capita, which had been set with the purpose of curbing excessive growth of housing prices. The RF Ministry of Regional Development believes that the necessary preconditions for the implementation of this scenario will be personal income growth, removal of the existing administrative barriers in the construction sector, implementation of technological innovations in the construction and building materials industry, promotion of a civilized lease market, and development of various forms of consumer lending.

Below we are going to discuss some of these factors in more detail.

The government's orientation to priority development of housing mortgage lending as one of the available mechanisms of providing housing to citizens has given rise to the interest rate issue.

¹ <http://finance.rambler.ru/news/nedv/128053726.html>, *Moskva sokrashchaet razdachu besplatnykh kvartir* [Moscow Reduces the Distribution of Free-of-charge Apartments] // *Vedomosti*. 8 May 2013.

Presidential Executive Order of 7 May 2012, No 600 ‘On Measures Designed to Provide Citizens with Affordable and Comfortable Housing’ set the goal, to be achieved in 2018, of bringing the interest rate on housing mortgage loans down to the inflation rate plus 2.2 pp.

At the same time in 2013, the monthly weighted average interest rate on ruble-denominated housing mortgage loans had remained stably above 12% over nearly a year-long period; in other words, it never fell below its 2012 level, in spite of the trend towards slow decline that had been visible since spring. It is only towards the year’s end (as seen by November’s results) that it amounted to 11.9%, which is 1 pp. below the record high observed in March 2013, and 0.7 pp. below the November 2012 index. These values are close to the record lows achieved in late 2011.¹

In order to create market-based possibilities for lowering the interest rates on housing mortgage loans, in the autumn of 2013 the RF Central Bank and the RF Government began to consider three possible options: (1) to reduce the risk coefficients when calculating the capital adequacy ratio and required reserve norms for housing mortgage loans; (2) to increase the RF Central Bank’s volume of refinancing for issued housing mortgage loans – for example, by means of lowering the discount rate on financing granted against pledged housing mortgage securities and adjusting that rate by the quality of mortgage insurance; (3) to simplify the legislative norms regulating assignment of the right of claim in a mortgage loan.

As estimated by experts, such measures may indeed result in a certain decline of the interest rates on housing mortgage loans. However, it is unlikely that the interest rates may drop by more than 1–2 pp. So, in face of a continuing upward movement of real estate prices, this negligible decline will hardly make housing more readily affordable for those who suffer from its shortage. At the same time, bank may become more inclined to take risks, which will have a negative effect on the quality of housing mortgage portfolios².

Generally speaking, according to analysts from the Agency for Housing Mortgage Lending, the existing fundamental economic factors will probably conduce to a slowdown of the housing mortgage lending market’s growth rate, because the current situation is fraught with hidden but increasingly strong risks that can not only curb growth of the mortgage market, but trigger its shrinkage in the future. First of all, this is the risk of rising unemployment among the potential borrowers coupled with increasing problems with liquidity in the banking system as a whole³. The looming stagnation in the real sector coupled with the sudden onset, in the autumn of 2013, of the campaign aimed at identifying ‘problem-ridden’ banks aggravate the situation even further.

As for the problem posed by the existence of administrative barriers, the Presidential Executive Orders of May 2012 have already prescribed that, before 1 January 2015, the cost of the bureaucratic procedures involved in launching a construction project should be significantly reduced, and the length of the period established for the issuance of a construction permit - considerably shortened. Meanwhile, Russia's ranking on the ease of obtaining a construction permit by Doing Business, the project launched by the International Finance Corporation and the World Bank, was nearly at the bottom of the list – 178th out

¹ <http://www.irn.ru/articles/36907.html>, 22 January 2014, *Kartina maslom: ipoteka stanovitsie vse populiarnее* [A Paining in Oil: Housing Mortgage Loans are Gaining Popularity].

² <http://finance.rambler.ru/news/banks/137586690.html>, *Zadachu snizit’ stavki po ipoteke vziala na sebia lichno glava Tsentrobanka* [The Task of Bringing Down the Interest Rate on Housing Mortgage Loans Was Assumed Personally by the RF Central Bank’s Head] // *Izvestiia*. 13 November 2013.

³ <http://finance.rambler.ru/news/economics/139480780.html>, *Ipoteka budet deshevet’* [Housing Mortgage Loans Will Become Progressively Cheaper] // *Ъ-Online*. 27 December 2013.

of 185. To obtain a construction permit in Russia, it is necessary to go through a total of 42 procedures and spend 344 days on the entire process. The construction permit fee in the RF amounts to approximately 130% of the average per capita income.

However, once the problem of administrative barriers is removed, its disappearance will by no means become a guarantee of lower construction costs because a market housing construction model per se implies that the developer must bear the costs of acquisition or lease of a land plot, elaboration of blueprints, connection to public utilities, creation of an engineering infrastructure, and a number of other components of a construction project – for example, participation in local community projects as part of interaction with the local government.

Some further potential for bringing down the aggregate construction costs can be created due to the efforts of Russian authorities and the activity of the Federal Housing Construction Promotion Fund aimed at transferring land plots to developer companies on preferential conditions and shouldering some of the expenses involved in building the engineering infrastructure. However, in this connection another question inevitably arises – what will be the scale of modeling and distributing this practice across Russia, a huge and heterogeneous country?¹

It can be expected that the situation in the housing construction sector will be somewhat changed as a result of the amendments introduced to the well-known law ‘On Participation in the Shared Construction of Multi-unit Apartment Buildings and Other Real Estate Objects, and on the Introduction of Alterations to Some Legislative Acts of the Russian Federation’, No FZ-214. These amendments, dating back to the end of 2012, actually came into force only from January 2014 and introduced one more method to guarantee the fulfillment of contractual obligations by property developers (alongside the pledge and the bank guarantee). The new legislation introduces civil liability insurance for property developers, effectuated by way of an insurance contract to be concluded by the property developer, or by the property developer’s membership in a mutual insurance company of developers (MIC). Also, the new legislation establishes requirements with regard to the minimum amount of insurance, the determination of an insured event, the procedure for payments, etc.

Special requirements have been introduced with regard to banks willing to act as a surety liable for a property developer’s obligation to transfer a residential unit to a party to a participatory share construction agreement: (1) the bank must hold a license, issued by the RF Central Bank, to conduct banking operations with the right to issue bank guarantees; (2) the bank must have a successful track record of banking activity for at least five years; (3) the bank’s charter capital must amount to no less than Rb 200m; (4) the bank’s equity must amount to no less than Rb 1bn; (5) the bank must comply with the mandatory norms as envisaged in existing legislation as of each reporting date over six previous months; (6) the bank must not be subject to any orders, issued by the RF Central Bank, that it should undertake financial recovery measures. A certain number of requirements have also been for the insurance company that a property developer may enter into agreements with, in order to insure individual responsibility for failure to fulfill, or for improper fulfillment of the property developer’s obligation to transfer a residential unit to a party to a participatory share construction agreement.

¹ *Kazhdomy grazhdaninu po kvadratnomy metro* [To Every Citizen – One Square Meter] // *Nezavisimaaia gazeta* [The Independent Newspaper]. 25 March 2013.

The requirements to a surety's subsidiary responsibility have also been established with regard to a property developer's obligations relating to the transfer of relevant residential units to the parties to a participatory share construction agreement; its amount must be no less than the amount calculated on the basis of the total floor area of the residential unit to be transferred under a participatory share construction agreement and the average market price index of 1 square meter of residential floor area for a given RF subjects, as determined by the federal body of executive authority responsible for the elaboration and (or) implementation of government policy and normative legal regulation in the construction sector; this amount is to be applied in the calculation of the amount of social payments from the federal budget to all categories of citizens entitled to social benefits to cover the cost of acquisition of residential units, as of the date of concluding the relevant surety agreement.

A surety is answerable to the parties to a participatory share construction agreement to the same extent as a property developer is, including the obligation to pay all the fines and penalties as stipulated in the relevant participatory share construction agreement and established by legislation, and the period of surety is extended 2 years beyond the established timeline for the transfer of the relevant residential units to the parties to a participatory share construction agreement (previously – 6 months).

In 2013, the Law was augmented by some new elaborations and alterations, whereby more precise definitions were introduced with regard to an insured event, the mandatory requirements to be presented by an insurance company to a property developer, and the powers granted to federal and regional bodies of authority in the field of government regulation, control and supervision of projects involving participatory share construction of multi-unit apartment buildings and (or) other real estate complexes (the relevant empowered and controlling bodies).

Thus, in particular, it is established that the empowered federal body is to coordinate the activity of federal bodies of executive authority relevant for the implementation of government policy with regard to projects involving participatory share construction of multi-unit apartment buildings and (or) other real estate complexes; to set the criteria for recognizing to be victims the citizens whose money was used under participatory share construction agreements and whose rights have been violated, and to establish the rules for the controlling body to keep a register of these individuals. In its turn, the controlling body functioning at the level of a RF subject is to recognize to be victims, in accordance with the established criteria, the citizens whose money was attracted under participatory share construction agreements to fund the construction of multi-unit apartment buildings, and whose rights have been violated, and to keep a register of these individuals. The criteria for recognizing to be victims the individuals whose money was attracted to fund the construction of multi-unit apartment buildings, and whose rights have been violated, and the rules for keeping a register of such individuals were approved by the RF Ministry of Regional Development's Order of 20 September 2013, No 403.

In this connection, it should also be noted that the controlling body was also granted the right to receive from property developers on a quarterly basis, in addition to their reports on their management of the monies attracted under participatory share construction agreements for the construction (or creation) of multi-unit apartment buildings and (or) other real estate complexes, including the reports on the execution of their duties under those agreements, prepared in accordance with the forms and in the procedure established by the RF federal body of executive authority empowered by the RF Government, also the property developers'

accounting reports (including annual accounting reports) drawn up as required by existing legislation.

6.5.3. Prices on the Housing Market

The Price Situation in the Secondary Housing Market

The main indicators of the movement of secondary housing markets in Russian cities are presented in *Table 26*. The data were supplied by housing market analysts certified by the Russian Realtor Guild¹. The data were collected, verified and processed on the basis of a single methodology recommended by the Russian Realtor Guild.

The sample under consideration consists of 37 cities and one region (Moscow Oblast, for which the averaged data for 85–90 inhabited localities are applied), including 30 cities with the status of a RF subject's center, with total population of approximately 46.9m.

The sample includes the following population units:

- Moscow (total population approximately 12m);
- Moscow Oblast (total urban population 5.8m) and St. Petersburg (более 5.1m) (total population 10.9m);
- 11 cities with a population of more than 1m – Novosibirsk, Yekaterinburg, Nizhny Novgorod, Kazan, Samara, Omsk, Chelyabinsk, Rostov-on-Don, Krasnoyarsk, Perm, Voronezh (total population 13.0m);
- 12 cities with a population of 500,000 to 1m – Krasnodar, Togliatti, Barnaul, Tyumen, Ulyanovsk, Izhevsk, Irkutsk, Yaroslavl, Orenburg, Kemerovo, Ryazan, Kirov (total population 7.6m);
- 9 cities with a population of 200,000 to 500,000 – Cheboksary, Stavropol, Tver, Vladimir, Surgut, Smolensk, Sterlitamak, Veliky Novgorod, Shakhty (total population 3.1m);
- 2 cities with a population of 100,000 to 200,000 – Salavat, Tobolsk; and one city with a population less than 100,000 – Ishimbay (total population more than 0.3m).

¹ All of the author's calculations are based on the data on median unit offer prices of housing and housing supply volumes in Russian cities' secondary and primary housing markets, published by the following housing market analysts certified by the Russian Realtor Guild: S.G. Sternik, LLC *Sternik's Consulting*; A.I. Rzhnevsky, A.N. Severianov, Real Estate Agency *Azbuka Zhil'ia* [Housing ABC]; and A.G. Beketov (all three operating in the city of Moscow and Moscow Oblast); S.V. Bobashev, M.A. Bent, *Bulleten' Nedvizhimosti* Group [Real Estate Bulletin] (St. Petersburg, Veliky Novgorod, Krasnodar); M.A. Khor'kov, A.A. Antasiuk, G.T. Tukhashvili, K.V. Oktaev, Realtor Information Center 'Urals Real Estate Chamber' (Yekaterinburg); A.L. Chemodanov, Analytical Center *Nizhny Novgorod Real Estate Market Indicators* (Nizhny Novgorod); E.G. Sosnitsky, A.A. Chumakov, *Titul* (Rostov-on-Don); E.A. Ermolaeva, K. Salmina, N. Ershova, *RID Analitics* (Novosibirsk, Kemerovo, Barnaul, Krasnoyarsk); S.G. Molodkina (ALKO Assotiation), E.S. Ershova K. Brednikov (Federal Realtor Company *Etazhi* [Storeys]) (both operating in Tyumen); E.D. Epishina, Yu.V. Seliverstova, Kamskaia dolina [Kama Valley] Group of Companies; A.V. Pechenkina (Perm), V.N. Kaminsky, E.I. Pesnia, Real Estate Agency *TITAN* (Tver); A.D. Gollay, LLC *Metro-Otsenka* [Metro Valuation] (Yaroslavl); A.M. Cheremnykh, *ASSO-Stroy* Asset Manager (Izhevsk); A.Yu. Chernov, *Ilekta* (Stavropol); E.R. Gamova, T.N. Kuklova, Tsentr nedvizhimosti [Real Estate Center] (Ulyanovsk); M.A. Repin, A.I. Zykova, *OMEKS* (Omsk); A.V. Trushnikov, *B.I.N. - Expert* (Sterlitamak, Ishimbay, Salavat); A.A. Moiseeva, Federal Network Company *ETAZHI* [Storeys] (Tobolsk); G.Yu. Eidlina, *Realty* (Shakhty); S.V. Esikov (Vladimir, Irkutsk, Orenburg, Smolensk, Togliatti, Cheboksary); A.I. Moskalev, *InvestOtsenka* [Invest Valuation] (Voronezh); R.R. Khabibrakhmanov, *TATRE.ru* (Kazan), M.B. Landikhov, portal 74dom.ru (Chelyabinsk); R.M. Kazakov (Yarmarka [Fair Publishing House]), M.Yu. Savina (Ryazan); A.L. Patrikeev, *SOFZhi* (Samara).

The sample's average weighted offer price was calculated on the basis of data on the number of offers. The total monthly volume for December 2013 was 276.7 thousand offers.

Table 26

**Prices on the Secondary Housing Market
in Russian Cities in 2013**

City (region)	Median unit offer price, thousands of rubles per square meter			Price index of December 2013, as percentage of December 2012		Sample size, thousands of offers, December 2013
	December 2012	December 2013	For reference: pre-crisis record high	nominal	real (IGS)	
Moscow	203.0/195.5*	203.3	191.5	1.040	0.976	38.2
St. Petersburg	95.0	96.0	107.7	1.011	0.949	22.1
Moscow Oblast	84.3	88.2	93.2	1.046	0.982	62.3
Surgut (Tyumen Oblast)	85.6	87.0		1.016	0.954	2.3
Yekaterinburg	70.1	72.8	67.3	1.039	0.975	8.9
Kazan	61.2	63.7	42.5	1.041	0.977	1.2
Tyumen	59.4	63.2	52.9	1.064	0.999	7.9
Nizhny Novgorod	61.3	63.1	61.4	1.029	0.967	5.7
Rostov-on-Don	62.8	63.0	64.1	1.003	0.942	0.9
Novosibirsk	59.1	61.4	65.2	1.039	0.976	15.2
Irkutsk	57.3	59.7		1.042	0.978	2.7
Samara	55.8	58.5		1.048	0.984	10.5
Yaroslavl	57.6	57.7	54.6	1.002	0.941	1.0
Krasnoyarsk	59.0	56.2	63.7	0.953	0.894	15.8
Tver	57.8	56.1	69.0	0.971	0.911	1.8
Perm	53.4	54.7	61.4	1.024	0.962	2.6
Vladimir	51.3	52.7		1.027	0.965	2.1
Veliky Novgorod	51.5	52.4		1.017	0.955	1.6
Kemerovo	50.2	52.1	54.0	1.038	0.975	14.3
Tobolsk (Tyumen Oblast)	46.1	51.1		1.108	1.041	1.0
Orenburg	49.6	51.0		1.028	0.965	1.2
Cheboksary	48.1	48.7		1.012	0.951	1.0
Kirov	43.3	48.5		1.120	1.052	2.7
Voronezh	48.1	48.4		1.006	0.945	2.1
Barnaul	48.1	48.3	43.3	1.004	0.943	6.9
Krasnodar	51.9	48.2		0.929	0.872	10.9
Smolensk	46.3	48.1		1.039	0.976	1.2
Omsk	44.7	47.4	45.6	1.060	0.996	13.5
Izhevsk	46.4	47.3	51.8	1.019	0.957	2.0
Ryazan	46.2	45.8	42.0	0.991	0.931	4.5
Togliatti (Samara Oblast)	43.5	45.7		1.051	0.986	1.7
Ulyanovsk	39.9	42.3	36.9	1.060	0.995	4.2
Sterlitamak (Bashkortostan)	40.3	43.8	29.1	1.087	1.021	1.1
Chelyabinsk	44.4	43.0	51.7	0.968	0.909	2.8
Salavat (Bashkortostan)	39.3	39.4		1.003	0.941	0.4
Ishimbay (Bashkortostan)	33.4	38.4		1.150	1.079	0.2
Stavropol	34.9	35.5		1.017	0.955	1.6
Shakhty (Rostov Oblast)	30.3	30.9	31.2	1.020	0.958	0.6
Sample's total	86.2 (63.8)**	85.5(63.0)**		99.2(98.7)**	0.931(0.927)**	276.7

* Numerator – Moscow (within its old boundaries); denominator – Greater Moscow.

** Sample's average weighted (by number of offers) offer price (in brackets – value less Moscow).

By its housing price index (Rb 203/3 thousand per square meter), Moscow is ahead of St. Petersburg which immediately follows, Moscow's index being more than twice above

St. Petersburg's (Rb 96.0 thousand per square meter). The group of cities with the housing price index in the interval from Rb 60 thousand to 90 thousand per square meter includes Moscow Oblast and 7 cities (Surgut, Yekaterinburg, Kazan, Tyumen, Nizhny Novgorod, Rostov-on-Don, Novosibirsk). The group with average prices in the interval from Rb 50 thousand to 60 thousand per square meter consists of 11 cities, and the group with lower prices in the interval from Rb 30 thousand to 50 thousand per square meter – of 17 cities. None of these cities had average unit prices in the secondary market at levels below Rb 30 thousand per square meter.

On the whole, as seen by the annual results, the housing markets of the cities included in the sample demonstrated stability of prices. The highest growth rates (above accumulate inflation rate of 6.5%) were displayed by housing prices in Ishimbay (15%), Kirov (12%), Tobolsk (10.8%), and Sterlitamak (8.7%). The nominal prices had declined by December 2012 in five cities: Krasnodar (by 7.1%), Krasnoyarsk (by 4.7%), Chelyabinsk (by 3.2%), Tver (by 2.9%), and Ryazan (by 0.9%).

Thus, the majority of the cities included in the sample were characterized by declining housing prices in real terms (cleared of consumer market inflation, whose rate for 2013 amounted to 6.5%) (IGS index)¹. The exceptions are represented by the already mentioned cities of Ishimbay and Ulyanovsk (growth of housing prices in real terms by 7–8%), Kirov and Tobolsk (growth by 4–5%), Sterlitamak (growth by 2%), as well as Tyumen, Omsk and Ulyanovsk, where the housing prices in real terms for December 2013 remained approximately at the same level as a year before. At the other end of the scale are Krasnoyarsk and Krasnodar, where IGS dropped by 10–13%. In Moscow, housing prices in real terms dropped by 2.4%; in St. Petersburg – by more than 5%.

On the whole, the average weighted housing price decline on December 2012 amounted to 0.8% (outside of Moscow – to 1.3%), thus pointing to a situation of stagnation on the secondary housing market and a relative cheapening of residential units when cleared of accumulate inflation.

By December, 2013 housing prices in the majority of cities across the sample under consideration had risen above their pre-crisis level (Moscow, Yekaterinburg, Kazan, Nizhny Novgorod, Yaroslavl, Tyumen, Barnaul, Omsk, Ryazan, Ulyanovsk, Sterlitamak) or closely approached that level (Rostov-on-Don, Shakhty, Kemerovo). However, the onset of economic stagnation halted any further growth in the cities with lower prices, as a result of which housing prices in Moscow Oblast, Novosibirsk, Izhevsk, St. Petersburg, Perm, Krasnoyarsk, Chelyabinsk, and Tver were recorded to be 5–20% below their pre-crisis level ².

The Movement of Prices on the Primary Housing Market

The primary market data for 18 cities were collected by analysts certified by the Russian Realtor Guild (*Table 27*). To obtain the sample's average offer price, the data – similarly to the secondary market data (*Table 26*) – were weighted on the basis of number of offers; the total monthly offer volume for December 2013 amounted to 153.2 thousand.

¹ IGS is calculated by applying the following formula: $IGS = I_{pr}/I_{cp}$, where I_{pr} is housing price index denominated in rubles; I_{cp} is consumer price index.

² The sample presented in *Table 26* consists of a total of approximately 40 cities. However, for some of these cities sufficient data is unavailable, and so no comparative results can be obtained.

Table 27

Prices on the Primary Housing Market in Russian Cities in 2013

City	Median unit offer price, thousands of rubles per square meter		Price index of December 2013, as percentage of December 2012	Sample size, thousands of offers, December 2013	Median unit price on primary market as percentage of secondary market price (December 2013)
	December 2012	December 2013			
Moscow	230.3/205.5*	215.5	104.9	15.0	106.0
St. Petersburg	85.0	90.5	106.5	2.7	94.3
Moscow Oblast	70.7	76.5	108.2	67.0	86.7
Nizhny Novgorod	66.5	64.8	97.4	8.7	102.7
Yekaterinburg	57.5	60.8	105.7	1.9	83.5
Tyumen	50.4	55.9	110.9	8.6	88.4
Veliky Novgorod	52.5	54.2	103.2	0.2	103.4
Novosibirsk	51.3	51.7	100.8	5.0	84.2
Samara	48.5	49.4	101.9	3.1	84.4
Kazan	50.9	49.4	97.1	0.8	77.6
Yaroslavl	46.4	48.2	103.9	2.8	83.5
Perm	48.0	47.1	98.1	2.4	86.1
Izhevsk	42.4	44.3	104.5	3.7	93.7
Voronezh	43.2	43.9	101.6	1.2	90.7
Krasnodar	40.2	42.8	106.5	20.0	88.8
Omsk	35.9	40.5	112.8	3.3	85.4
Ryazan	36.2	37.0	102.2	5.7	80.8
Stavropol	31.2	30.4	97.4	1.1	85.6
Sample's total	75.6 (53.2)**	77.7 (56.7)**	102.8 (106.6)**	153.2	90.9 (90.0)**

* Numerator – Moscow (within its old boundaries); denominator – Greater Moscow.

** Sample's average weighted (by number of offers) offer price (in brackets – value less Moscow).

The factors that determine these regularities in the comparative price levels are as follows:

- the differences in the quantitative and qualitative structure of the housing fund offered in these markets, based on individual features of construction projects and their location. Thus, about half of all offers in Moscow's primary market are apartments in residential complexes with above-average quality features (business class and elite class), which are situated, as a rule, in the downtown area and other prestigious districts. In the other cities, the bulk of offers come from the 'mass-scale construction' market segments (economy class and comfort class), where the quality of new residential complexes is better than that of the 'old housing fund', but they are situated predominantly in districts that are remote from the city center and have an underdeveloped transport and social infrastructure, or lack any such infrastructure altogether;
- a delay in taking up residence in a new apartment; increased risks involved in the purchase of residential units, as a result of which property developers have to grant deductions to the prospective buyers (20 to 40% of the planned price of a newly commissioned apartment) in order to ensure their participation in participatory share construction agreements at early stages of implementing a construction project;
- absence, with only a few exceptions, of finished interior decorations, or even basic decoration in almost all the newly commissioned residential complexes.

The price ratios also vary over time depending on the following factors:

- shifts in the qualitative structure of newly commissioned residential complexes towards an increasing share of 'massive-scale construction' caused by a variety of factors: general trends in local government policies; development of new territories away from downtown

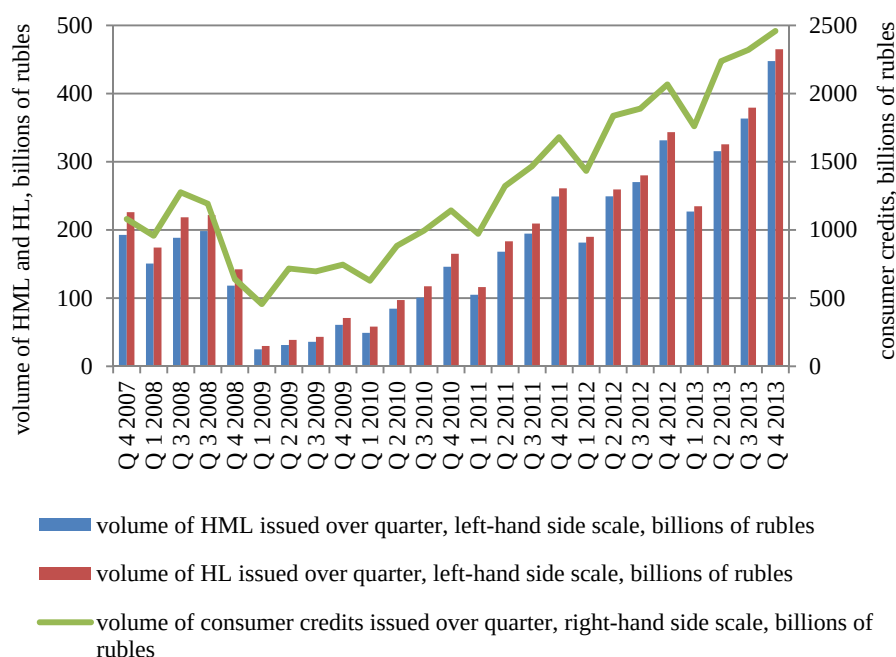
areas and at the outskirts of a city; changing consumer preferences under new economic conditions;

- widespread practice of large-scale market offer of residential complexes in the initial phase of their construction, or large-scale sale of finished newly commissioned projects, which conduces to construction project restructuring depending on the phase of project implementation.

Many buyers, when acquiring a new apartment for the purpose of investment at a stage when a construction project is still in progress, prefer to make a down payment of only part of its price and then pay the rest of it in installments extended over a longer period of time. In such a case, the apartment's price from the onset of the construction project to the moment of its sale usually increases by a quarter.

6.5.4. Housing Mortgage Lending

In 2013, according to data released by the RF Central Bank, 657 credit institutions issued a total of 824.8 housing mortgage loans (HML) in the amount of Rb 1,353.6bn, which represents a 19.2% rise on 2012 in terms of number of loans, and a 31.2% rise on the aforesaid year in money terms. The quarterly movement of the lending indices (*Fig. 9*) points to stable growth, over the past few years, in the sectors of both consumer and housing mortgage lending. However, the total volume of consumer loans issued in 2013 (Rb 8,778/2bn) is only 21.5% above the corresponding index for 2012, which is less than the growth rate displayed by the volume of HML.

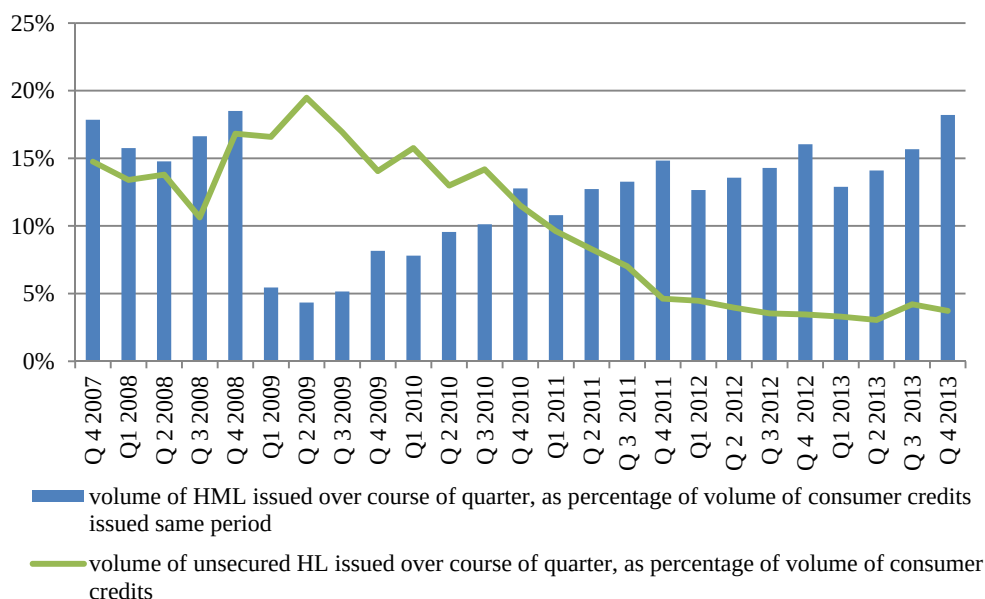


Source: data released by the RF Central Bank.

Fig. 9. The Dynamics of Loans Issued to Individuals over the Course of a Quarter, 2007-2013

In Q4 2013, the share of HML in the volume of consumer lending grew by 2.2 pp. on Q4 2012 - to 18.2%, while still staying 0.3 pp. below its pre-crisis record high registered in Q4

2008. The downward trend displayed by the share of unsecured housing loans (UHL) in the total housing lending volume continued over the course of 2013, with some fluctuations. The share of UHL in the total volume of HL issued in Q4 2013 increased 0.3 pp. above the corresponding index for Q4 2012 (*Fig. 10*). This trend, most likely, is going to persist in 2014 due to the RF Central Bank's policy aimed at toughening the requirements for obligatory (required) reserves against unsecured loans (Regulation No 254-P 'On the Procedure for the Creation, by Credit Institutions, of Required Reserves against Potential Losses on Loans and Outstanding Debt against Loans and Similar Categories of Outstanding Debt'.

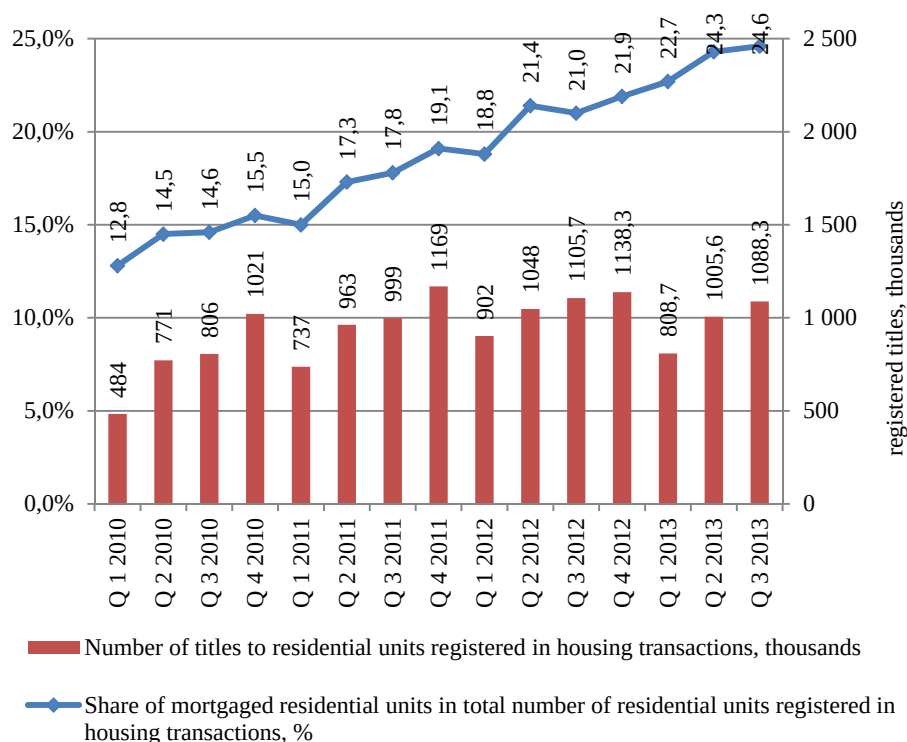


Source: data released by the RF Central Bank.

Fig. 10. The Dynamics of the Housing Mortgage Lending Volume as a Percentage of Consumer Lending Volume, 2007-2013

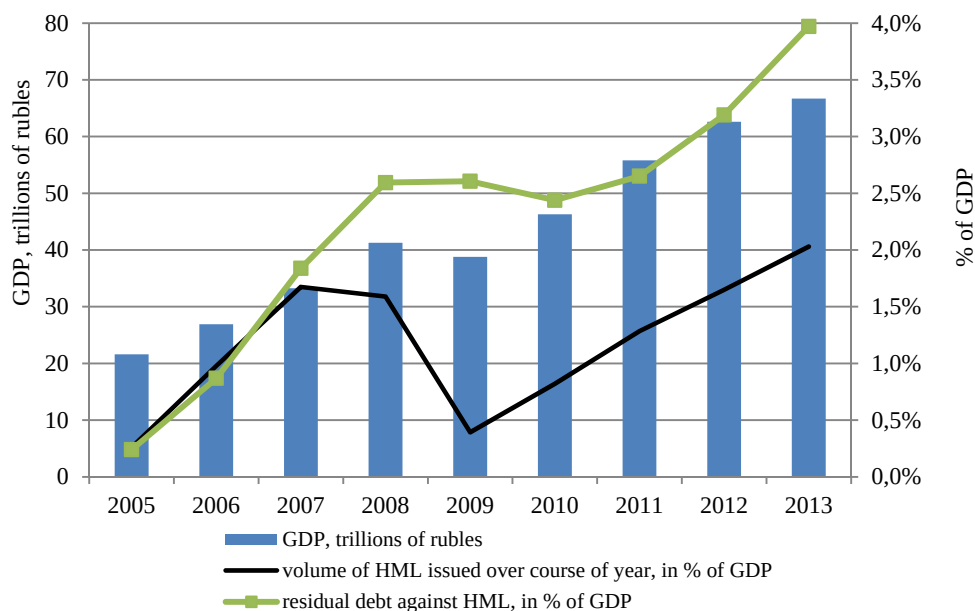
According to *Rosreestr's* data released by the Agency for Housing Mortgage Lending (AHML) (*Fig. 11*), in Q3 2013 the share of mortgaged real estate objects in the total number of real estate objects registered in housing transactions rose on Q3 2012 by 3.6 pp. - to 24.6%; i.e., one in four housing transactions was a residential mortgage transaction. Over the same period, the number of titles to residential units registered in housing transactions dropped by 1.6% and amounted to a total of 1.1m.

In spite of the declining economic growth rate displayed by Russia's national economy, the volume of HML issued in 2013 increased, as a percentage of GDP, to 2.0% (vs. 1.7% in 2012), and so surged 0.35 pp. above its pre-crisis record high registered in 2007 (*Fig. 12*). The total amount of debt against HML as of 1 January 2014 amounted to 4.0% of GDP, which is by 0.78 pp. higher than this index's value for 2012. However, in the post-crisis year 2012 the amount of debt against housing mortgage loans in the USA rose to 60% of GDP, or \$ 9.5 trillion. If we look at the European Union, Europe's average index of HML as a percentage of GDP amounted to 51.7%; more specifically, in the UK it amounted to 84%, in Spain – to 62%, in Germany – to 45%, and in The Netherlands and Denmark it rose above 100%. Russia's HML rate was 15 times below that of the USA, and 13 times below that of the EU.



Source: OAO «AHML» data, released by Rosreestr.

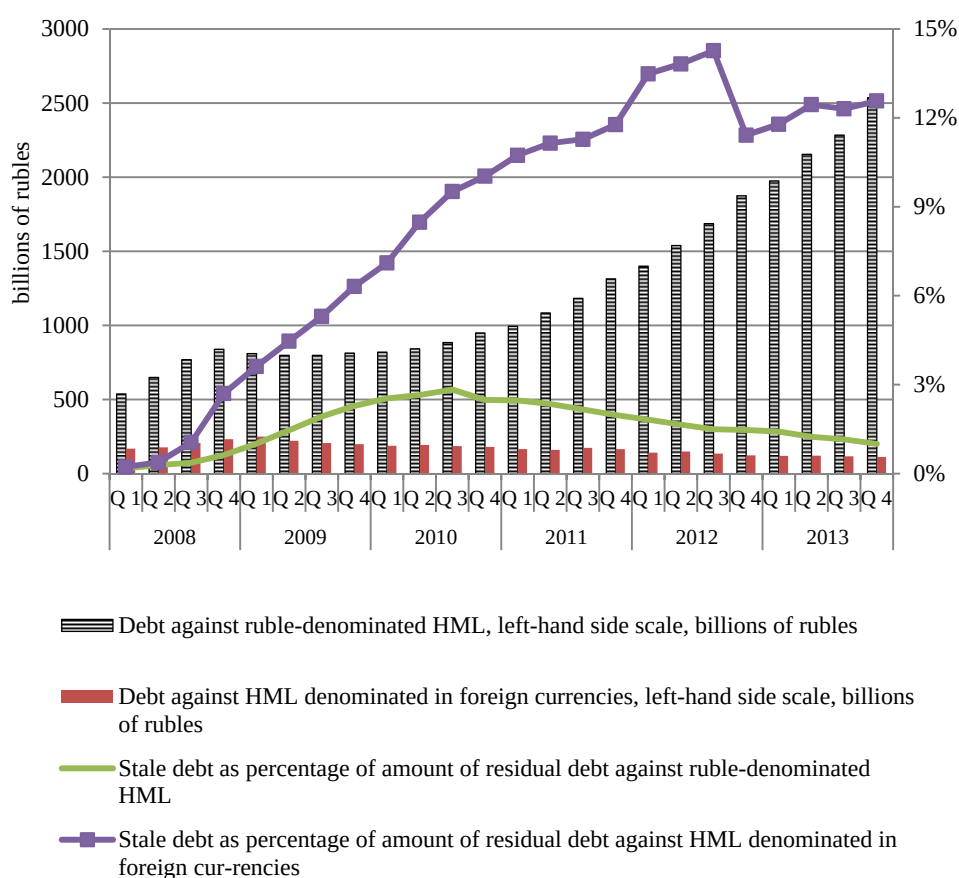
Fig. 11. The Dynamics of the Number of Residential Units Registered in Housing Transactions (Units), and the Share of Mortgaged Residential Units in Total Number of Residential Units Registered in Housing Transactions, 2010–2013



Source: data released by the RF Central Bank.

Fig. 12. The Dynamics of Housing Mortgage Lending as a Percentage of GDP, 2005–2013

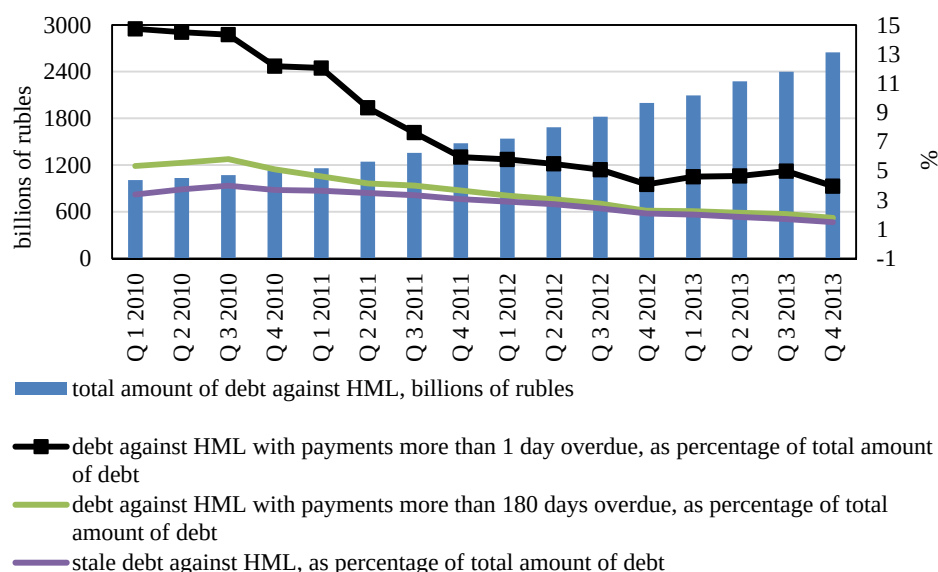
In 2013, the amount of debt against HML denominated in rubles increased by 35.3% on 2012 – to a total of Rb 2,536.4bn (*Fig. 13*). In spite of the increasing size of the ruble-denominated HML portfolio, its quality also improved, because the amount of stale debt against HML denominated in rubles (25.4 bn Rb) shrank by 7.6% on 2012, and by 0.15 pp. - to 1.0% the amount of residual debt. The quality of the portfolio of HML denominated in foreign currency, on the contrary, deteriorated. Over the same period, although the amount of residual debt against HML denominated in foreign currency declined by 9.0% to Rb 111.8bn, the amount of stale debt (Rb 14.1bn) increased both in terms of money (by 0.2%) and as a percentage of the amount of residual debt (by 0.26 pp. to 12.6%). The share of effective stale debt in effective residual debt declined to 1.5% as of 1 January 2014.



Source: data released by the RF Central Bank.

Fig. 13. The Dynamics of Residual and Stale Debt against Housing Mortgage Loans, 2008–2013

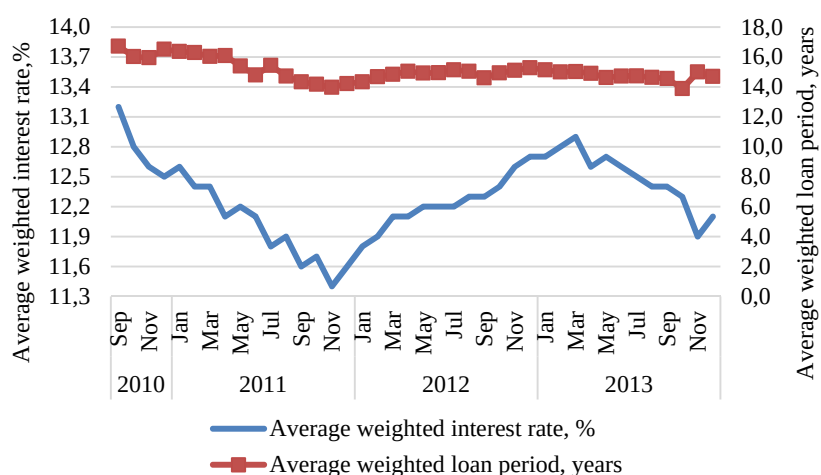
The HML portfolio's quality also improved in terms of the period of overdue payments. As of 1 January 2014, the share of residual debt against HML with no overdue payments (Rb 2,648.3bn) in the total amount of debt amounted to 96.1%, which represents a 0.12 pp. rise on its index as of 1 January 2013. The share of debt against HML with payments more than 180 days overdue (debt against defaulted loans) in the total amount of debt as of 1 January 2014 was at the level of 1.8%, or by 0.48 pp. below its level as of 1 January 2013 (*Fig. 14*).



Source: data released by the RF Central Bank.

Fig. 14. The Dynamics of Debt against Housing Mortgage Loans, by Period of Overdue Payment, 2010–2013

The average weighted interest rate on ruble-denominated HML issued over one month dropped from 12.9% in March 2013 to 11.9% in November, and then again rose to 12.1% in December 2013. The average weighted loan period for ruble-denominated HML issued over one month hit its record high (15.1 years) in January 2013, and its record low (13.9 year) – in October 2013 (*Fig. 15*). For reference: in Q1 2013, the representative annual percentage rate (APR) for HML in Sweden was 2.7%, in Germany – 2.8%, in Spain – 2.9%, in France – 3.0%, in the UK – 3.5%, in Poland – 6.0%, and in Hungary – 11.2%. In early 2013, the inflation rate in the EU was at the level of 1.8–2.0%. Thus, in the Eurozone the margin between the interest rate of 3.0% on housing mortgage loans was only 1%, while in Russia it amounted to approximately 5.5%.



Source: data released by the RF Central Bank.

Fig. 15. Average Weighted Data on HML Denominated in Rubles, by Month, 2010–2013

As of 1 January 2014, the average weighted interest rate on HML denominated in foreign currencies, issued since the year's beginning, dropped to 9.6% on its 2013 record high of 10.1%, registered as of 1 June 2013. The average weighted loan period for HML denominated in foreign currencies and issued since the year's beginning amounted to 12.7 years as of 1 January 2014.

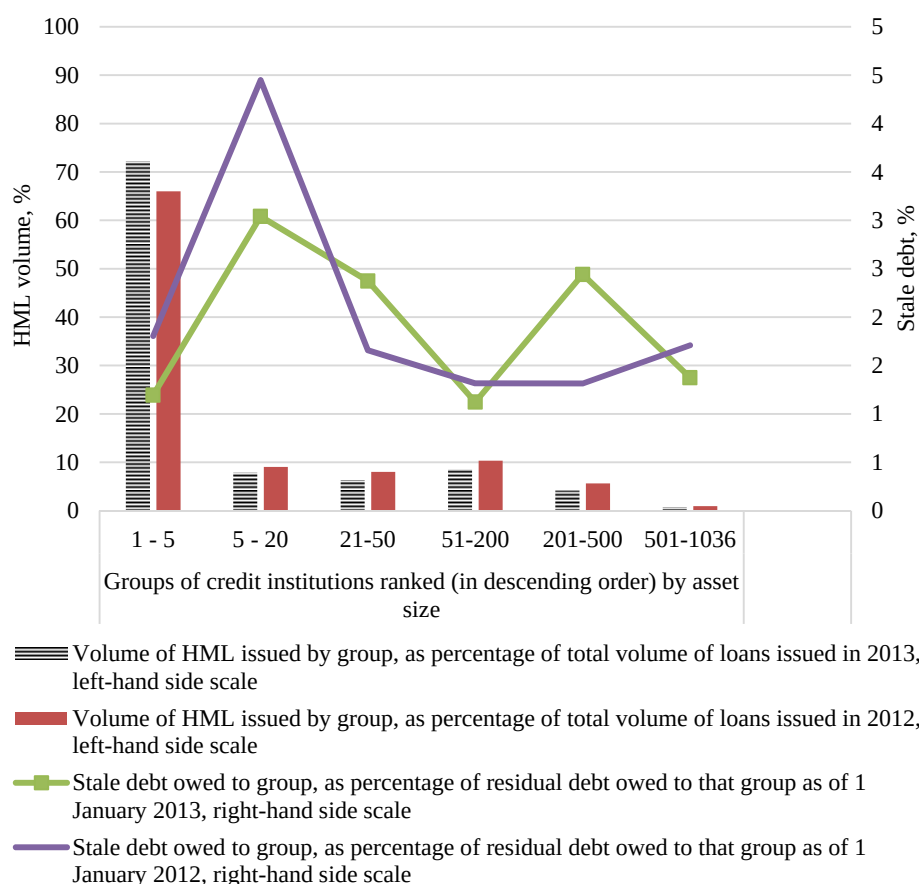
Housing mortgage lending as a priority tool to be employed in acquiring a dwelling becomes attractive in the eyes of consumers when the yield obtainable in the framework of available saving schemes is higher than the interest rate on housing mortgage loans. In this case even those who have some money to spend would prefer to take a housing mortgage loan and save the money for other purposes – which is essential for economic development.

However, another situation is possible - when housing prices grow at a higher rate than the payments against housing mortgage loans do. In this case, housing mortgage lending, instead of a method of acquiring a dwelling, becomes a financial mechanism for getting a good yield on investment, even if the actual amount of money to be invested is very limited. Credit risks plummet, there emerges a 'class' of borrowers capable of getting unsecured loans, and the resulting 'housing mortgage boom' pushed up prices on the housing market, with the looming threat of a housing mortgage crisis.

In 2013, the share of HML denominated in foreign currencies, issued since the year's beginning, in the total volume of HML and the share of debt against HML denominated in foreign currencies in the total volume of debt against HML continued their downward movement and as of 1 January 2014 amounted to 1.1% and 4.2% respectively. The share of stale debt against HML denominated in foreign currencies in the total volume of stale debt against HML varied in the course of 2013 from 33.5% to 36.0%, amounting as of 1 January 2014 to 35.6%, which points to the fact that the quality of HML denominated in foreign currencies is significantly lower than that of HML denominated in rubles.

The share of the topmost group of credit institutions with the largest assets, comprising 5 such entities, in the total volume of HML issued over the course of 2013 amounted to 72.2%, having gained 6.23 pp. on its 2012 index (*Fig. 16*) and 18.46 pp. on its 2011 index, a fact indicative of the ongoing monopolization in the housing mortgage market. The share of all the other groups of credit institutions shrank accordingly. Given the existing trend towards a decline in the share of stale debt in total debt across Russia -1.5% in 2013 vs. 2.1% in 2012 - the second group of credit institutions continued to keep the largest share of stale debt (3.0%), which means that its HML portfolio is the most risky one. As of 1 January 2014, the first two groups of credit institutions accounted for 80.1% of the HML market (*Fig. 16*).

According to the expert estimation carried out by the Agency for Housing Mortgage Lending (AHML), in 2013 the share of HML in the primary housing market, including the construction projects in progress, continued to be on the rise and over the period January – November 2013 amounted to 30.0% of the total volume of HML, having risen by 10.0 p.p. on 2012. As of 1 July 2013, housing mortgage loans in the amount of Rb 113.1bn had been repaid ahead of schedule with the borrowers' own money, which represents a 4.1% rise on 1 July 2012. This sum amounts to 20.8% of the total of HML issued over the first half-year period, and 77.7% of the total volume of HML repaid ahead of schedule, which represents a drop of 0.04 pp. on the first half-year period of 2012. The amount of HML repaid before schedule by the money raised through the sale of mortgaged properties was Rb 1.6bn, or by 20.5% less than the amount repaid over the first half-year of 2012.



Source: data released by the RF Central Bank.

Fig. 16. The Dynamics of the Volumes of Issued HML and State Debt, by Group of Credit Institutions Ranked by Asset Size

In 2013, the Agency for Housing Mortgage Lending refinanced a total of 32.7 thousand ruble-denominated mortgage loans in the amount of Rb 48.0bn, which represented a 21.3% drop on 2012 in money terms, and a 28.1% drop on the aforesaid year in terms of number of loans. Over January - November, the mortgage redemption rate set by the Agency for Housing Mortgage Lending amounted to 11% (for the following standard products: 'Standard', 'House Under Construction', 'Young Teachers – Standard', 'Young Scholars' and 'Military Mortgage'), which is by 1.47 p.p. lower than Russia's average weighted rate for that period, based on RF CB data.

The Agency for Housing Mortgage Lending is switching over part of its resources to the direct support of housing construction projects, and the elaboration of special support programs. Over the period from 1 October 2009 through 1 November 2013, it assumed obligations under the *Stimul* [Stimulus] project in the amount of Rb 95.8bn, of which a total of Rb 37.2bn has already been invested in the project's implementation. Out of the total sum of Rb 48.5bn issued by banks to legal entities to be invested in housing construction under the *Stimul* [Stimulus] project at an average interest rate of 13.2%, the Agency refinanced a total of Rb 47.9bn at the rate of 7.8%. While the average market price of standard residential units in the *Stimul* project is Rb 56,130 per square meter (Q2 2013), the average market selling price declared by the program's participant was Rb 63,213 per square meter.

The declining economic growth rate in the RF makes it difficult to adequately estimate the prospects of the housing mortgage lending market in 2014. Nevertheless, in 2013, housing affordability somewhat increased – the housing affordability coefficient in 2013 dropped by 10%. The growth rate displayed by the housing mortgage lending market was higher than that in the consumer lending market. In this connection, the volume of HML issued in 2013 increased as a percentage of GDP, to 2.0% vs. 1.7% in 2012, while the total volume of debt against HML amounted to 4.0% of GDP – thus rising 0.35 pp. above its pre-crisis record high achieved in 2007. The HML portfolio's quality improved: the amount of stale debt against ruble-denominated HML shrank to 1%, the total amount of stale debt – to 1.5% of the amount of residual debt, and the amount of debt against defaulted loans – to 1.8%. The upward movement of the interest rate observed in 2012, in 2013 changed its direction – largely because the lower interest rates introduced by Sberbank and the Agency urged other banks to follow this example in their interest rates policies. It should be added, however, that in December 2013 the interest rate once again gained 0.2 pp.

6.5.5. The Prospects for the Housing Market's Development

The period of post-crisis recovery is over, but no new economic growth drivers have emerged so far. The forthcoming cuts in budget expenditure is an unequivocal signal to Russia's economic agents that the current situation in the national economy is uncertain and precarious – a fact that has been officially recognized.

The RF Government's basic scenarios for Russia's economic development in the next three years (until 2016) build on the assumption that the trends prominent over the past one-and-a-half years will either persist or disappear as a result of some fundamental changes. A fundamental change implies that the main economic indicators will once again display growth at a rate of 3% per annum or higher. It is precisely this scenario (let us call it 'the optimistic one') that has been applied in the official forecast oriented to economic revival in the next three years:

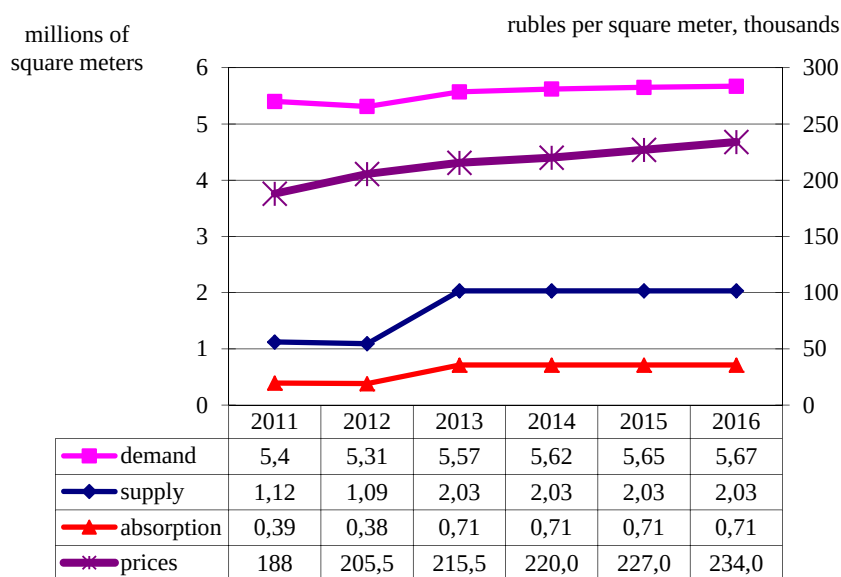
- accelerated domestic demand growth;
- revival of growth demonstrated by investment in fixed assets;
- stable consumer spending indices;
- improving competitive capacity of domestic industry;
- an intensive process of import substitution.

The second scenario (chosen by the Ye. T. Gaidar Institute for Economic Policy's experts as a basic one) implies that economic activity in the next few years will remain at a low level; at the same time, it is assumed that the economic growth rate will be gradually accelerating in response to the implementation of a comprehensive government program designed to improve the business climate in the Russian Federation. The key factor of this growth will be a persistently positive external situation, primarily maintained by high oil prices (at levels above \$ 100 per barrel) and a stable demand for Russia's exports of raw materials (in individual volumes). We believe that this scenario (stagnation-oriented) is the most realistic one. The principal theme of the basic scenario is a low rate of economic growth (below the world's average), its factors being negligible growth of the investment activity and a slowdown in the household final consumption expenditure. The population's real disposable money income in 2014–2016 will be growing at the rates of 0.9%, 0.4%, and 1.0% respectively.

However, if oil prices plummet to the level of \$ 80 per barrel, another scenario will evolve (let us call it a pessimistic one), triggered in the main by a negative growth rate in the real sector, significant depreciation of the ruble, and so on. In other words, even the stagnation-oriented (or realistic) scenario implies that the external background will remain positive.

In accordance with the realistic (stagnation-oriented) scenario, a forecast for the future housing market development in Moscow and Perm until 2016 was prepared. The calculations are based on a local residential real estate market model (version 2.0, 2013)¹. The results are shown in *Fig. 17* and *18*².

A. The Primary Market

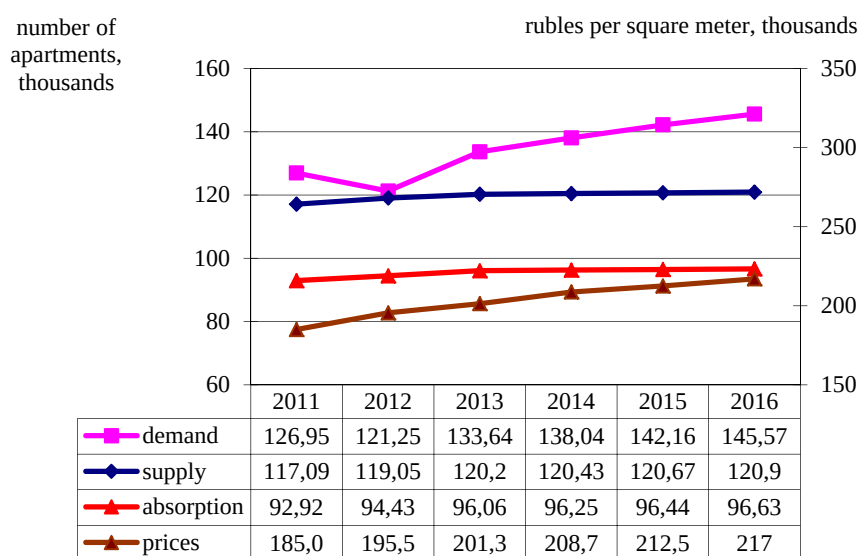


¹ Sternik G. M., Sviridov A. V. *Sovershenstvovanie i retrospektivnaia proverka metodiki srednesrochogo prognozirovaniia razvitiia lokal'nogo rynka zhiloi nedvizhimosti* [Improvement and Retrospective Verification of the Methodology of Medium-term Forecasts of the Local Residential Real Estate Market's Development] // *Imushchestvennye otnosheniia v Rossiiskoi Federatsii* [Ownership Relations in the Russian Federation]. 2013. No 10 (145). P. 48–63. <http://realtymarket.ru/metodi-eskie-materiali>.

Sternik G. M., Sviridov A. V. *O vliianii makroekonomicheskikh uslovii na razvitiie rynka zhiloi nedvizhimosti (na primere Moskvy)* [The Influence of Macroeconomic Conditions on the Development of the Residential Real Estate Market (A Case Study Based on Moscow's Data)]. A report delivered at the International Development Association (IDA) Conference. 30 August 2013. <http://realtymarket.ru/konfa.html>.

² In *Fig. 17* and *18*, the absorption curve reflects the movement of the number of purchase-and-sale and exchange transactions in the secondary market, and the total floor area of apartments sold in the primary market. The unit applied to measure the absorption volume in the secondary market is the number of apartments, that in the primary market – square meter.

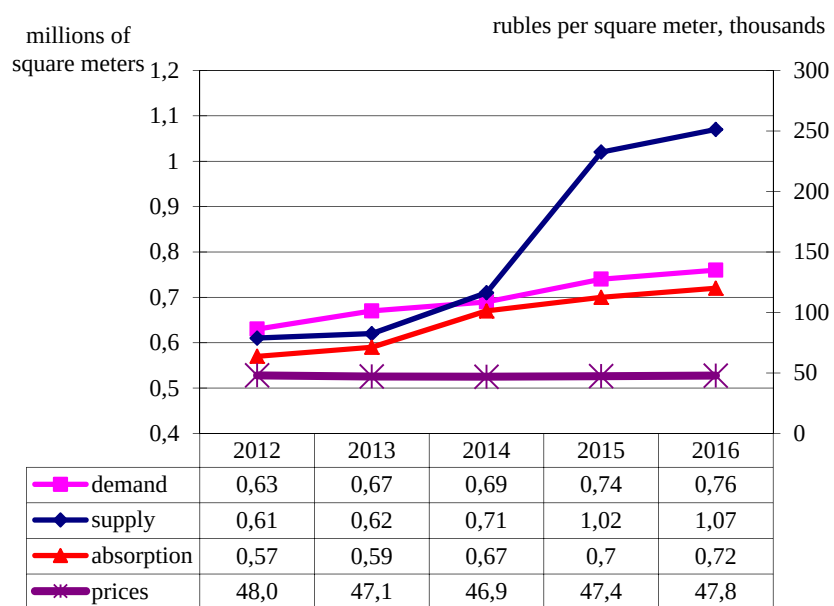
B. The Secondary Market



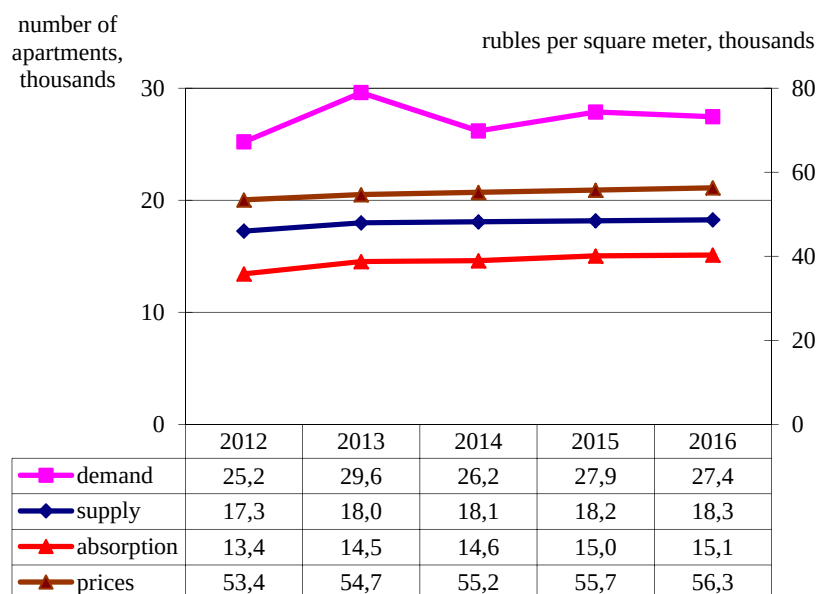
Source: OOO Sternik's Consulting.

Fig. 17. Forecast of Moscow's Residential Real Estate Market in the Macroeconomic Conditions Plotted under the Most Probable Scenario

A. The Primary Market



B. The Secondary Market



Source: initial data - by LLC *Analiticheskii Tsent* KD-konsulting [KD Consulting Analytical Center], Perm; calculations by LLC *Sternik's Consulting*.

Fig. 18. Forecast of Perm's Residential Real Estate Market in the Macroeconomic Conditions Plotted under the Most Probable Scenario

According to this forecast, the most likely situation in the residential real estate markets of these two cities (Moscow and Perm) will be characterized by stability with a low rate of growth/decline of prices, supply volumes, and floor area absorption in the primary and secondary markets (+/- 3–4% per annum).

6.6. Defense economy and military reform in Russia

The national military establishment of Russia continued developing in 2013 in the same manner, i.e. ill directed, as it was launched in and proceeded after 1992. This refers to both the reforms of the Ministry of Defense of the Russian Federation and the modernization of Russia's Armed Forces (AF).

Technically, in 2013 Russia had all the documents required for stagewise development of its military potential, namely the State Armaments Program for the Period of 2011–2020 (SAP-2020), the National Security Strategy (NSS-2020), and the Military Doctrine of the Russian Federation. The foregoing documents were approved by the then incumbent Presidents.

However, not all of these documents saw successful implementation, in particular in addressing socio-economic problems faced by the military personnel. All in all, the Russian military personnel didn't seem to feel content with a "new image" of the Armed Forces and the Ministry of Defense of Russia. A fraud row broke out nationwide on the eve of 2013.

President Putin had to replace those in charge of the military development program. Strategic miscalculations were revealed.

Therefore, the year 2013 saw an unscheduled turning point in the development of the national military establishment in Russia. After the Russian President made short-notice replacements of those military high-ranked officials who dishonored their names, “by-default” civil servants began to view the strategic concept of the military reform only through Presidential orders. Under the circumstances, however, pursuant to the regulations of a law-governed state and the management theory, the NSS-2020 and the Military Doctrine should have been updated and the unsuccessfully launched SAP-2020 adjusted so that all those involved in the management can consider these documents as long-term guidelines.

Conceptual changes required to the national military establishment of Russia still remain to be defined clearly. Even a decision to introduce a new branch of troops capable to conduct information-specific (cyberspace) operations was announced but not covered in the strategic planning documents. In 2013, the newly appointed officials in the Ministry of Defense neither recalled nor reminded of the NSS-2020 and the Military Doctrine. All of them were engaged in correcting the “errors” committed by the replaced military officials.

It should be noted that a few years ago, after the United States and some other countries introduced similar troops into their armed forces, the Kremlin didn't rush into commissioning the Ministry of Defense with the same task, restricting itself to setting respective tasks to other government agencies, mostly the Federal Security Service of the Russian Federation (FSC), which can be explained by that protection should be provided to individuals (the population) as the key target of potential information wars. Moreover, the situation in the area of information changed especially with regard to the population. For example, the share of adults with cell phones increased to 91% in Russia while Internet services expanded. Consequently, the role of government-controlled television and printed media declined. Even when natural emergencies occurred, the population received a great deal of information from non-government sources of information, as was the case with the flood in Krymsk, the asteroid crash in Chelyabinsk etc., when mass communication sources outstripped government-controlled mass media. This explained why the Kremlin was so cautious about the recent war events in the Middle East which showed that mass communication sources may well have an unwanted effect on the noncombat (until a certain point) population and their uncontrolled “self-organization”.

It was later realized that modern information (cyberspace) systems may impact not only humans but also fully computerized technical (military) systems with automated control processes. This implies that it is not only the FSC of Russia and similar agencies, but also the Ministry of Defense which operates military and technical systems in the Armed Forces and seeks various ways of impacting the systems operated by potential enemy forces, that should be engaged in planning and running information wars.

There was another reason why foreign state's leaders expressed concerns about means of information wars in 2013, i.e. the situation was further aggravated by a recession that hit most of the economies and impacted both respective government agencies and the population who were discontent with degrading living standards.

Addressing these issues, a few states updated the development concept of their national defense and security agencies, especially the armed forces. The goals and objectives of military agencies were revised. As a rule, new insights of foreign state leaders were documented based on serious scientific research.

For instance, a new document – France New Strategy: The 2013 White Paper¹ – was adopted in April 2013. Without setting ourselves a task of comparing this document with the NSS-2020 (or a package of the provisions set forth in President Putin’s orders), we can highlight the following. According to the developers of the new French document (the fourth one in the history of France), it was an indication of a new stage in ensuring the national security of both France and the entire Europe”. Furthermore, many strategic provisions of the previously developed concepts were kept intact. However, some significant innovations were introduced. A key aspect of the document concerns the establishment of an agency for counteracting information and cyber threats (l’Agence de la sécurité des systèmes d’informatiques) aimed at both ensuring national security and being engaged in offensive operations.

Nonetheless, French military (national defense) outlays are expected to decline despite its growing geostrategic ambitions. The developers of the strategy suggest that financial supply to future operations should be shared among the EU members. Other states including the United States, also had to update their military development concept and limit the traditional military (national defense) outlays to keep their population stay happy.

This review is not intended to cover such issues as whether or not Russia may begin to make up a new (or update the old) development concept (strategy) of its Armed Forces and, most importantly, dare to curtail its military (national defense) outlays.

However, the following relevant aspects are worth noting. First, growth in the federal budget military (national defense) outlays after 2010 and their bias towards spending on the Armed Forces equipment, so-called “development outlays”, against spending on the Armed Forces maintenance (“consumption”) was based on disinformation rather than reliable military and economic data. The authors of this review repeatedly pointed to such facts in their previous publications² with reference to the primary source of information, but the facts were ignored.

Second, it is not the President but lower level officials who need the documents to be refined and updated so that they can better understand the concept of the modern modernization and “horizontal” cooperation in addressing sub-problems and tasks. Furthermore, it would be useful to raise general public awareness of the changes to the Russian Armed Forces.

6.6.1. Topic military construction issues and how they can be addressed

None of the military and political leaders, or an insider made an attempt to explain publicly the economic feasibility of the military reform concepts and their actions as administrators, so that it can be available for analysis by independent experts. No speeches for the population and reporters can replace a scientific discussion with independent experts.

Under the circumstances, Sergei Shoigu was unexpectedly appointed as Russian Defense Minister. He took the office predictably beginning with addressing the issues which cannot be

¹ Watanabe L. France New Strategy: The 2013 White Paper]. URL: <http://www.isn.ethz.ch/Digital-Library/Publications/Detail/?lng=en&id=169217> (date of access: 15.07.2013). Summary translation into Russian is available at: <http://csef.ru/index.php/ru/oborona-i-bezopasnost/project/340-voenno-strategicheskie-otsenki-i-prognozy/1-stati/4742-strategiya-frantsii-2013-ofitsialnyj-dokument>.

² Tsybal V. I. Military construction plans need to be adjusted // *Economicheskoye Razvitiye Rossii*. 2013. No. 8. pp. 49–52].

considered either topical or requiring new substantial outlays, and investigation into sophisticated fraudulent schemes.

Shoigu announced his first decision at a meeting with the senior executives of the Ministry of Defense which was held immediately after his appointment as Minister of Defense. He issued an order directing cadets from the Suvorov Military School and the Nakhimov Naval Academy to take part in Victory Day Parades. So they did on May 09, 2013. Additionally, the Minister announced his plans to reassign the control of military higher education institutions which under former Minister of Defense Serdyukov A. used to be coordinated by the Ministry of Defense Education Department, to Commanders-in-Chief and branch commanders on whose behalf the military personnel are supposed to be trained as new weapons come into operation. This was done too.

The Defense Minister's statements concerning the military uniform received a positive response. Additionally, other minor, as it may seem, but important daily-life issues have been addressed.

The concept of rational military formation structure and dislocation of troops has been refined. In particular, the "division – regiment" organizational structure was restored in the Air Force (AF), as well as air defense and aerospace defense brigades were reorganized into air defense divisions. The AF deployment became to be based on the "one regiment – one airfield" principle.

Much more complicated is the situation with recovering the "lost" assets, i.e. those that were virtually stolen at the time when A. Serdyukov held the Minister's office. The case is doomed to encounter challenges, because the skillfully disguised allegedly legal nature of the deals requires filing legal actions aimed at terminating and invalidating such deals.

It would be much easier to predict what is going to happen with the excessive stock of non-core military assets (property) left at the Ministry of Defense. It is the Federal Agency for State Property Management (Rosimushchestvo) that is expected to be assigned to dispose of such assets (property).

The Ministry of Defense is still facing the issue of getting rid of unneeded stock of outdated military hardware, a total of almost 300,000 tons of dangerous "metal scrap" which need to be guarded for the time being. Not only may long-lasting efforts to destroy these hardware using the Ministry of Defense's resources result in manpower losses but they are also inefficient.

Of great importance is the new Defense Minister's statements about the Ministry getting more transparent, making public its plans and performance results. The introduction of conference calls with varying composition of participants, as well as publishing the results of such conferences in mass media has proved efficient. Although the expected release of the Ministry of Defense White Book was delayed, the Ministry published its MO-2013 Report on the official website, which can be considered a positive result¹.

Summing up the results of Shoigu's actions in 2013, most of them can be considered efficient. However, it might take long to see the effect of such actions.

6.6.2. Military recruitment policy and procurement

The appointment of a new Defense Minister and reappointment of some of the top executives at the Ministry of Defense was followed by a proposal to make adjustments to, above all, the military recruitment policy (MRP), and bring back all skilled specialists.

¹ <http://vil.ru/files/result2013/index.html>

Regretfully, this hardly seems feasible though, after so many years of “reforms” and because of personnel ageing, loss of research schools and succession.

The originally initiated by Serdyukov A. and Makarov N. reduction of total commissioned officers strength from 335,000 to 150,000 persons and subsequent increase up to 220,000 has raised the question of whether the military recruitment policy was smart enough? Is it well estimated for the time being? Isn't this number of regiment officers too big for the announced manpower strength in the Armed Forces totaling 1 million? The Land Force and Navy need specialists at the low and mid-levels of military command.

Furthermore, a few so-called “science squadrons” staffed with “most gifted graduates” were introduced into the Armed Forces. It will take long, however, until any visible results can be achieved.

At the same time, this has been opposed by those lobbying traditional-type military education institutions and training programs. The lobbyists aren't concerned by that military schools and higher education institutions should graduate about 10,000 persons annually to maintain the number of military officers at a level of 220,000. Any bigger number of graduates will be excessive. Nevertheless, higher military schools accepted cadets were accepted 15680 in 2013.

There is misbalance in selecting and training the required number of enlisted military personnel and junior command personnel for the voluntary contractual military service. The President's call for increasing the number by 50,000 annually means not only selecting newly contracted military personnel, but also retain though any possible incentives those who serve well. Furthermore, numerous studies show that the amount of military compensation (MC) including other incentives should be higher than the national average wage (AW). At present, the basic MC, net of new increments, amounts to about Rb 20,000 per month, while the national average wage is near Rb 29,000. No changes to this are expected in the short run. New increments will be introduced for some but not all of the military personnel. They managed to increase the number of contracted personnel in the Russian Armed Forces to 225,000, whereas the plan was to increase it to 241,400 at 2013 year-end, and this despite the fact that enlistment in 2013 reached 81,000, i.e. by 27% more than planned. At the same time, a bigger than expected number of the previously contracted military personnel refused to extend their contract, whereby showing low incentives to do military service.

President Putin pointed out that five years ago about Rb 600bn were allocated annually to the Ministry of Defense. The sum was subsequently doubled, and in 2014 it will amount to Rb 2,3 trillion. Furthermore, most of the increment refers to the equipment of the Russian Armed Forces. The Government was and is “running short of the money” which is required to increase the MC to contracted military personnel (approximately Rb 30bn by estimates). And, however, there is no money to finance the promised indexation of pension benefits for the retired military personnel, and many other costs falling under the “consumption” category.

Total manning level in the Russian Armed Forces remains the same, around 82%. One may reasonably ask whether the value of this indicator is substantiated, whether it's high time to recognize a strength of less than 1 million. It is more important for the civil society to know whether this country really needs enlisted military personnel in time of peace. Even considering that the term of their basic training for full military service was reduced down to four months by making the training more intensive, one may reasonably want to know whether these personnel are able to “pay off” within the eight months left for service?

There are more issues that need to be addressed. It is not for the first time that Russia's people were assured that only contracted military personnel would be engaged in hotbeds of tension¹. There, however, are lots of facts of repeated failures to keep such promises. Some of the procurement issues, above all, the provision of military personnel with living accommodations need to be addressed too. Although a huge success has been achieved here, the dynamics runs counter to common sense, i.e. the greater is the number of provided living accommodations, the tougher is getting the situation with the "homeless" military personnel on the waiting list, which is also influenced by their (officers who were and are to be dismissed) requirements to the quality and location of the provided living accommodations. Vague differences between budget and extrabudgetary resources required to satisfy the need for living accommodations make the system tend to be less transparent, thereby making corruption unavoidable in this area.

Perhaps, this is the reason why the Defense Minister suggested that from January 1, 2014 it is not residential apartments but an adequate amount of lump sum payment that should become the key form of providing the military personnel with living accommodations², which, as he assumes, will make it easier for those in the waiting list. A respective law was adopted in December 2013.

Enhancing operational training of the military personnel, units, forces, and conducting joint exercises can be regarded as positive results for the MRP.

Summing up the achievements and lost opportunities regarding the MRP pursued in 2013, what should not be left unmentioned is the initiatives launched by the Ministry of Defense and the legislative bodies at the end of 2013, when it became clear that the planned manning in the Armed Forces was facing even more challenges. A series of amendments to the applicable laws and regulations were drafted and submitted to the State Duma for consideration. However, there are no guaranties of success, because the two key factors still remain to be overcome, namely compulsion to military service (regarding to the enlisted personnel) and greediness (regarding to those who serve on a contractual, voluntary basis).

6.6.3. Military-technical policy and supplying new weapons to the Russian Armed Forces

It is difficult to analyze the results achieved in 2013 in the key areas of the Russian military-technical policy (MTP) because of numerous promises that were made in substantiating the level of military expenditures on its implementation, and indistinctness of a comparative analysis of not only actual achievements, but also lost opportunities.

As a reminder, a promise was made not only to increase supplies of new weapons and military equipment (WME) to the Russian Armed Forces, but also to address a few other issues, such as:

- 1) providing a comprehensive development of the military-industrial complex (MIC) of the Russian Federation, its technical equipment, and manufacturing personnel training;
- 2) manufacturing WME not only for the Russian Armed Forces, but also as part of the military and technical cooperation with other countries (export and import);
- 3) maintaining WME in a serviceable condition fit for combat;
- 4) developing new military technologies and latest combat weapons, as well as training of engineers and designers specializing in modern technologies;

¹ Gavrilov Y. Professionals to be engaged // *Rosyiskaya Gazeta*. 2013. February 15, 2013.

² http://ria.ru/defense_sofety/20130204/921125299/.html

5) sharing latest technologies and design concepts with the civil sector and vice versa.

It is well known that these objectives were formulated inexplicitly, “literary”. They were set in the Armed Forces Long-term Strategic Objectives Plan, the SAP-2020 for the period of 2011 thru 2020, the MIC development programs, and specified in government defense orders (GDO), and a series of documents. Additionally, the objectives were ascertained as part of continuing management of the development of the Armed Forces and the MIC by Russia’s political and military leaders who often function in the manual control mode.

However, the legal and regulatory framework failed to work the way it was supposed to. Although Deputy Prime Minister Dmitry Rogozin expressed his appreciation to the legislators for drafting the required laws, “We have done what had to be done and the President signed the federal laws we adopted by the upcoming 2012 year, above all, the Federal Law No. 275-FZ On the Government Defense Order, the Federal Law No. 44-FZ On the Contract-Based System of Procurement of Goods, Works and Services for Public and Municipal Needs which is coming into force. And, of course, the Federal Law On the Advanced Research Foundation¹.

Speaking of the 2013 results, it should be noted that any state armaments program (SAP) has its initial, most essential 5-year implementation period, i.e. the current program has the same period of time spanning between 2011–2015. Therefore, the year of 2013 is in a sense the principal year over the period under review, although the results of that year shouldn’t be set apart from the SAP failures in the two preceding years.

Additionally, preparations for the development of a new SAP-2025 for the period of 2016 thru 2025 have kicked off. The MIC top executives should take as obligation President Putin’s words that the Russian Federation will not expect to incur such huge SAP costs in the future (no exact period was specified).

These seemingly natural issues have so far been kept outside the scope of issues that aren’t supposed to be addressed or even discussed. It is not until the very end of 2013 that President Putin mentioned the issue in his Presidential Address and called for a solution. And, let’s face it, he did it in the right time, because a new budget for the period of 2014 thru 2016, i.e. beyond the first 5-year period of the SAP-2020, has been approved. However, it contains no signs of financing the transition to a closer end of a period of highest ever costs on the equipment of the Armed Forces.

The still remaining interpretation of the current MTP in Russia keeps the principle of “grab- swiftly-as-much-as-you-can” prevailing and most important incentive for many Russia’s top managers. Therefore, the struggle over budget allocations keeps going, and President’s words about inevitably upcoming military budget cuts are being ignored.

The net effect is that there is no integral vision at successful development of the MIC, equipment of the Armed Forces, let alone a positive effect of the MIC on the development of the national economy despite unconditional success on some of the five aforementioned objectives. This can be illustrated by the following.

MIC development in the Russian Federation

Considering that the Russia’s military establishment has been assigned the task of making the current Armed Forces into innovative ones, the former needs latest WME samples which can be provided through further upgrading the research-and-technology and engineering-and-manufacturing framework at MIC facilities. A respective MIC modernization program was developed and resources allocated.

¹ Rogozin D. Reviving the defense industry. // VPK No. 49 dated 18.12.2013.

The problems faced by the MIC were discussed extensively late in 2013¹ during a meeting attended by Deputy Minister of Defense Yury Borisov, senior officials, and deputies CEO's of major state-run corporations and holdings, i.e. arms suppliers. The discussion was dedicated to the GDO and its role in the implementation of the SAP-2020.

According to the Deputy Defense Minister, "the use of public resources is subject to a series of conditions virtually diluting the very idea of using them. For example, there is a provision for cooperation with engineering companies. There is no way that a modern cost-efficient, high-end manufacturing can be established without sound engineering. There is another big problem, i.e. the way the federal laws and regulations regulate tenders. The state has to buy from the winner low-quality cheap products, i.e. machine tools without after-sales service and supplies of respective spare parts tools and accessories". Additionally, Yury Borisov also pointed out that under the law 50% of machine tools should be manufactured in Russia. However, these machine tools are most often the "last century hardware". The issues of pricing have long been left unresolved. However, neither the Ministry of Defense, nor the MIC see any reason for being blamed for this, "because the issues are first of all supposed to be addressed through laws and regulations. It's another matter that the Ministry of Defense and the MIC should intensify their lobbying efforts and participate more actively in drafting well-defined laws and regulations which promote rather than constrain the scientific and industrial development".

Therefore, it derives from the available data on the MIC organizational and technical development that the resources allocated to the MIC have been spent ineffectively. This can be explained by an excessive monopolistic power prevailing at top levels of the MIC's manufacturing hierarchy, who tend to set prices, terms, and even WME basic characteristics. Another reason is that it is mostly principal enterprises of the MIC that managed to survive at hard times, whereas manufacturers of components degraded, failed to upgrade and compete with foreign suppliers, and many of them went bust.

Under the circumstances, some contracts cannot be concluded, because there is nobody who would wish to do it. The situation cannot be saved by simply raising the amount of allocations. "The state has to pay a dear price to purchase military equipment", said Deputy Chairman of the Military Industrial Committee under the Russian Government (MICRG) O. Bochkarev. "This area is riddled heavily with corruption and nontransparent procurement schemes, added Polyakov I., Chairman of the MIC Industrial Branch of Delovaya Rossiya, an all-Russian public organization. Light fingered contractors tend to make sure the price is low, obtain 80% upfront, and then disappear. Furthermore, those enterprises which have failed to complete an order may easily receive a new one".

Manufacturing WME for the Russian Armed Forces and for export

The beginning of 2013 held promise. The Russian Navy flag was hoisted on January 10, 2013 on the K-535 Yuri Dolgoruky Borei-class ballistic missile submarine (SSBN). Another underwater nuclear cruiser Aleksander Nevsky came into operation at the end of the same year as part of the same project. It should be noted, however, that this had no effect whatsoever on the Russia's strategic deterrence potential, because the notorious Bulava submarine-launched ballistic missile designed for such cruisers failed to be put into service, i.e. Russia's nuclear submarines (NS) remain disarmed for the time being. It is only the

¹ Military arts – a competent conversation. The materials of a roundtable which was held in RIANOVOSTI late in 2013.

previously tried and tested strategic deterrence assets that can save the situation. As a reminder, the national strategic posture is meticulously measured on the basis of the treaty signed between the United States and the Russian Federation and, as equally important, the results are published.

The level of compliance with the arrangements on the reduction of strategic offensive arms (SOA) as of 1.09.2013 is shown in *Table 28*.

Table 28

Data on the SOA quantities in the Russian Federation and the United States

SOA title	Threshold values under the treaty	U.S.A. on actual basis	Russia on actual basis
Deployed launchers: intercontinental ballistic missiles (ICBM), submarine-launched ballistic missiles (SLBM), and heavy bombardment aircrafts (HBAC)	700	809	473
Deployed launching and non-deployed launching platforms for the same classes of launchers	800	1015	894
Warheads on deployed launchers	1550	1688	1400

Data source: Bureau of Arms Control. Verification and Compliance. Washington, DC: US Department of State, 2013.

It derives from the data presented in *Table 28* that Russia is currently behind the United States by number of strategic offensive assets which may be recognized within the deterrence concept. As a reminder, the United States (besides the assets recognized under the treaty) has incomparably more sea-launched cruise missiles than the Russian Federation does, as well as other assets which weren't covered by the international treaties. This implies that the balance of powers has been becoming increasingly asymmetric and approaching the deterrence threshold limit. Measuring the military assets of NATO members, such as Great Britain and France, as well as deployment of ABM systems leads even closer to the threshold limit. True, Russia cannot ignore the imbalance. Neither can it ignore the fact that China and a few other states have similar nuclear weapons (NW). This is why the situation with Russia's strategic deterrence assets was and still remains the principal, essential indicator of Russia's military potential and national security.

Besides the NW, the potential of conventional high-precision guided weapons has been growing year after year in many countries. Russia is still behind in the development of such weapons and therefore compelled to retain its tactical NW stocks and delivery systems, as well as the possibility of their use in regional conflicts.

Providing information support to the strategic deterrence assets is equally important. Russia has been making efforts to resolve this issue. In 2013, three new prefabricated radar stations (RS) for missile warning system (MWS) were built (in the Krasnoyarsk Territory, the Altai Territory, and the Orenburg Region) to control ballistic, space-based, and aerodynamic targets¹.

Regarding the development of conventional combat weapons, the possibility and practicability of purchasing such weapons from other countries moved to a new phase in 2013. On the one hand, it would be wrong to resolve the issue behind-the-scenes, as A. Serdyukov wanted to do. On the other hand, Russian top executives cannot resolve it through a comprehensive analysis of all factors and controversial arguments. To date, at least the order on the supply of French made Mistral-class multirole surface warships to the Russia's Naval Force has been still in force so far.

¹ Voenno-promyshlenny weekly journal No 2 dated 16-22.01.2013

There is neither need nor technical capacity to list in this review the achievements or, *a contraria*, failures in the development of all conventional arms. Even if we restrict ourselves to, for example, analysis of the results achieved in the development of military air vehicles and weapons based on the latest scientific attainments. Moreover, they are traditionally linked to the development of the civil aviation and in this context can serve as illustrative example for the given MIC objectives in general.

However, it should be kept in mind that the development of modern military air vehicles has been evolving into manufacturing of unmanned drones (UMDs), with information and cybernetic means of control playing the principal role. Russia is behind other countries in this. It cannot be but mentioned that Rb 3bn worth of long-time mission air vehicles are under development in the Russian Federation at such companies as Transas (St. Petersburg) and OKB Sokol (Kazan). A heavier UMD is being development at the Sukhoi Aviation Holding Company (JSC) ¹. However, like in the previous years, not a single UMD has come to operation yet to pay off the costs of their development.

It is the United States and Israel that are leading in the development and combat employment of UMDs. However, Russia is facing difficulties in terms of military and technical cooperation with these countries. The United States has been steering away from dealing with Russia's enterprises, while Israel is cooperating with certain reservations. There is an interesting information though: ADCOM Systems, an Emirati company, is ready to deliver to the Russian Ministry of Defense its United 40 drone for test. According to some data, engineers from the Kharkiv Aviation Institute were actively engaged in the development of this drone. Indeed, competitive relationships move in a mysterious way. If the Russian military need such a vehicle, it might seem more rational for the Russian party to deal directly with the Kharkiv specialists. However, relationships between Russia and Ukraine and, consequently, between their MICs are so controversial that politics leaves no room for practicality.

After all, failures to fulfill the seemingly key objective with a huge financing are the indication of that the SAP-2020 has failed to be up to a "perfectly estimated to the last kopek" program, as the Russian President described it once, and, therefore, not subject to any cuts. The defense industry simply has no enough time to spend the money which can be invested. This is why the SAP-2020 began to see gradual cuts in 2013. Russia's Finance Minister Siluanov A. gave comments on this said at the end of the first half of the year, saying that "the Ministry of Finance and the Ministry of Defense have agreed to carry over a part of the state armaments program expenditures", and explained that it refers to carrying over to 2017–2018 a part of the budget expenditures scheduled for allocation for these purposes in 2014–2016. At the same time, he pointed out that "the program's deadline, 2020, remains unchanged"² as well as the total amount of budget expenditures does.

Some experts considered this a reason to infer that "Russia's Arms Forces and the MIC are facing the main issue of deep disorganization and generally overflowing incompetence of the administrative body, rather than lack of financing, and even embezzlement. The Bulava missile has been tested for nine month, half of the missile flights were abortive. However, no one could say that this ill-fated project lacks financing"³?

¹ Nikolsky A. A wide product line of drones // Vedomosti. 2013. December 5, 2013 (No. 226).

² mn.ru/society/20130614/348897295.ht...

³ <http://www.kommersant.ru/doc/2282902>

Nonetheless, annual accounting is still expressed in rubles showing neither success nor visible failures.

WME operation issues

The idea to switch to EPC contracts with industrial enterprises¹ in order to ensure WME “life cycle” was a Defense Minister’s new proposal entailing serious effects. He stated that this is supposed to “minimize risks of failure to fulfill government defense order (GDO) assignments”. A new scheme of WME repair and disposal was for the first time suggested by the Defense Minister at a meeting with President Putin late in a January 2013. Explaining the Defense Minister’s decision, his Deputy Y. Borisov said that every device designed for the Armed Forces will be subject to support services from the release date until the disposal stage. He also assured that “such contracts have been approved by manufacturers”. Technically, it will look like service support of the products supplied “to the Russian Armed Forces effective this year ...through sub-agreements on the provision of support services, repair, and disposal throughout the device’s entire service life”. An agreement on the provision of support services to Yury Dolgoruky Borei-class ballistic missile nuclear submarine, as well as frontline, military airlift, and strategic airplanes is expected to be signed among first such contracts.

There is nothing yet to say, or worth saying, about whether or not this innovation is useful. Indeed, it should be useful for industrial enterprises, because they will have profitable orders. However, it may not be the case for military units and, broadly speaking, the national defense. It cannot be ruled out that the effect might be inverse when special conditions are required for the deployment, as it was the case with unfounded introduction of outsourcing to meet the Army needs. Furthermore, no one can quarantine an “eternal life” to manufacturing enterprises. And it will appear then that we have given up our historically proven experience in training WME maintenance personnel in regular line units, while no field experts will be available at all or such experts will not be able to reach the battlefield or operate in harsh natural conditions, for example, subarctic environment.

Developing new WME and engineering personnel training

Advanced Research Foundation (ARF) was established in order to ensure dynamic development of groundbreaking but risk-bearing technologies for the sake of national defense and security. However, it might take longer for the Foundation to be formed, and there is little hope of turning it into something that resembles successful foreign analogues, in particular, the U.S. Defense Advanced Research Projects Agency (DARPA)².

The issue of manufacturing personnel training hasn’t been put aside. Top managers of industrial enterprises and holdings report on the issue to the Military-Industrial Commission under the Government of the Russian Federation. Overall, as it was repeatedly stated, the SAP-2020 is synchronized with the MIC Development Federal Targeted Program (FTP) whose public contractor-coordinator is the Ministry of Industry and Trade of the Russian Federation (Minpromtorg). As part of the foregoing FTP enterprises reequip their production facilities to be able to manufacture new models. However, it will take long until these works can be fully linked with the works performed as part of the projects promised by, for example,

¹ http://ria.ru/defense_safety/20130213/922638863.html

² Tsymbal V.I. How the adoption of the ARF Act may influence the Russian economy? // Ekonomicheskoye Razvitiye Rossii. 2013. No. 2. pp. 48–52. What Russia’s Economy Should Expect from the Adoption of the Federal Law on the Advanced Research Foundation? http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2271110;

ROSNANO or Skolkovo. One cannot but hope that all these entities and foundations will approve themselves at next stages of the SAP-2020, most importantly, as part of the new SAP-2025.

The issue hasn't been forgotten, but the way it has been addressed rises some questions. To bring up questions and look for solutions, let's cite a few lines from Dmitry Rogozin's report in the State Duma: "the focus should be placed on manufacturing brand new models of arms, military and special equipment, rather than deep modernization of the models which can be manufactures by our industry. This requires new materials, new knowledge, new solutions. In other words, a new program must be innovative. This is a challenge. The huge scientific and technological potential which our fathers and grandfathers created has been exhausted. We have no new solutions left for materialization"¹.

Indeed, there is no room for argument here. Nevertheless, applied research and development was financed on an annual basis. Furthermore, having succeeded in the ARF establishment, Military Industrial Committee Chairman Dmitry Rogozin suddenly points to other high-ranking officials, a new need "to upgrade the status of chief designer, a person who assumes full liability for looking for new solutions".

Where new components, let alone "dual purpose" ones, may come from if the principal generator of latest scientific and technical ideas is not the ARF but a team of competing chief designers aimed at creating WME end products rather than components, materials, technologies is? Doesn't such a concept contradict the U.S. DARPA concept and, consequently, that of the ARF?

Transferring military technologies to civil industries

Like in the case with the previous task, no serious results were achieved here in 2013. What happened led to more questions than answers. For example, Russian Rostec Corporation, a military-oriented company, announced late in 2013 its unexpected "contribution" to the production of a new dual-screen smart phone called YotaPhone. YotaPhone's main application properties imply that it is designed to enhance reliability of transmitting vital information (if the main screen battery runs out of power) to the consumer.

Nothing was said about using such devices for military purpose, although the need to equip the Armed Forces with modern reliable and user-friendly means of communication and spatiotemporal provision, for example, GLONASS, has long been discussed. However, such a presentation of the potential dual-use feature of the gadget is unlikely to cover its production costs and enhance its military relevance. The rest of the new device is rather discouraging, because it was previously announced that nothing but the dual screen was designed in Russia. The gadget that was demonstrated to the Prime Minister turned out to be assembled of imported components in Singapore, not Russia.

Sukhoi Superjet-100 (SSJ-100), a passenger air jet, is much more serious illustration of dual (civil and military) use of the products manufactured by the MIC. However, it may hardly be considered a success. Since the original plan on sales in external markets didn't work out, the WME customers had to buy these air jets despite the strict home airfield quality requirements, which is untypical of military aviation.

Most importantly, both military and civil aviation are facing equally pessimistic prospects in Russia, as convincingly evidenced by Russia's high-profile test pilot M. Tolboyev who named the main reason for the failures and even tragedies (in particular, the civil aircraft crash

¹ Rogozin D. Reviving the defense industry. 2013. December 18, 2013 (No. 49).

in the city of Kazan) that took place: “This is corruption in its pure form”¹. He also predicted a pessimistic outcome.

Innovation “products” are often fictitious. Let’s take a look at the results of a few audits. “Having spent huge public allocations, the Minpromtorg of Russia has failed to fulfill the objectives of developing and introducing cutting edge technologies and enhancing the research and intellectual potential of the aircraft and shipbuilding industries. The obtained results have been found to be insufficient to cover the costs of the inventions which the state has made no use of”². Furthermore, as specified in the cited publication, “facts of the Ministry paying for unperformed R&D and overpricing have been revealed. Preliminary estimates show that the damage may reach about Rb 1bn”.

Overall, summing up the 2013 results concerning all the issues of equipment of the Armed Forces, the Defense Minister expressed satisfaction: “in 2013, R&D (research and development) GDOs were fulfilled 96%, and it cannot but satisfy. WMSE (weaponry, military and special equipment) have been purchased 93%, WMSE repair and service support – 91%. This is a serious achievement”. “We have seen a substantial growth in arms supplies: we have received 1.7 times more equipment than in 2012. The number of reclamations will be the same or less than in 2012. We have to work on further reducing the number of reclamations, and a lot depends on the Ministry of Defense Acceptance Committee”³, added the Minister.

6.6.4. Military and financial policy

The 2013 federal budget implementation didn’t differ much from the schedule of the two previous years, except that two major adjustments were made in June and December. Furthermore, in June, the mid-year expenditures under the item of National Defense were reduced by Rb 6bn 540m for the first time since the recession in September 2009. Under the Federal Law on the Federal Budget, expenditures under the same item were initially established Rb 2 trillion 106bn⁴, or Rb 223bn less than what the Russian Government planned in the preceding year⁵. A decision was made at the end of the year to increase by Rb 11bn 783m the corresponding federal budget expenditures.⁶

As a result of the foregoing mixed changes by the end of the fiscal year federal budget expenditures under the item of National Defense increased as little as 0.25% to Rb 2 trillion 111bn 705m (3.17% of GDP), while total budget expenditures remained unchanged. Expenditures under the same budget item increased 7.4% in real terms (14.4% in nominal terms) against 2012.

Since all of the foregoing military expenditures are not available in the published budget acts, they were determined on the basis of the reports made by the Federal Treasury reports and core committees of the Russian Federation Federal Assembly. Confidentiality of federal

¹ Magomet Tolboev: Bribes lead to plane crashes // Pravda.ru. 2013. December 3, 2013.

² Nikolayev S., Safronov I. Prosecutors in defense // Kommersant. 2014. January 29, 2014.

³ http://ria.ru/defense_safety/20140114/989097405.html.

⁴ The Federal Law of 03.12.2012, No 216-FZ On the Federal Budget for 2012 and the Planning Period of 2013 and 2014.

⁵ The draft law No. 607158-5 On the Federal Budget for 2012 and the Planning Period of 2013 and 2014. M., 30.09.2011.

⁶ The Federal Council Committee for Defense and Security’s conclusion on the Federal Law On the Amendments to the Federal Law On the Federal Budget for 2013 and the Planning Period of 2014 and 2015. No. 3.3-04/1892 dated 26.11.2013.

budget expenditures was visibly enhanced in 2013 vs. the previous years, 2 p.p. above the 2006 historical high (see *Table 29*), while confidential budget allocations amounted to Rb 1 trillion 865bn 442m, of which 63% were allocated mainly as GDO to the MIC and 26% to secret-service agencies. The secrecy system of federal budget allocations has seen no quality changes whatsoever, while the state keeps thoughtlessly adhering to the Soviet way of doing it.

Table 29

**The share of confidential expenditures in the federal budgets
of 2005 thru 2013, %**

Code and item (sub-item) containing confidential expenditures	2005	2006	2007	2008	2009	2010	2011	2012	2013
1	2	3	4	5	6	7	8	9	10
Federal budget expenditures, overall	11.3	11.8	10.3	11.9	10.0	10.5	11.7	11.7	13.9
0100 NATIONAL-LEVEL ISSUES	3.7	6.3	5.5	8.7	5.1	4.8	9.8	11.4	9.5
0108 International relations and international cooperation	–	<0.1	< 0.1	3.7	–	–	–	–	–
0109 State material reserves	82.9	89.2	92.2	90.2	85.0	85.1	86.6	86.8	87.2
0110 Basic research	2.1	1.2	1.1	1.0	0.8	0.3	1.0	2.7	0.7
0114 Other national-level issues	0.1	0.7	0.3	4.4	1.6	1.1	1.3	1.3	2.3
0200 NATIONAL DEFENSE	42.1	42.8	45.3	46.1	48.1	46.4	46.9	47.6	51.0
0201 Armed Forces of the Russian Federation	33.1	35.6	37.1	39.0	40.2	39.0	40.9	41.2	48.3
0204 Mobilization preparation of the economy	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
0205 Preparation for and participation in collective security and peace-making efforts	100.0	100.0	100.0	–	–	–	–	–	–
0206 Nuclear weapons complex	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
0207 Fulfilling international commitments concerning military-technical cooperation	45.2	46.9	50.7	100.0	100.0	100.0	100.0	100.0	80.1
0208 Applied research studies in the area of national defense	98.4	93.9	93.7	93.2	92.9	91.3	92.2	94.5	94.1
0209 Other national defense issues	2.5	8.8	24.4	29.2	34.6	42.0	36.8	44.9	41.9
0300 NATIONAL SECURITY AND LAW ENFORCEMENT ACTION	28.5	31.6	31.1	31.8	30.8	32.1	32.5	23.3	27.4
0302 Internal affairs agencies	4.8	6.3	5.2	5.0	3.7	4.3	3.9	3.4	3.8
0303 Internal troops	11.8	10.3	9.8	10.3	8.2	8.3	7.9	4.6	4.5
0306 Security agencies	97.8	95.5	97.3	99.1	99.6	97.1	99.6	99.6	99.7
0307 Russia's border service agencies	100.0	99.0	97.6	100.0	99.5	98.6	99.1	99.1	99.6
0309 Protection of the population and territories from natural and man-made emergencies	59.0	62.4	50.7	51.4	51.0	51.3	47.0	42.6	40.7
0313 Applied research studies in the area of national defense and law enforcement action	74.0	66.4	64.4	75.5	79.4	92.1	86.0	85.9	91.4
0314 Other issues concerning national security and law enforcement action	8.3	50.7	40.0	56.3	68.4	67.9	78.3	13.6	12.3
0400 NATIONAL ECONOMY	0.1	<0.1	0.4	0.6	0.6	1.6	1.8	2.4	4.9
0411 Communications and informatics	–	–	–	–	–	–	–	–	1.6
0411 Applied research studies in the area of national economy	–	–	5.2	5.8	4.5	5.6	11.9	14.2	18.2
0412 Other issues concerning national economy	0.1	0.1	< 0.1	0.3	0.7	4.5	1.9	2.3	8.5
0500 HOUSING AND PUBLIC UTILITIES	–	3.4	0.9	7.0	10.1	19.3	14.2	6.6	11.0
0501 Residential sector	–	4.2	5.7	16.0	12.9	20.8	20.7	8.5	21.3
0700 EDUCATION	2.8	2.7	2.4	2.6	3.1	3.6	4.0	3.2	4.3
0701 Pre-school education	2.0	2.2	2.4	2.5	2.5	3.9	3.9	4.4	4.5
0702 General education	1.5	1.9	2.1	2.0	2.8	3.5	0.4	0.2	0.5
0704 Secondary vocational education	1.1	1.0	1.0	0.9	1.0	–	–	–	–
0705 Professional training, retraining, and advanced training	16.9	15.8	17.2	1.8	2.5	9.4	17.4	8.6	6.2
0706 Higher education and postgraduate vocational education	3.2	2.9	2.5	3.1	3.6	4.1	5.2	4.1	5.2
0709 Other education related issues	0.3	0.3	0.3	0.3	0.5	0.6	0.3	0.4	0.4
0800 CULTURE, CINEMATOGRAPHY, MASS MEDIA	0.2	0.2	0.2	0.2	0.2	0.2	–	–	–
0800 CULTURE AND CINEMATOGRAPHY	–	–	–	–	–	–	0.1	0.1	0.1

Cont'd

1	2	3	4	5	6	7	8	9	10
0801 Culture	0.1	0.1	0.2	0.1	0.1	0.1	0.1	0.1	0.1
0804 Periodic press and publishing companies	13.5	7.5	2.6	2.6	3.2	3.6	–	–	–
0806 Other issues concerning culture, cinematography, and mass media	<0.1	0.2	–	–	–	–	–	–	–
0900 HEALTHCARE, PHYSICAL CULTURE, AND SPORTS	4.3	4.0	2.6	4.1	3.5	3.0	–	–	–
0900 HEALTHCARE	–	–	–	–	–	–	2.7	2.4	2.7
0901 Inpatient medical assistance	5.6	4.7	2.9	3.2	2.8	2.4	2.3	2.0	1.8
0902 Outpatient medical assistance	n/a ¹	n/a	n/a	13.9	4.3	3.8	2.9	3.1	4.2
0905 Sanatorium and related medical assistance	n/a	n/a	n/a	14.1	15.9	10.7	11.2	10.8	12.2
0907 Sanitary and epidemiological safety	n/a	n/a	n/a	2.1	0.6	0.6	0.7	1.4	0.8
0908 Physical culture and sports	0.3	0.3	0.2	0.4	0.3	0.6	–	–	–
0910 Other issues concerning healthcare , physical culture and sports	–	–	–	1.7	1.1	1.0	–	–	–
0910 Other issues concerning healthcare	–	–	–	–	–	–	0.4	0.4	0.3
1000 SOCIAL POLICY	–	–	–	<0.1	<0.1	–	–	0.1	0.1
1003 Social security	–	–	–	<0.1	<0.1	–	–	0.3	0.3
1100 PHYSICAL CULTURE AND SPORTS	–	–	–	–	–	–	0.3	0.3	0.4
1101 Physical culture	–	–	–	–	–	–	62.0	41.5	9.1
1200 MASS MEDIA	–	–	–	–	–	–	0.3	0.3	0.4
1202 Periodic press and publishing companies	–	–	–	–	–	–	3.4	3.5	4.6
1400 INTER-BUDGET TRANSFERS BETWEEN THE CONSTITUENT ENTITIES OF THE RUSSIAN FEDERATION AND GENERAL MUNICIPALITIES	–	–	0.2	–	–	–	–	–	–
1401 Equalization transfers to the constituent entities of the Russian Federation and municipalities	–	–	0.5	–	–	–	–	–	–

Source: the Federal Budgets of 2005–2013. The data on 2005–2010 is presented in accordance with respective items and sub-items of the budget classification effective since 2011. Italicized is the data of the previous budget classification, as well as estimates which are subject to change.

Table 30 shows absolute and relative values of the basic components of Russia's direct military allocations in the federal budget and changes to these values against 2012. The data of the Federal Law of December 3, 2012, No. 216-FZ was used for 2013, because the final version of the Federal Law on the 2013 Budget² contains no data on the federal budget expenditures by item and sub-item of the budget expenditure classification. Recalculation into 2012 prices was made using Rosstat's first estimation³ of the GDP deflator index for 2013 (106.5%).

Military allocations in other federal budget items are shown in *Table 31*. Here, unlike the practice of the previous years, special agencies' confidential expenditures on education, healthcare , housing and public utilities, etc, as well as civil defense expenditures and maintenance costs on the EMERCOM (the Ministry of the Russian Federation of Civil Defense, Emergences and Elimination of Consequences of Natural Disasters) forces are no longer classified as military expenditures in other budget items (the latter – due to changes to the UN standards for reporting military expenditures⁴ effective since 2012 and classifying the military personnel pension provision as military expenditure).

¹ Non-applicable due to changes to the budget classification.

² The Federal Law of 02.12.2013, No. 348-FZ On the Federal Budget for 2013 and the Planning Period of 2014 and 2015.

³ Gross domestic product (GDP) production and usage in 2013. M.: Rosstat, January 31, 2013.]

⁴ Government experts' report on the overview of functioning and further development of the United Nations system for the standardized reporting of military expenditures. A/66/89. UN, June 14, 2011.

Table 30

Direct military allocations in the federal budget, “National Defense” item

Budget item and sub-items	2013, millions of rubles / the same in 2012 prices	Changes in 2013 against 2012, millions of rubles / growth, %	The share of allocations, % / changes against 2012, p.p.	
			2013 federal budget	in GDP
1	2	3	4	5
NATIONAL DEFENSE	<u>2,106,462</u> 1,977,899	<u>131.648</u> 7.13	<u>15.73</u> 1.49	<u>3.16</u> 0.17
Armed Forces of the Russian Federation	<u>1,628,112</u> 1,528,743 661	<u>171,140</u> 12.61	<u>12,16</u> 1.68	<u>2.44</u> 0.24
Mobilization pre-prescription and reserve military training	<u>6,792</u> 6,378	<u>-938</u> -12.82	<u>0.05</u> -0.01	<u>0.01</u> -
Mobilization preparation of the economy	<u>5,662</u> 5,316	<u>421</u> 8.61	<u>0.04</u> -	<u>0.01</u> -
Nuclear weapons complex	<u>29,289</u> 27,501	<u>26</u> 0.10	<u>0.22</u> 0.01	<u>0.04</u> -
Fulfilling international commitments in the area of military-technical cooperation	<u>5,804</u> 5,450	<u>814</u> 17.55	<u>0.04</u> 0.01	<u>0.01</u> -
Applied research studies in the area of national defense	<u>195,134</u> 183,225	<u>16,391</u> 9.82	<u>1.46</u> 1.17	<u>0.29</u> 0.02
Other national defense issues	<u>235,668</u> 221,285	<u>-55,789</u> -20.14	<u>1.76</u> -0.38	<u>0.35</u> -0.09

Source: Gaidar Institute’s estimates.

Table 31

Direct and indirect military allocations, other federal budget items

Budget item or type of allocations	2013, millions of rubles / the same in 2012 prices	Changes in 2013 against 2012, millions of rubles / growth, %	The share of allocations, % / changes against 2012, p.p.	
			2013 federal budget	in GDP
1	2	3	4	5
National security and law enforcement action				
Internal troops	<u>129,029</u> 121,154	<u>-2,744</u> -2.21	<u>0.96</u> 0.01	<u>0.19</u> -0.01
Russia’s border service agencies	<u>142,386</u> 133,696	<u>47,732</u> 55.53	<u>1.06</u> 0.40	<u>0.21</u> 0.07
National economy				
Alternative civil service	<u>6</u> 5	<u>-1</u> -10.46	<u><0.01</u> -	<u><0.01</u> -
Destruction of chemical weapons stockpiles in the Russian Federation Presidential Program	<u>6</u> 6	<u>-711</u> -99.21	<u><0.01</u> -0.01	<u><0.01</u> -
Subsidies to transport organizations for purchasing motor vehicles to replenish the military convoy rolling stock	<u>55</u> 52	<u>-3</u> -6.10	<u><0.01</u> -	<u><0.01</u> -
Subsidies to maintain the Russia-NATO Coordination Center	<u>51</u> 47	<u>-2</u> -3.01	<u><0.01</u> -	<u><0.01</u> -
Construction of special-purpose and military facilities	<u>14,306</u> 13,433	<u>1,666</u> 14.16	<u>0.11</u> 0.02	<u>0.02</u> -
Industrial Utilization of weapons and military equipment (2011–2015) Federal Target Program	<u>87</u> 82	<u>-18</u> -18.36	<u><0.01</u> -	<u><0.01</u> -
Contributions to charter capital and subsidies to organization pertaining to the military-industrial complex	<u>48,285</u> 45,338	<u>-7,066</u> -13.48	<u>0.36</u> -0.04	<u>0.07</u> -0.01
Scholarships to young personnel employed by organizations pertaining to the military-industrial complex	<u>240</u> 225	<u>-15</u> -6.10	<u><0.01</u> -	<u><0.01</u> -
Confidential expenditures	<u>86,124</u> 80,867	<u>32,479</u> 67.12	<u>0.64</u> 0.27	<u>0.13</u> 0.05

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Cont'd

1	2	3	4	5
Housing and public utilities				
<i>Destruction of chemical weapons stockpiles in the Russian Federation Presidential Program</i>	<u>362</u> 340	<u>131</u> 62.82	<u><0.01</u> –	<u><0.01</u> –
<i>Provision of military personnel with temporal living accommodation owned by the employer and permanent living accommodation owned by the employee</i>	<u>38,382</u> 36,039	<u>–93,615</u> –72.20	<u>0.29</u> –0.71	<u>0.06</u> –0.15
Education				
<i>Ministry of Defense expenditures</i>	<u>58,511</u> 54,949	<u>7,260</u> 15.23	<u>0.44</u> 0.07	<u>0.09</u> 0.01
Culture and cinematography				
<i>Ministry of Defense expenditures</i>	<u>2,137</u> 2,006	<u>115</u> 6.08	<u>0.02</u> –	<u><0.01</u> –
Healthcare				
<i>Ministry of Defense expenditures</i>	<u>47,963</u> 45,963	<u>2,924</u> 6.94	<u>0.36</u> 0.03	<u>0.07</u> –
Social Policy				
<i>Pension provision at the Ministry of Defense</i>	<u>254,910</u> 239,352	<u>–12,731</u> –5.05	<u>1.90</u> –0.04	<u>0.38</u> –0.03
<i>Pension provision to the Border Troops and Internal Troops under the Ministry of Internal Affairs</i>	<u>29,012</u> 27,241	<u>3,390</u> 14.22	<u>0.22</u> 0.03	<u>0.04</u> –
<i>Tangible support to specialists employed by the nuclear weapons complex of the Russian Federation</i>	<u>6,110</u> 5,738	<u>–6</u> –0.11	<u>0.05</u> –	<u>0.01</u> –
<i>Extra monthly tangible support to persons disabled as a result of war injuries</i>	<u>617</u> 579	<u>138</u> 31.34	<u><0.01</u> –	<u><0.01</u> –
<i>Assistance in repairing individual residential houses owned by the families of the military personnel who lost the bread-winner</i>	<u>216</u> 203	<u>–403</u> –66.50	<u><0.01</u> –	<u><0.01</u> –
<i>Provision of servicemen' survivor benefits</i>	<u>1,709</u> 1,605	<u>88</u> 5.81	<u>0.01</u> –	<u><0.01</u> –
<i>Benefits and compensatory payments to military personnel and equated persons, as well as the retired of them</i>	<u>7,256</u> 6,813	<u>–2,016</u> –22.84	<u>0.05</u> –0.01	<u>0.01</u> –
<i>One-time pregnancy allowance to spouses of enlisted servicemen, as well as monthly child's benefit to enlisted servicemen</i>	<u>2,503</u> 2,350	<u>82</u> 3.62	<u>0.02</u> –	<u><0.01</u> –
Physical culture and sports				
<i>Ministry of Defense expenditures</i>	<u>1,824</u> 1,713	<u>1,615</u> 1653.93	<u><0.01</u> –	<u><0.01</u> –
Inter-budget transfers between the constituent entities of the Russian Federation and general municipalities				
<i>Subsidies to the budget of Closed Administrative-Territorial Units (ZATOs)</i>	<u>11,566</u> 10,860	<u>1,984</u> 22.35	<u>0.09</u> –0.02	<u>0.02</u> –
<i>Migration from ZATOs</i>	<u>527</u> 495	<u>–32</u> –6.10	<u><0.01</u> –	<u><0.01</u> –
OTHER BUDGET ITEMS	<u>884,178</u>	<u>–25,823</u>	<u>6.60</u>	<u>1.33</u>
TOTAL	<u>830,214</u>	<u>–3.11</u>	<u>–</u>	<u>–0.06</u>

Source: Gaidar Institute's estimates.

As a result, in 2013, total military (national defense) allocations (*Table 32*) of the Russian federal budget, as calculated compliant to the UN standards for military expenditures, were estimated at 4.5% of GDP, demonstrating equal values for Russia and the United States, as well as such countries as Azerbaijan and Myanmar (economy's encumbrance in Europe and China ranged within 1% to 2%, except for Great Britain (from 2.5%) and France (from 2.3%).

Table 32

Total military and military-related allocations of federal budget in 2013

Allocations title	Sum of allocations, millions of rubles	The share of allocations, % / changes against 2012, p.p.	
		2013 federal budget	in GDP
Total military (national defense) allocations related to the current and previous military activity	2,990,640	<u>22.34</u> 1.48	<u>4.48</u> 0.11
Total allocations under the budget items of National Defense and National security and law enforcement action	4,144,794	<u>30.96</u> 2.68	<u>6.22</u> 0.29

Source: Gaidar Institute's estimates.

Overall, in 2013, resources under the item of 0200 National Defense were spent, saving Rb 8bn 124m (0.4%) over the allocations provided for by the latest version of the Federal Law on the Federal Budget.

Federal budget savings under the item of 0201 Armed Forces of the Russian Federation totaled Rb 25bn 725m (6.7%) through Ministry of Defense's costs on subsistence support alone against the allocations provided for by the initial version of the Federal Law on the Federal Budget. In 2013, the Ministry of Defense saw just a 0.84% increase (in real terms) in subsistence support costs after the Russian Government made no indexation of the military compensation, despite a 20% increase in the number of enlisted personnel by the end of the year, from 186,000 to 225,000 persons. The Ministry of Defense spent a total of Rb 360bn 420m (0.54% of GDP) on the subsistence support in 2013.

The Ministry of Defense spent Rb 211bn 598m on civil personnel wages, an increase of 5.41% year over year in real terms despite a 5% headcount reduction in civil personnel compliant to the Russian Federation Security Council's decision of July 5, 2013 On the enhancement of the national military establishment of the Russian Federation until 2020¹.

Ministry of Defense spent 4% less (in real terms) on petroleum, oil and lubricants (POL) in 2013, amounting to Rb 59 bn 266 m, saving Rb 4 bn 609 m (or 7.2%) over the amount allocated in the initial version of the Federal Law on the Federal Budget. It may therefore be assumed that a visible increase in 2013 in the frequency of spot operability tests and field training exercises was compensated by savings through an increased use of simulators for military personnel training.

Federal budget expenditures on the Ministry of Defense's subsistence and tangible support in 2013 increased 19.3% year on year in real terms (to Rb 54bn 693m and Rb 20bn 636 m respectively). Actual budget expenditures under these two items exceeded Rb 24bn 141 m, or 45.5%, the expenditures provided for by the initial version of the Federal Law on the Federal Budget.

Ministry of Defense's construction costs on civil facilities in 2013 increased 86% year over year to Rb 14bn 488 m under the item of National Defense and dropped 67% to Rb 41bn 210m under the item of Housing and public utilities. Construction costs of special and military facilities increased substantially 35.5% year over year and 57.2% of the costs provided for by the initial version of the Federal Law on the Federal Budget. Furthermore, military infrastructure costs increased to Rb 113bn 29m by the end of the year in response to the redistribution of Rb 75bn which the Ministry of Defense originally allocated to POL. Federal budget expenditures Concerning the Savings and Mortgage System of Housing

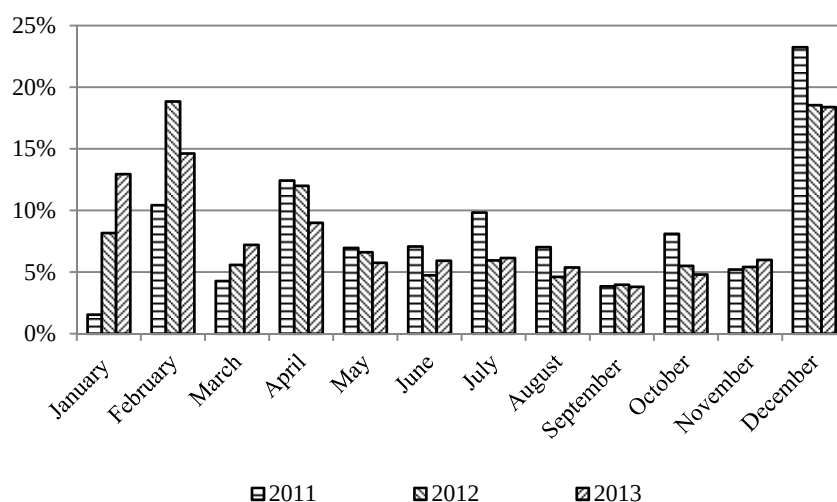
¹ Approved by the President of the Russian Federation on 22.07.2013.

Provision for Servicemen of the Ministry of Defense increased 25% year over year to Rb 58bn 834 m.

The item of 0200 National Defense keeps calling attention by rapidly growing expenditures under the sub-item 0209 Other national defense issues (Rb 259bn 602 m), where actually spent budget expenditures outstripped by Rb 23bn 934m (10%) the allocations provided for by the initial version of the Federal Law on the Federal Budget.

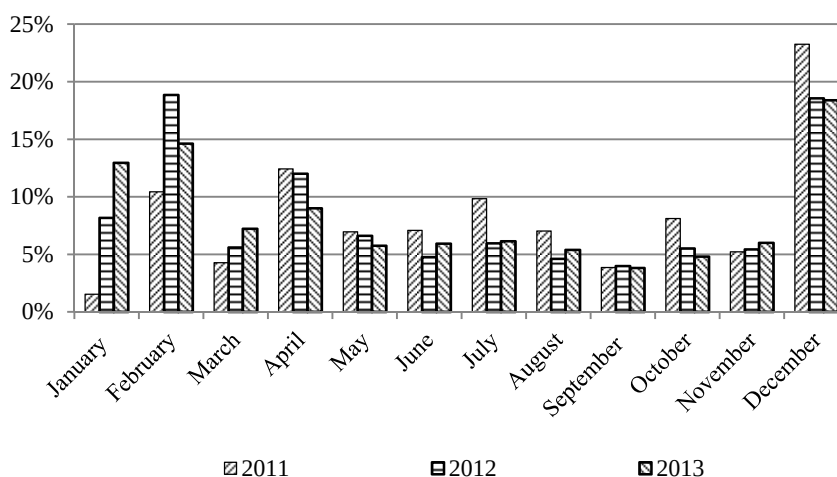
Pension provision costs on the Ministry of Defense military personnel in 2013 amounted to Rb 262bn 612 m, seeing a contraction of 2.4% year over year despite indexation, which is indicative of decrease in the number of retired military personnel.

The dynamics of actual monthly expenditures under the federal budget's major sub-items of the item 0200 National Defense in 2011 thru 2013 is shown in *Fig. 19–21*.



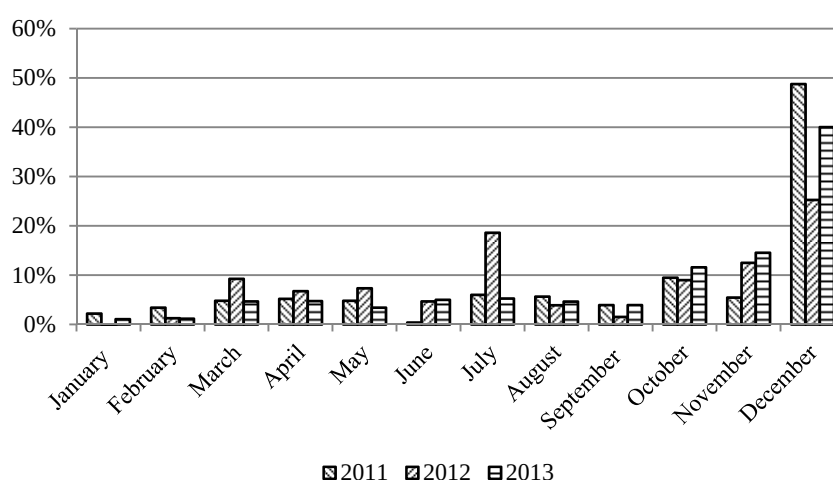
Source: Gaidar Institute's estimates based on the data supplied by the Federal Treasury of Russia.

Fig. 19. Implementing federal budget expenditures under the sub-item Armed Forces of the Russian Federation in 2011 thru 2013



Source: Gaidar Institute's estimates based on the data supplied by the Federal Treasury of Russia.

Fig. 20. Implementing federal budget expenditures under the sub-item Applied research studies in the area of national defense in 2011 thru 2013



Source: Gaidar Institute's estimates based on the data supplied by the Federal Treasury of Russia.

Fig. 21. Implementing federal budget expenditures under the sub-item
Other national defense issues in 2011 thru 2013

Table 33 presents military expenditures of the government of the constituent entities of the Russian Federation, being indicative of pertaining years-long trends. These expenditures account for 0.01% of GDP or less, whereby being considered as rather ritual expenses, and partial financing of these expenditures with federal transfers¹ may result in double count, what should be given a special attention during the evaluation thereof.

Table 33

**Military expenditures in the consolidated budget of the constituent entities
of the Russian Federation in 2005 thru 2013, millions of rubles***

Expenditure classification sub-item	2005	2006	2007	2008	2009	2010	2011	2012	2013
Armed Forces of the Russian Federation	—	3,5 0,1	0,5 0,3	0,3 0,3	—	—	—	—	—
Modernization of the Armed Forces of the Russian Federation and military units	—	—	—	1,0 0,5	—	—	—	—	—
Mobilization pre-conscription and reserve military training	65,6 65,6	899,3 808,6	1 351,9 1 245,6	1 797,9 1 702,2	2 116,0 2 021,6	2 003,7 1 958,4	2 250,0 2 187,3	2 366,7 2 316,4	2 506,5 2 444,7
Mobilization preparation of the economy	485,4 468,6	708,3 692,8	861,2 840,9	1 137,2 1 063,9	1 045,4 989,7	1 298,4 1 247,8	1 351,2 1 266,3	1 781,0 1 689,1	2 343,1 1 935,1
Other national defense issues	109,6 97,5	32,8 32,1	5,5 5,7	0,7 0,5	4,4 4,4	<0,1 <0,1	2,7 2,7	3,2 3,0	3,2 2,9
Internal troops	9,9 9,9	3,5 1,4	1,0 1,0	0,3 0,3	—	—	—	—	—
Russia's border service agencies	0,1 0,1	—	—	—	—	—	—	—	—
TOTAL	670,6 641,7	1 647,4 1 535,0	2 220,1 2 093,5	2 937,4 2 767,7	3 165,8 3 015,7	3 302,1 3 206,2	3 603,9 3 456,3	4 150,9 4 008,5	4 852,8 4 382,7

* The numerator means allocated, the denominator means actually spent.
Source: Federal Treasury of Russia; Gaidar Institute's estimates.

¹ Financy Rossii. 2012: Statistical book. M.: Rosstat, 2012. P. 27.

Table 34 presents Russia's military expenditures incurred in the period of 1999 thru 2013, net of the military expenditures of the consolidated budget of the constituent entities of the Russian Federation shown in *Table 33*. The data presented in the Table allows one to assume that period-specific double-digit nominal growth rates of the military expenditures in real terms came to nought to a large extent because of outstripping growth in prices of the Russian MIC's products (for example, in 2012 the added value deflator stood at 122.9% in the shipbuilding industry and 127.7% in the aerial vehicles sector)¹.

Table 34

**Key indicators of military (national defense) expenditures
in the Russian Federation in 1999 thru 2013**

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
1. In nominal terms (in current prices), billions of rubles															
Federal budget implementation under the item of "National Defense" according to the current budget classification ^a	115,6	191,7	247,7	295,4	355,7	430,0	581,1	681,8	831,9	1040,8	1188,2	1276,5	1516,0	1812,3	2103,6
Federal budget allocations under the item of "National Defense": according to the current budget classification	93,7	209,4	214,7	284,2	354,9	427,4	578,4	686,1	839,1	1031,6	1192,9	1278,0	1537,4	1846,3	2111,7
moved to other items of budget classification ^b	—	—	—	—	—	—	44,3	77,7	91,3	126,5	202,4	270,8	324,4	223,1	149,2
in a comparable budget classification	93,7	209,4	214,7	284,2	354,9	427,4	622,6	763,9	930,4	1158,1	1395,3	1548,8	1861,9	2069,4	2260,9
military (national defense) expenditures, based on the UN data ^c	—	201,2	291,5	322,7	442,5	494,3	659,0	815,9	942,0	1118,0	1166,1	1162,5	1423,3	1689,3	—
Total defense appropriations related to current and past military activities ^d	137,5	292,2	301,0	424,8	549,7	578,8	780,8	952,2	1219,1	1433,8	1736,6	1893,6	2209,9	2651,3	2990,6
2. In real terms (in 2013 prices)^e, billions of rubles															
Federal budget implementation under the item of "National Defense" according to the current budget classification	1586,6	1695,6	1645,0	1669,0	1648,6	1700,5	1863,9	1772,2	1856,0	1892,6	1962,3	1944,8	2042,1	2051,6	2103,6
Federal budget allocations under the item of "National Defense": according to the current budget classification	1286,1	1852,3	1426,5	1605,5	1645,0	1690,2	1855,0	1783,5	1872,1	1875,7	1970,0	1947,1	2071,1	2090,0	2111,7
moved to other items of budget classification	—	—	—	—	—	—	142,0	202,0	203,7	230,0	334,3	412,5	437,0	252,6	149,2
in a comparable budget classification	1286,1	1852,3	1426,5	1605,5	1645,0	1690,2	1997,0	1985,5	2075,8	2105,7	2304,3	2359,6	2508,1	2342,6	2260,9
military (national defense) expenditures, based on the UN data	—	1779,8	1936,6	1823,4	2050,9	1954,7	2113,6	2120,8	2101,8	2032,9	1925,8	1771,1	1917,4	1912,3	—
Total defense appropriations related to current and past military activities	1882,9	2584,1	1999,7	2400,0	2547,8	2288,9	2504,4	2475,1	2719,9	2607,1	2868,1	2885,0	2976,9	3001,2	2990,6
3. In real terms (in 1999 prices), billions of rubles															
Federal budget implementation under the item of "National Defense" according to the current budget classification	115,6	123,5	119,9	121,6	120,1	123,9	135,8	129,1	135,2	137,9	143,0	141,7	148,8	149,5	153,3
Federal budget allocations under the item of "National Defense": according to the current budget classification	93,7	135,0	103,9	117,0	119,8	123,1	135,2	129,9	136,4	136,7	143,5	141,9	150,9	152,3	153,9
moved to other items of budget classification	—	—	—	—	—	—	10,3	14,7	14,8	16,8	24,4	30,1	31,8	18,4	10,9
in a comparable budget classification	93,7	135,0	103,9	117,0	119,8	123,1	145,5	144,7	151,2	153,4	167,9	171,9	182,7	170,7	164,7
military (national defense) expenditures, based on the UN data	—	129,7	141,1	132,8	149,4	142,4	154,0	154,5	153,1	148,1	140,3	129,0	139,7	139,3	—
Total defense appropriations related to current and past military activities	137,2	188,3	145,7	174,9	185,6	166,8	182,5	180,3	198,2	189,9	209,0	210,2	216,9	218,7	217,9

¹ Russia's national accounts in 2005–2012: Statistical book./ Rosstat. M., 2013, p.220.

Cont'd

1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
4. Military encumbrance on the economy, as percentage of GDP															
Federal budget implementation under the item of "National Defense" according to 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	2.76	2.72	2.93	3.15
Federal budget allocations under the item of National Defense: according to the current budget classification	1.94	2.87	2.40	2.63	2.69	2.51	2.68	2.55	2.52	2.50	3.07	2.76	2.76	2.99	3.17
moved to other items of budget classification	–	–	–	–	–	–	0.20	0.29	0.27	0.31	0.52	0.58	0.58	0.36	0.22
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	3.34	3.35	3.35	3.39
military (national defense) expenditures, based on the UN data	–	2.75	3.26	2.98	3.35	2.90	3.05	3.03	2.83	2.71	3.00	2.51	2.56	2.73	–
Total defense appropriations related to current and past military activities	2.84	4.00	3.36	3.93	4.16	3.40	3.61	3.54	3.67	3.47	4.48	4.09	3.97	4.29	4.48
5. By purchasing power parity (in current prices), billions of US dollars															
Federal budget implementation under the item of "National Defense" according to the current budget classification	21,9	26,8	30,2	31,9	34,2	36,2	45,6	54,0	59,5	72,6	83,6	81,5	87,0	97,9	110,5
Federal budget allocations under the item of National Defense: according to the current budget classification	17,7	29,3	26,2	30,7	34,1	35,9	45,4	54,3	60,1	71,9	83,9	81,6	88,3	99,7	111,0
moved to other items of budget classification	–	–	–	–	–	–	3,5	6,2	6,5	8,8	14,2	17,3	18,6	12,0	7,8
in a comparable budget classification	17,7	29,3	26,2	30,7	34,1	35,9	48,9	60,5	66,6	80,8	98,1	98,9	106,9	111,7	118,8
military (national defense) expenditures, based on the UN data	–	28,1	35,6	34,8	42,5	41,6	51,7	64,6	67,4	78,0	82,0	74,2	81,7	91,2	–
Total defense appropriations related to current and past military activities	25,9	40,9	36,7	45,8	52,8	48,7	61,3	75,4	87,3	100,0	122,1	120,9	126,9	143,2	157,2
For reference															
Gross domestic product deflator, as percentage of the previous year	172,5	137,6	116,5	115,5	113,8	120,3	119,3	115,2	113,8	118,0	102,0	114,2	115,5	107,4	106,5
deflator of expenditures on final consumption of collective public administration services ^e , as percentage of the previous year	140,1	155,2	133,1	117,6	121,9	117,2	123,3	123,4	116,5	122,7	110,1	108,4	113,1	119,0	113,2
Purchasing power parity ^f , Rb/\$	5,29	7,15	8,19	9,27	10,41	11,89	12,74	12,63	13,97	14,34	14,22	15,66	17,42	18,52	19,03

^a For 2013 – the Federal Treasury's preliminary data on the federal budget implementation.

^b Total the Ministry of Defense's expenditures and secret outlays on items 05–09 and 11 of the federal budgets in 2005–2011, for 2012–2013 – additionally on item 12.

^c For 2013 – will be presented by the Russian Government in UN in 2014, also including maintenance costs on internal troops and border troops.

^d Including pensions of the retired military personnel.

^e Deflated by using the deflator of expenditures on final consumption of collective public administration services.

^{f, g} For 2013 – Gaidar Institute's estimates.

Source: Federal laws on the federal budgets for 2000–2013 and implementation of the federal budget in 2000–2012; Russia's national accounts in 1997–2012: Statistical book./ Rosstat. M., 2005–2013; Objective information on military issues including military (national defense) expenditures transparency. The UN General Secretary's reports in 2001–2013; Rosstat; the Federal Treasury of Russia.

* * *

Military and economic situation in the Russian Federation has stabilized considerably after the notorious events that took place at the end of 2012 and ended up with Serdyukov and his inner circle resigning from their high-rank posts. On December 10, 2013, the Supreme Commander-in-Chief of the Russian Armed Forces and newly appointed top executives of the Ministry of Defense summed up in the ordinary course the results of 2013 and acknowledged

that a few positive results were achieved in modernizing the Russian Armed Forces and strengthening the national defense capability. Success in the development of the MIC and equipment of the Armed Forces with advanced combat weapons was acknowledged early in 2014.

However, there are many issues that still remain to be addressed not only at the level of Russia's national military establishment, but also at the top strategic level, requiring to ensure both successful economic development and national security at a time. It stands to reason that the Russian President began to hold regular enlarged government meetings to address, *inter alia*, the issues arising between the traditional government and subordinate security and law enforcement agencies.

Practical mastering of brand new WME coming into operation has become most important for the Russian Armed Forces. Therefore, the military-recruitment policy should be focused on personnel professionally trained to employ advanced technologies to fulfil their missions based on a computer-aided control and management system. Professional requirements should be applied to the personnel at all levels, i.e. from the private level to the highest level of the military command structure which should be based on a system of incentives towards a rational, long-term and efficient military service, encouraging career advancement and ensuring a high social status in the society.

Comparative analysis of the military component of the Russian federal budget with the budget of the world leading economies shows that further growth in expenditures, which previously never was reasonably substantiated, on the MIC development and technical equipment of the Russian Armed Forces has totally lost its credibility amid the current recession. Otherwise, overall level of Russia's military expenditures and, most importantly, the share of expenditures on the equipment of the Armed Forces in prejudice of costs on their maintenance and combat training may list Russia as sponsor of arms race, thereby damaging its peacemaker image.

It would be reasonable to refine the Russian budget classifier by approximating the same to the UN standard, because the UN standard and most countries' practice show that military expenditures are better to be divided into components which, on the one hand, describe the development of the Armed Forces, and, on the other hand, their current maintenance.

6.7. The North Caucasus in 2013: the conflicts are escalating

The most obvious feature of the situation in the North Caucasus during last year was the disturbance of the fragile balance which had apparently begun to form in the preceding period, the escalation of existing conflicts and the emergence of new ones, including those related to resources. What was the cause of this escalation? What are its possible consequences? How does all this affect the economic situation in the region? These are the key questions which the authors aim to answer in this review.

6.7.1. Return to a power model: possible consequences

The post-Soviet history of the republics of the North Caucasus has been characterised by two approaches towards the resolution of the conflicts in these regions. Usually, these are presented as two variants of the counter-terrorism policy, but in fact, the choice of one model over the other, can fundamentally affect many other aspects North Caucasian society.

The first model can be described as the "tough course" model. It has the following main features:

- the broadest possible interpretation of the concept of “terrorists and their accomplices”, which in fact includes all representatives of those Islamic movements in the region which are not considered by the government to represent traditional Islam and are therefore considered to be a source of radical views;
- uncompromising priority given to tough methods of counter-terrorism;
- the goal is to fight to the bitter end, to achieve a full overthrow of the enemy.

In relation to the second model experts use the term the “policy of soft power”. It takes a less linear view of the problem of terrorism:

- the followers of non-traditional Islam are allowed to practise their particular religions within the freedoms guaranteed by the Constitution of the Russian Federation and are considered as being separate from the terrorists and their accomplices, i.e. separate from those people violating the law and guilty of particular crimes;
- terrorists themselves are divided into the arrant, uncompromising ones, and those who would be prepared to end their unlawful activities; the latter include some who “have blood on their hands” and some who “have no blood on their hands”;
- a different policy should be applied to each of the above groups:
 - subscribing to non-traditional Islam, in the absence of any violation of Russian laws is generally taken to be that individual’s private business;
 - young people who “got into the forest” by accident or through folly, and who do not have blood on their hands should be helped to withdraw from “the forest” as soon as possible and enabled to live a peaceful existence;
 - militants who are ready to cease terrorist activities should be enabled to adapt to peaceful life, although views on the form of this kind of ‘adaptation’ vary: from full amnesty to the commutation of sentences in return for voluntary surrender;
 - tough forceful methods should unequivocally be applied to uncompromising militants;
- enforcement action and counter-terrorist operations should be carried out in strict compliance with the law, and should observe the rights of civilians;
- the purpose of the policy is civil pacification, reduction of conflicts, and a termination of splits within society.

The period of conduct of counter-terrorism policy in the North Caucasus can be divided into three sections, each of which is characterised by a different combination of these two ideologies. Until autumn 2010 the power model almost fully dominated. The period from autumn 2010 to late 2012 can be interpreted as a combination of approaches typical of both models: along with the continuing military pressure in a number of North Caucasus regions (Dagestan, Ingushetia) with commissions for the ‘adaptation’ of militants being created and the start of an inter-confessional dialogue between conflicting Islamic movements. It can be stated that in early 2013 a return to dominance of the “tough course” model began. This change has been particularly pronounced in the Republic of Dagestan, although it also affects other territories of the North Caucasus Federal District (NCFD). It was manifested in the following ways:

1. All forms of inter-confessional dialogue and coercion of militants that had been tried and tested in the preceding year almost completely ceased. As early as 2012, the activities of the Commission for Adaptation in Dagestan were being increasingly blocked by the representatives of the national security forces included in its composition and, finally, when the government of the Republic changed in early 2013, it was liquidated with the following assessment by the leader: “it played its part but this was insignificant”. In Ingushetia, with the

assassination of the Secretary of the Security Council, Ahmed Kotiev, who had been responsible for the Commission's activities, this work, apparently, also trailed away. After the terrorist attack on Shafii Shaykh Said Afandi al-Chirkawi, one of the the most influential people in Dagestan, the dialogue also proved to be in a deep crisis.

2. Using large special operations, increasingly tough methods have begun to be applied, targeting not only the militants themselves but also their families and the communities from which they come. For example, in April 2013, during a large-scale special operation in the village of Gimry in the Untsukulsky District of Dagestan, all the inhabitants of the village were temporarily evicted, and when they returned, they found that much of their property (both personal and public) had been stolen. Ten houses in the village had been blown up, which the local residents believe was because they belonged to the relatives of militants (even though such information was not always accurate)¹.

3. Detachments, formed of local residents, were involved in military actions, and although their activities went far beyond legality, they were supported by the security agencies. There are two well-known examples of this are. In Khadzhal'makhi village in the Levashinsky District of Dagestan the activities of armed members of a vigilante group resulted in the followers of non-traditional Islam being forced to flee their village, leaving their property behind, and some of them were killed². In Leninkent village (a part of Makhachkala) there were several forcible attempts to prevent the activities of a Salafi mosque and dozens of people were injured as a result of the clashes³. In both of the above cases, not only did the law enforcement agencies not intervene to prevent such violent actions, but on some occasions they even supported them.

4. Pressure, clearly including significant force, was applied on representatives of non-traditional Islam who were not using any violent practices to achieve their goals but were focused on promoting Islam through preaching and personal example, and who were ready to associate and cooperate with the State in areas where this did not conflict with their ideology.

5. Many of the above practices have even been recognised in legislation. For example, the basis for the approach of adaptation has been almost completely removed with the sharp curtailing of opportunities for the mitigation of punishment of militants in the case of voluntary surrender. There has been legal recognition of some forms of liability of the families and close friends of militants for their activities. The evolution of legislation in similar directions is still continuing.

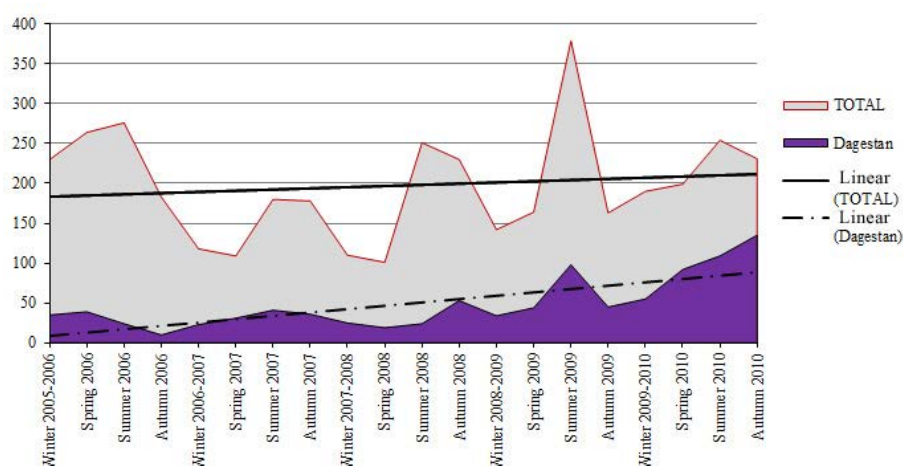
Can we conclude that this change in policy, implying a return to the force scenario, is the result of the failure of attempts at non-forceful settlement? An analysis of the situation in the period from autumn 2010 to late 2012 does not provide any grounds for such a conclusion. Let us consider just one confirmation of this thesis. *Figures 22 и 23* shows the changes in the numbers of victims of terrorist activities amongst members of the national security services (total numbers of killed and wounded), according to the "Memorial" Society, for the entire North Caucasus and for the Republic of Dagestan from 2005 (the authors do not have any earlier data) to the autumn of 2010, and from autumn 2010 to early 2013. Whilst the first

¹ See, for example: R. Kadiev, M. Shevchenko. Gimry is Common Heritage of Dagestan. Kavpolit.com, 20 September 2013 (<http://kavpolit.com/ramazan-abdulatipov-gimry-eto-obshhedagestanskoe-dostoyanie/>).

² General characteristic of the situation in the village based on the media materials and the author's own impressions obtained during her visit to Khadzhal'makhi is laid out in: I. Starodubskaya, K. Kazenin. Expert report: "North Caucasus: Quo Vadis?" (<http://polit.ru/article/2014/01/14/caucasus/>).

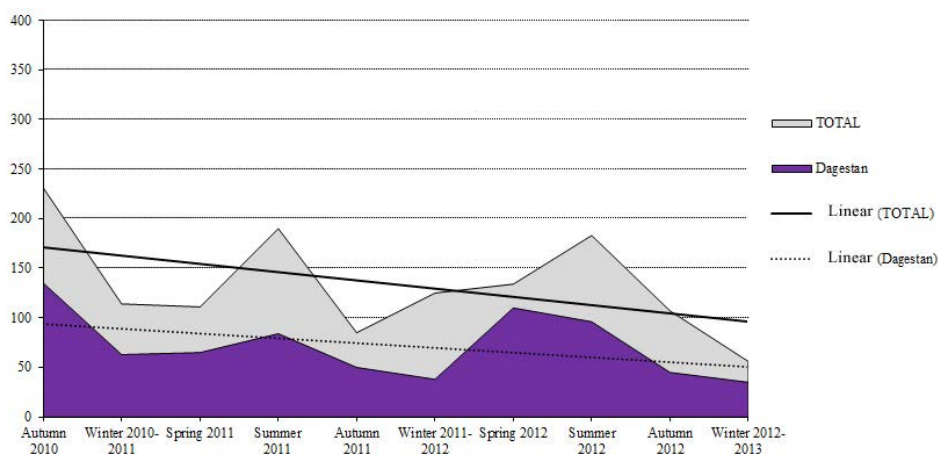
³ See, for example, <http://ndelo.ru/novosti-7/2340-ozhidaemoe-krovoprolitie>; <http://regnum.ru/news/1734663.html>

period is characterised by an insignificant upward trend in casualty numbers, despite considerable fluctuations in the specific indicators, in the second period an obvious downward trend can be observed. These trends can be observed in the number of victims both in the NCFD and in Dagestan where casualties have recently been the most significant. It should also be noted that the trend reversal is even more obvious for Dagestan. The data available for 2013 are insufficient to draw definitive conclusions about the influence of the return to the force scenario on the dynamics of casualty numbers but there are some grounds to assume a return to the trends of the period up to the autumn of 2010. However, it is obvious that additional circumstantial factors also have some effect here, for example, the Olympic Games in Sochi.



*total number of killed and wounded (The “Memorial” Centre for the Protection of Human Rights maintains statistics based on data from open sources: official websites of the national security agencies and the media)
Source: “Memorial” data, authors’ calculations.

Fig. 22. Casualties amongst members of the national security services in the NCFD and Republic of Dagestan in 2005 – autumn 2010



* total number of killed and wounded (The “Memorial” Centre for the Protection of Human Rights maintains statistics based on data from open sources: official websites of the national security agencies and the media)
Source: “Memorial” data, authors’ calculations.

Fig. 23. Casualties amongst members of the national security services in the NCFD and Republic of Dagestan in autumn 2010-2013

However, the consequences of the return to a force scenario go beyond the area of counter-terrorism. In fact, such a change has considerably affected various areas of public life, including the interaction between government and business. It is especially obvious from the example of Makhachkala where the force scenario manifested itself mainly through two processes: firstly, an increase in direct pressure on the so-called Salafi businesses and, secondly, in a toughening of policy in respect of the shadow economy (in particular, in the field of payments).

First, we should explain the term “Salafi businesses”. In Makhachkala a considerable proportion of small and medium-sized businesses in various industries are run by followers of non-traditional Islam. This type of business has developed both in spheres which have particular religious connections – for example, halal cafés and restaurants (where the food and atmosphere reflect Islamic canons) and in many other areas. The origin of the term “Salafi business” is associated with the fact that all the followers of non-traditional Islam are usually equated with Salafists (one of the Islamic movements), although in fact this is not completely accurate.

Reputedly, the most well-known action against “Salafi businesses” was carried out in October 2013, when, over a period of three days, halal café employees and visitors were being detained en masse, without any explanation. They were subjected to mandatory fingerprinting and had their photographs taken, and some of the detainees were subjected to violence. As a result, one of the most famous halal restaurants in the city was closed and some others were forced to change ownership¹. The reason behind such action is still not entirely clear – maybe it was an attempt at business redistribution or a peculiar demonstration of potential preventive measures ahead of the Olympic Games in Sochi. But, according to available data, such actions were taken not only with respect to halal business: “this wave ... affected private kindergartens, cafés, restaurants and the manufactures of windows and furniture, and shops selling cell-phones and clothes”². In all cases serious damage was caused to the businesses (for example, on the pretext of the use of unlicensed software, computers were confiscated which resulted in paralysis of company activities).

While the above measures in respect of Salafi businesses have an obviously forceful nature, the effects of toughening the policy towards the shadow economy requires separate comment. At first sight, the shadow economy which operates outside the control of Russian legislation constitutes a violation of the law and the fight against it should be as uncompromising as that against any other offence. However, the situation is not so simple.

One must take into account that the reason for the shadow nature of the Dagestan economy is not solely due to an unwillingness to pay taxes. It is primarily an attempt not to demonstrate publicly the real potential of one’s business, in a situation where people possessing administrative resources could destroy or take away almost any successfully developing business. Moreover, in many cases the government agencies themselves are not interested in the legalisation of such businesses, preferring bribes and extortion over taxes being paid to the budget. For example, a few years ago a fishery in one of the coastal villages close to Makhachkala made an attempt to legalise its business. Once the fishery started demonstrating really good results, it was subjected to a huge fine forcing it to retreat to ‘the shadows’. At the

¹ See, for example: <http://ndelo.ru/novosti-7/2110-mentovskoj-bespredel>; <http://wordyou.ru/v-rossii/religioznye-pretenzii-na-ekonomicheskoy-osnove.html>; <http://chernovik.net/content/lenta-novostey/siloviki-v-mahachkale-proveli-reydy-po-kafe-zaderzhivali-predstaviteley>.

² O. Ostrovsky. Shurik, those are not our methods ...// Chernovik, No.46, 29 November 2013.

same time the shadow sector provides employment and a means of livelihood to a considerable part of the city population. There are no alternative sources of employment in the city.

Even now the first results of the toughening of State policy in respect of business can be seen.

Firstly, according to the available evidence, medium-sized business (Salafi businesses, initially) are making efforts to leave the Republic by moving funds to other regions of Russia or abroad.

Secondly, the possibilities for illegal employment are being reduced even though there are no legal substitutes.

Thirdly, public protest is increasing against clearly discriminatory measures towards a group of businessmen on religious grounds (the headlines of articles reporting on the raids on halal cafés speak for themselves: “Abuse of power by cops”, “Your halal threatens our freeloading”, “Shurik, these are not our methods...”).

All this is happening in a situation where small and medium-sized businesses in Makhachkala, and in the whole Republic, are already in quite a difficult position. The economy has been depleted in many respects by the large-scale financial fraud (pyramids) in which huge amounts of money were invested¹. Competition in the market is increasing due to an inevitable process of penetration by national Russian companies which reduce the demand from traditional manufacturers and suppliers. Under such conditions any additional complications have particularly severe consequences.

So, paradoxically, it can be stated that the attempts to suppress negative social phenomena, in particular, terrorism-related ones, using force may have the opposite effect. People who have lost their businesses or jobs, and are outraged at clearly illegal sanctions, create an enabling environment for the propagation of radical views, including religious ones. The economy is just one of the examples of increased tension and widespread discontent in the society here, but there are many, many others. This complicates the process of combatting extremism and terrorism, so the tendency towards increasing casualties amongst members of the security services under these conditions is hardly surprising.

At this point we should like to remind you of the example of alternative policy in respect of the shadow economy that is described in the book “The Other Path” by Hernando De Soto, which has often been discussed before². It is based on working with the communities of shadow businessmen themselves and identifying the conditions under which they would agree to legalisation. This can be facilitated by the simplification of administrative procedures and a reduction of administrative barriers, the enforcement of property rights guarantees and the creation of trust-based relations between business and government. According to De Soto, such approaches played a crucial role in the suppression of terrorism in Peru.

6.7.2. Land conflicts: intensifying the confrontation

Land conflicts in 2013 continued to occupy an important position in the socio-economic and political agenda in the North Caucasus. The following can be outlined as key results in this area last year:

1. The issue of the regulation of land rights, and the access of rural peoples to land disposal, came to the fore as the main subject of land conflicts; this issue has become more

¹ See, for example, <http://dargo.ru/news/2013-12-03-1417>.

² De Soto, Hernando. *The Other Path: The Economic Answer to Terrorism*. Chelyabinsk, Socium, 2008.

important to participants in land conflicts than the so-called “ethnic boundaries” which had previously taken centre stage.

2. Mechanisms are still not being developed within the framework of Russian legislation to allow for the effective resolution of problems relating to “overlapping land rights”.

3. Land conflicts have repeatedly transformed into confrontations in which the party that was not satisfied with the decisions of the governmental authorities has tried to establish its own system for regulation of land issues.

Let us first consider the transformation of land conflicts from being a conflict around “ethnic boundaries” to the fight for people’s access to land disposal. This transformation can be considered for the example of a conflict in Belaya Rechka village (Kabardino-Balkaria; population: 3,430 people according to data of the 2010 All-Russian Population Census). The conflict around this large village and its neighboring village, Khasanya, began as early as 2005 and at that time had the classic features of a dispute for “ethnic lands”. The conflict in Belaya Rechka, as with many other land conflicts in Kabardino-Balkaria, commenced as a result of the adoption by the regional parliament in February 2005 of a set of laws on the composition and borders of municipalities in the region. According to these laws, the Balkarian villages Belaya Rechka and Khasanya were included in the urban district of the city of Nalchik, thereby losing their local self-regulation. From that moment on, the heads of the rural administrations were appointed by the City Mayor’s Office of the capital of the republic, Nalchik. From 2005 Balkarian public organisations regularly put forward demands to return Belaya Rechka and Khasanya to the status of municipalities, formulating their requirement in ethnic terms: the 2005 municipal division was presented as infringing the interest of the Balkar people in favour of republican power in which the representatives of Balkaria were in a minority. There were demands to establish in the republic another “Balkar” region like that which had existed before the deportation of the Balkars in 1944, and to include both villages therein.

The development of the conflict in 2013 marked a change in the key requirements from the republican government by the residents of Belaya Rechka. In March-April hundreds of the village residents took part in a number of protest actions against the leasing out of a land plot with total area of 25 Ha to a local entrepreneur who intended to set-up orchards there. The lands that were at the centre of the conflict had previously been assigned to Belorechensky Sovkhoz (a state-owned farm). Now they were at the disposal of the City Mayor’s Office, which planned to lease the land out. The residents’ protest was because they had reckoned to obtain plots of the land for building work (according to the village activists and the administration, the number of village residents who need a plot to build their own house, varies from 500 to 800 people). This time, the residents initially demanded, not a revoking of the resolutions on municipal borders, but to change the order of land disposal, to transfer land plots into their ownership and to avoid the situation where the lands directly adjoining the village, that had been used by its people in Soviet times, were now legally alienated from the village. (An important point in the development of the conflict in Belaya Rechka in 2013 was that the beneficiary party of the decision against which the villagers were fighting, was a fellow villager, the businessman planning to lease the land. That was why the focus of the dispute automatically moved away from being an issue of the ethnic background of the land.)

We should note that, today, the problem which has now become central in this conflict is typical of regions of the North Caucasus and one which has arisen lately in many other protest actions relating to land issues. In particular, those participating in conflicts related to the allocation of land for resort construction or various types of industry, etc., are demanding, not

an abstract recognition of the fact that the land belongs to a certain ethnic group, but a precise settlement of ownership rights¹. This is not surprising given that one of the key sources of conflict over land in North Caucasian republics is the absence of private ownership of agricultural lands (a moratorium on land turnover is effective in each of the republics, except for Karachay-Cherkessia). The lands of the former sovkhozes and kolkhozes (state and collective farms) which were not privatised, were mainly at the disposal of the regional or district administrations. Under their control a lease and sublease market has developed, to which local residents often have no access. The transition of land protests from the theme of “ethnic boundaries” to the problem of people’s rights to land is, in our opinion, an important change recorded in recent last years.

At the same time, the course of the conflict in Belaya Rechka demonstrated that the regional government is not yet ready to reconsider the existing system of allocation of land assets. The villagers’ protests, which started in the spring failed to achieve a productive dialogue with the Nalchik City Mayor’s Office, after which the situation actually turned into open confrontation, where the actions of the protesters have turned much more towards being a power struggle. In November, the villagers held a meeting where they divided the land that the government planned to lease out for orchards into construction plots. The plots were allocated in accordance with informal rules developed in the course of the meeting (for example, under these rules priority was given to those families with larger numbers of children). The Republican Prosecutor’s Office and Nalchik City Mayor’s Office declared this plot allocation to be illegal, however, they abandoned the attempt to transfer the land to the businessman for lease, and the situation “froze” at a stage close to a direct conflict between traditional law and the system of land relations established by regional normative acts.

To understand the position of the regional government in this conflict one must take into account that, without its involvement, the problems of villagers’ access to the land cannot be solved, at least insofar as it relates to the regulation of the turnover of agricultural land by the regions. As to Kabardino-Balkaria, it can be said that the policy of the republican administration in this field is still unclear. In particular, in the period from 2010 to 2013, the former head of the Kabardino-Balkar Republic, Arsen Kanokov, repeatedly stated the necessity for conducting a land reform in the region, with the privatisation of agricultural lands favouring the interests of rural people; however, he took no actual steps in this direction. Yuri Kokov, who became the temporary Head of the Kabardino-Balkar Republic in December 2013, has not yet outlined his plans with regard to land policy.

The conflict generating potential of the problem of overlapping land rights was also manifested to the full last year in land conflicts in the NCFD. Analysis of such conflicts in the North Caucasus shows that overlapping land rights can have several origins. Firstly, they arise as a result of corrupt practices where lands which have a legal status forbidding their use for construction, are nevertheless used for such. As a result, private households are found, for example, on forest lands and often their owners have documents confirming their ownership rights to the land plot for construction purposes, with a simultaneous existence of documents stating that the status of the same land does not allow construction thereon. Secondly, special situations of overlapping rights can occur as the consequence of the many organised

¹ The fact that unresolved land relations impede resort construction was recognised in January 2014 by the Director General of the Open Joint-Stock Company “Resorts of the North Caucasus” Sergey Vereschagin (Sergey Vereschagin: Land Issues Impede the Development of a resort Cluster in Dagestan. IA REGNUM, January 22, 2014.<http://regnum.ru/news/kavkaz/1757231.html>).

resettlements conducted during the Soviet period. This source of overlapping land rights plays an especially important part in the Dagestan plain where, in the 1940-50s, within the framework of many of the activities of the Soviet State, tens of thousands of peasant farmers were forcibly displaced (sometimes even twice)¹. Nowadays the situation often arises where representatives of the rural communities, deprived of a certain territory during such resettlements, claim their rights to this territory. These rights may be confirmed by particular documents but are in conflict with the rights of others.

The above two sources of overlapping land rights remain a serious destabilising factor for the economy and for public relations in the North Caucasus. At the same time, as the events of 2013 have shown, effective mechanisms for the resolution of conflicts relating to overlapping land rights have still not been developed in the North Caucasian regions. Moreover, there is every indication that these conflicts are escalating. We shall illustrate this with the example of one of the biggest land conflicts of last year – the conflict around the so-called “Karaman lands” (named after the Karaman area) adjoining the northern part of the capital of Dagestan, Makhachkala.

The special feature of this conflict, which was widely covered in the regional media in 2012-2013, and which still provokes an active response from the general public in the region, is that it originates from both of the above sources of overlapping land rights. The subject of the conflict is a piece of land with a total area of 195 Ha located between the federal highway and the Caspian coast. In the 1930s these lands were transferred by state orders to several kolkhozes which functioned in three Makhachkalan suburban settlements inhabited by Kumyks – the villages of Tarki, Kyakhulai and Alburikent. In 1944, after the Chechens had been deported to Kazakhstan and Central Asia, the residents of these three villages were relocated to the suburbs of the city of Khasavyurt in Dagestan, situated close to the border with the Chechen-Ingush ASSR, in villages that had previously been inhabited by Chechens. After they returned from there in the second half of the 1950s, the residents of the three villages did not regain the lands to the north of Makhachkala which had been used by them as pastures prior to the resettlement. These lands were mainly distributed amongst farms in the mountain regions that, in the 1950-1980s received considerable areas of the plains for the seasonal grazing of cattle. In the 1990s, by order of the republican government, a part of this land was allocated for settlements belonging to the Laks who were migrating because of the abrogation of the Novolaksky District of Dagestan located next to the Chechnya border. In 2012 the residents of the three Kumyk villages claimed their rights to the 195 Ha and set up a tent camp there. They justified their rights by claiming that the state orders by which these lands had been transferred to the Kumyks kolkhozes had not been legally annulled. This became the first “historical” source of the overlapping rights to this land. However, the fate of the disputed land created an additional situation of overlapping rights in the 2000s. Since 2008 the land has been under the jurisdiction of the Federal Agency for State Property Management of the Russian Federation and has the status of forest land, however, as evidenced by the participants in the conflict, a considerable part of the land had been distributed as plots for construction which was also confirmed by specific documentation².

¹ For more detail see K. Kazenin. *The Elements of Caucasus: land, power and ideology in the North Caucasian republics*. M: REGNUM, 2012.

² No agreement, no compromise // *Caucasian Policy*. December 4, 2013. <http://kavpolit.com/ni-soglasiya-ni-primireniya/>

Houses have already been built on plots adjoining the disputed land, even though these plots are also classified as forest land.

In 2013 the conflict around the “Karaman” lands indicates the significant source of tension resulting from the overlap of both “historical” land rights and rights which have arisen in recent years. In August the situation around the disputed land was inflamed as a result of the conflict between the residents of the three Kumyk villages and the Laks who were migrating to the neighboring territory from the Novolaksky District. A unit of the Special Police Force had to intervene to stop the violent confrontation which arose¹. Later tension has mainly been associated with the “new” overlapping rights. The Commission for Conflict Settlement at the Head of Dagestan made a proposal to carry out an inventory check of households located on the forest land and to set up a park zone on the undeveloped land, i.e. precisely on the land claimed by residents of the Kumyk villages. This proposal received a highly critical response from representatives of the Kumyk villages: at a meeting of the residents of the three villages, held on 4 December, a demand was made to transfer the disputed land to the villages. These events evidenced that no progress in the resolution of this conflict had been made. We should also note that attempts, in the autumn, by the Dagestan government to create a dialogue between the Commission for Conflict Settlement and the participants of the “Kumyk protest” met with strong resistance: for example, on 11 November the public leaders of the villages were detained and taken to the police station². A forceful element is also seen in the actions of the protesters as well: they keep watch on the disputed land, restricting the access of strangers to it, and, completely disregarding the status of the land, they have carried out a division of the land amongst the villagers who want it for building.

So, from these examples of two land conflicts, both characterised by particularly active public response in their regions, but quite different in the subject of the dispute, one can see that, at the moment, there are no “working” mechanisms for the settlement and congruence of interests over the control of land in the North Caucasus. Furthermore, the absence of any prospect of settlement has created a situation where rural peoples carry out their own distribution of lands, the claims to which they fail to vindicate, ignoring the unlawfulness of such procedures. This creates a risk of the occurrence of a conflict between jurisdictions in land issues. It can be stated that such actions of rural populations, which in fact constitute the introduction of a new system of settling land relations as an alternative to Russian legislation, but without preliminary legal permission, have become a notable tendency just in the last year. This confirms the seriousness of the problems in the field of land regulation in the North Caucasus.

Moreover, unresolved land conflicts continue to create considerable political tension because they remain a consolidating factor for ethnic movements: in the protest actions relating to land issues - it is not only the residents of villages directly affected by these issues who participate, but activists from ethnic movements also join in. In fact they become involved even where the essence of the conflict is not associated with a conflict of ethnic interests.

It is our opinion that, in order to decrease the tension over land issues, first of all, it is necessary to take into account the current drivers of this tension, in particular, the lack of

¹ Dagestan Public Activist: Incident in Karaman Should Be Discussed at a Meeting //IA REGNUM. 22 August, 2013. <http://regnum.ru/news/1697871.html/>

² They are Trying to Chase Away the Camp in Karaman // Caucasian Policy. 11 November, 2013. <http://kavpolit.com/lager-v-karamane-pytayutsya-razognat/>

access by rural peoples to land disposal, together with the overlapping of land rights. The solution of both problems is possible only within the framework of a full-scale land reform which should include at least the following components:

- the development and implementation of a mechanism for the resolution of disputes relating to overlapping land rights that should guarantee a reconciliation of the interests of stakeholders and the establishment of compromise solutions;
- a cancellation of the moratorium on the privatisation of agricultural lands followed by the transfer of land plots to the ownership of local residents.

6.8. Review of Legislation in the Sphere of Tax and Civil Legislation in 2013¹

This section deals with the most important changes which took place in the existing legislation. Primarily, it is the new procedure for calculation and payment of the corporate property tax which is already applied starting from 2014 by the entire range of taxpayers due to a switchover to payment of the tax on the basis of the cadastre value of the property. The purpose of introduction of a new calculation of the tax is replenishment of the budget of a constituent entity of the Federation on the basis of a real property's value which is set closer the market price. Tax experts agree that the new calculation of the tax on the basis of the cadastre value will contribute to development of territories and ensure a more fair calculation of the property tax. It is known that the balance value of "old" buildings is rather low, so an increase in tax will primarily affect the buildings of the "old" fund, as well as those situated in "prestigious" districts.

Also, the first legislative amendments of Part 1 of the Civil Code of the Russian Federation due to the reform of the civil legislation are analyzed. An entire range of amendments aimed both at small "technical" corrections and specifications of a number of norms and bringing of the Civil Code of the RF in general in compliance with the changed realities directed at harmonization of the Russian legislation with that of European countries was introduced.

Corporate Property Tax: The New Procedure for Calculation and Payment

In accordance with Federal Law No.307-FZ of November 02, 2013 on Amendment of Article 12 of Part One and Article 30 of Part Two of the Tax Code of the Russian Federation a number of real property items in respect of which the corporate property tax base can be determined as a cadastre value was identified.

By general rule of the Tax Code of the RF, the corporate property tax base is determined as the average annual cost of property of the recognized item of taxation (Article 375 (1) of the Tax Code of the RF), that is, the corporate property tax is calculated by legal entities on the basis of the balance-sheet value of the real property. From January 1, 2014, in respect of individual items of real property the above tax can be calculated on the basis of a cadastre value (that is, the value which is maximum close to the market one) as of the first day of the regular tax period.

According to the new procedure for calculation of the tax (Article 378.2 of the Tax Code of the RF), the corporate property tax base is calculated on the base of the cadastre value as regards the following items of real property:

The 1st category: administrative and business centers and trade centers (complexes) (with total floorspace of over 5,000 square meters) and premises in those centers. It is to be noted

¹ The Review was prepared with assistance of the Konsultant Plus legal system.

that deemed as an administrative and business centre is a free-standing nonresidential building (construction and structure) where premises are owned by one or several owners and which building meets at least one of the following criteria:

- the building (construction and structure) is situated on the land plot whose type of permitted utilization allows for placement of office buildings of business, administrative and commercial purposes;
- the building (construction and structure) is meant for utilization or actually used for business, administrative or commercial purposes.

The 2nd category: nonresidential premises whose purpose in accordance with cadastral passports of real property items or documents of technical accounting of real property items envisages placement of offices, retail trade facilities, public catering facilities and public amenities or which premises are actually used for placement of offices, retail trade facilities, public catering facilities and public amenities.

At least 20% of utilization of floorspace for placement of the above facilities is recognized as actual utilization of nonresidential premises for above purposes (Article 378.2 (5) of the Tax Code of the RF).

The 3rd category: nonresidential real property of foreign entities which do not carry out activities in the Russian Federation through their permanent representative offices, as well as such real property items of foreign entities as are not related to the activities of those entities through their permanent representative offices.

The type of actual utilization of buildings and premises in those buildings is determined by the authorized executive authority of a constituent entity of the Russian Federation in accordance with the procedure set by the Ministry of Economic Development of the Russian Federation by agreement with the Ministry of Finance of Russia (Article 378.2 (9) of the Tax Code of the RF). Prior to approval of the relevant statutory act, the procedure recognized by a regulatory statutory act of a constituent entity of the Russian Federation is applied.¹

The authorized executive authority of a constituent entity of the Russian Federation (Article 378.2 (7) (1) of the Tax Code of the Russian Federation) has to determine on an annual basis not later than the 1st day of the regular tax period the list of real property items which are attributed to the above 1st and 2nd categories.

As a calendar year is deemed as a tax period, the relevant list of real property items is approved not later than January 1. Then, such a list of real property items is sent in an electronic format by the executive authority of a constituent entity of the Russian Federation to tax authorities at the place of location of real property items (Article 378.2 (7) (2) of the Tax Code of the Russian Federation) and places it at its official Web-sites or the official Web-site of a constituent entity of the Russian Federation (Article 378.2 (7) (3) of the Tax Code of the Russian Federation). If within a year a new real property which was not included in the list has been identified, the information on that property is to be included in the list which is being formed for the next tax period (Article 378.2 (10) of the Tax Code of the Russian Federation)². So, in the current tax period the property tax is calculated by a legal entity in accordance with the old procedure on the basis of the average annual value.

¹ See Part 2 of Article 4 of Federal Law No.307-FZ of November 02, 2013.

² It is to be noted that the data which is to be included into the list is determined by the Federal Tax Service of the Russian Federation (Article 378.2 (8) of the Tax Code of the Russian Federation). Prior to approval by the tax authorities of such an act, relevant powers are granted to the supreme state executive authority of a

If the cadastre value is determined for the whole building in which nonresidential premises – the item of the corporate property tax – are situated and the cadastre value of those premises is not determined, the latter is calculated as the share of the cadastre value of the building pro rata the share of the area of those premises in the total floorspace of the building (Article 378.2 (6) of the Tax Code of the Russian Federation).

A special provision is made for foreign entities' real property items specified in Article 378.2 (1) (3) of the Tax Code of the Russian Federation and recognized as items of taxation (the 3rd category): if the cadastre value has not been set in respect of those real property items, the tax base is deemed equal to zero (Article 378.2 (14) of the Tax Code of the Russian Federation).

The specifics of calculation of advance payments on the corporate property tax as regards real property items whose tax base is calculated as the cadastre value has been provided for in Article 378.2 (12-13) of the Tax Code of the Russian Federation. So, by general rule an advance payment is equal to the product of a quarter of the cadastre value of the real property item as of January 1 of the year which is the tax period and the respective tax rate (Article 378.2 (12) (1) of the Tax Code of the Russian Federation). If the cadastre value of the property is not determined or the real property is not included in the list approved by the authorized executive authority of a constituent entity of the Russian Federation as per Article 378.2 (7) of the Tax Code of the Russian Federation, advance payments and the property tax are still calculated on the basis of the average annual cost of the property, that is, without application of special norms (Article 378.2 (12) (2) of the Tax Code of the Russian Federation).

So, the taxpayers do not have to determine individually whether their premises are attributed to administrative and business centers or trade centers; that is the task of the authorities. Owners of the real property have only to see to it that their property is attributed to the list of premises in respect of which the property tax is calculated on the basis of the cadastre value.

In particular, for example, in accordance with Article 378.2 of the Tax Code of the Russian Federation the Government of Moscow has determined the 2014 list of real property items in respect of which the tax base is determined as their cadastre value¹. The 2014 list includes 1,842 real property items with the total floorspace of over 33m square meters. The list includes buildings with the floorspace of over 5,000 square meters if a type of permitted utilization of the land plot in which that building is situated suggests placement of retail, office, administrative and commercial facilities².

constituent entity of the Russian Federation by agreement with the Federal Tax Service of the Russian Federation (Article 4 (1) of Federal law No.307-FZ of November 02, 2013).

¹ The above list is made up in accordance with provisions of Article 1.1 (1) of Law No.64 of the City of Moscow of November 5, 2003 on The Tax on the Property of Legal Entities; it is specified in the annex to Resolution No.772-PP of November 29, 2013 of the Government of Moscow on Determination of the List of the Real Property Items in Respect of Which the Tax Base is Determined as Their Cadastre Value in 2014.

² In reality, a type of permitted utilization of a land plot may not comply with actual utilization of the building. To eliminate conflicts that may arise due to the above, it is determined by Resolution No.772-PP of November 29, 2013 of the Government of Moscow that in case of disagreement with inclusion and/or failure to include the relevant real property to the specified list the interested parties are in a position to turn until December 18, 2013 to the State Inspectorate in Charge of Control over Utilization of Real Property Items of the City of Moscow with an application to check compliance of the actual utilization of the building (construction and structure) with the type of permitted utilization of the land plot in which that building (construction and structure) is situated (construction and structure). The outputs of the examination are sent by the State Inspectorate in Charge of

It is to be noted that in new Article 380 (1.1) of the Tax Code of the Russian Federation maximum admissible values of tax rates are set in respect of the real property whose tax base is calculated as the cadastre value. It is to be noted that gradual increase in the upper limit of the above limitation from 1% in 2014 to 2% in 2016 and in subsequent years is envisaged. As regards Moscow, higher maximum rates as compared to other constituent entities of the Russian Federation were introduced for the first two years (*Table 35*).

Table 35

	2014	2015	2016 and in subsequent years
Moscow	1.5%	1.7%	2%
Other constituent entities of the Russian Federation	1%	1.5%	2%

According to Law No.63 of November 20, 2013 of the City of Moscow on Amendment of Law No.64 of November 5, 2003, the tax rate in respect of real property items whose tax base is determined as their cadastre value is set as follows: 0.9% – in 2014; 1.2% – in 2015; 1.5% – in 2016; 1.8% – in 2017; 2.0% – in 2018.

It is important to take into account that by virtue of Article 378.2 (13) and Article 383 (6) of the Tax Code of the Russian Federation the corporate property tax and advance payments in respect of real property items whose tax base is determined as a cadastre value are transferred to the budget at the place of location of that real property.

Let's examine how evaluation of real property items is carried out. In accordance with Article 24.12 of Federal Law No.135-FZ of July 29, 1998 (as amended of July 23, 2013) on Evaluation Activities in the Russian Federation the state cadastre evaluation of capital development projects is carried out on the basis of a decision of the state executive authority of a constituent entity of the Russian Federation (such an evaluation is to be carried out at least once in five years).

So, in Moscow the state cadastre evaluation of capital development projects was carried out on order of the Government of Moscow. In accordance with Article 24.17 of Law No.135-FZ, the outputs of that examination were approved by Government Resolution No. 752-PP of November 26, 2013 on Approval of the Results of Determination of the Cadastre Value of Capital Development Projects in the City of Moscow and the information on the cadastre value was sent to the Federal Service for State Registration, Cadastre and Cartography (Rosreestr).¹

As of the moment of preparation of this section, the author can state that the Rosreestr has completed determination of the cadastre value of capital development projects in Moscow. The results of evaluation can be found on the Web-site of the Rosreestr in the Cadastre Accounting Section or order a certificate on the cadastre value of the real property project from any office of the cadastral chamber.

Control over Utilization of Real Property Items of the City to the Department of the Municipal Property of the City of Moscow. On the basis of the results of consideration of the above outputs and in case of confirmation of the facts on noncompliance of actual utilization of the building (construction and structure) with the type of permitted utilization of the land plot in which the building (construction and structure) is situated, draft resolution of the Government of Moscow on introduction of relevant amendments to the above resolution is prepared. In cases established by the legislation, a decision is taken on amendment of the type of permitted utilization of the land plot in which the building (construction and structure) is situated.

¹ The information is published on the official Web-site of the Rosreestr: <http://maps.rosreestr.ru/>.

Order No.779 of December 24, 2013 of the Ministry of Economic Development of the Russian Federation on Introduction of Amendments to the List of the Data of Cadastral Plans Approved by Order No.416 of October 19, 2009 of the Ministry of Economic Development of the Russian Federation was registered in the Ministry of Justice of the Russian Federation; at present a public plan of the Rosreestr will become a more detailed one. According to the amendments, the public cadastral plan placed on the official Web-site of the Rosreestr will be supplemented with the following data:

- on the main parameters of buildings and their values and on the main parameters of uncompleted development projects and their design values;
- on the purpose of buildings and constructions, as well as design purpose of uncompleted development projects.

It is to be noted that due to a number of reasons the cadastre value of real property items can be much higher than the market value of the real property item. As a rule, the above is related to the so-called “mass” evaluation¹, which is a rather labor-intensive process where the executive authorities may encounter such problems as insufficiency (asymmetry) of the information of the state cadastre of real property, lack of the complete and required volume of the data on a real property item and other.

Law No. 135-FZ includes norms which provide for the opportunity to individuals and legal entities to appeal against the results of determination of the cadastre value at the court of arbitration or the commission on consideration of disputes as regards the results of determination of the cadastre value in case the results of determination of the cadastre value affect the rights and obligations of those persons.

In particular, Article 24.19 of Law No.135-FZ grants the owners of real property the right to appeal against the determined cadastre value in the following order:

1) pretrial process provides for making of an appeal at special commissions which were established under the Rosreestr within six months from the day of entry of the cadastre value into the state cadastre of real property;

2) legal process provides for making of an appeal against the decision of a special commission at the court of arbitration if the owner does not agree with that decision or the period of six months set by the law for making of an appeal against the results of evaluation at commissions has passed.

The same article 24.19 of Law No.135-FZ provides for the following two reasons for revision of the results of cadastre evaluation:

1) Unreliability of the data on the real property item used in determination of the cadastre value of that property;

2) Determination of a market value in respect of a real property item as of the date on which the cadastre value of the property was set.

In case of pretrial appeal against the cadastre value, the documents which are required for submission to the commission for revision of the cadastre value are specified by Law No.135-FZ (Article 24.19). They include the following:

- An application for revision of the cadastre value;
- A cadastre passport of a real property item;

¹ That is a unified procedure for evaluation of a large number of real property items as of the specific date with utilization of certain standard methods of statistical analysis.

- A notary copy of a title establishing document or title certification document on the real property item in case an application for revision of the cadastre value is submitted by a person who has the title to the real property;
- Documents certifying the fact that the data on the real property item – which data is used in determination of the cadastre value – is unreliable in case an application for revision of the cadastre value is submitted on the basis of unreliability of the above data;
- A report in case an application for revision of the cadastre value is submitted on the basis of determination of the market value in respect of the real property item;
- A positive expert opinion prepared by an expert or experts of a self-regulating organization of appraisers whose member is an appraiser who prepared a report on compliance of the report on evaluation of the market value of the real property item with the requirements of the legislation of the Russian Federation on evaluation activities.

At the same time, in addition to the above documents the applicant has the right to submit other documents to the commission for consideration.

In case of litigation, a claim is filed by the applicant (plaintiff) against a state executive authority of the constituent entity of the Russian Federation which is authorized to pass a decision on carrying out of state cadastre evaluation in the territory of the constituent entity of the Russian Federation with the above and other documents enclosed.

It is important to pay attention to the fact that as per Article 12 (3) (4) of the Tax Code of the Russian Federation legislative (representative) authorities of a constituent entity of the Russian Federation are entrusted with powers to set the specifics of determination of the tax base as regards regional taxes and, consequently, the corporate property tax.

As regards privileges introduced by regions, let's take for example the regulations introduced in the city of Moscow. The Moscow State Duma approved Law No.63 of November 20, 2013 on Amendment of Law No.64 of November 5, 2003 of the City of Moscow; according to Article 4.1 of the above Law privileges in the form of a tax deduction of the cadastre value of 300 square meters of floorspace were established. The tax base is reduced with simultaneous compliance by a legal entity-taxpayer with the following requirements:

- 1) a legal entity-taxpayer is an entity of a small business;
- 2) a legal entity-taxpayer has been registered with a tax authority for at least three calendar years preceding the tax period;
- 3) during the previous tax period the average number of workers of the business entity amounted to at least 10 persons and the sum of the revenue received from sales of goods (jobs and services) per worker amounted to at least Rb 2m.

In addition to the above, the amount of the tax has been reduced to 25% of the calculated tax amount in respect of those real property items which are utilized for carrying out of educational and medical activities, as well as research organizations which engage in R&D using budget funds.

Also, privileges in the form of tax exemptions are envisaged for all the state-financed entities, entities which are registered at special economic zones and are part of innovation centers, city public transport organizations and metro, housing cooperatives, housing associations and condominium partnerships, entities which employ disabled persons, car-making companies, defense facilities, cultural heritage facilities and religious organizations.

Part One of the Civil Code of the Russian Federation: New General Guidelines for Deals, Representation, Decisions of Meetings and Legal Limitation

In 2013, numerous amendments were introduced to Part One of the Civil Code of the Russian Federation; the above amendments deal with transactions including grounds and consequences related to invalidity of those deals, legal limitations and rules of calculation thereof, meetings to which the law attributes civil and legal consequences for all the persons who had the right to participate in that meeting, as well as other persons. The main amendments were introduced by Federal Law No.100-FZ of May 7, 2013 (other amendments were introduced by Federal Law No.302-FZ of November 02, 2013) on Amendment of Subsection 4 and Subsection 5 of Part 1 and Article 1153 of Part III of the Civil Code of the Russian Federation.

In the Civil Code of the Russian Federation, new Article 157.1 “Consent on a Deal” was introduced. If a consent of the third party, a body of the legal entity, a state authority or local government authority is required by virtue of the law to make a deal, the third party or a respective authority informs about its consent or refusal to grant its consent to the person who asked for such a consent or other interested party within a reasonable period from the day of receipt of the request for a consent. In particular, consent of third persons on a deal is needed in case a person with a limited ability or a minor (at the age of 14 years old to 18 years old) intends to make a deal which he/she has no right to make at his/her own discretion. Consent is to be granted by a parent (adoptive parent) or a fiduciary (Article 26, Article 30 and Article 33 of the Civil Code of the Russian Federation).

A consent on the deal can be a preliminary one and a subsequent one (Article 157.1 (3) of the Civil Code of the Russian Federation). According to the above Article, a preliminary consent is to be expressed for transacting a deal, while the subsequent one, after the deal was finalized, so, it is also called an approval. In the preliminary consent, the subject of the transaction to which consent has been granted is to be determined. In the subsequent consent (approval), the very transaction to which consent has been given, rather than the subject of the transaction alone is to be specified. However, in Article 157.1 of the Civil Code of the Russian Federation the form of the consent has not been determined. In addition to the above, it is specified that silence is not regarded as consent on the deal, except for cases established by the law.

Amendments were introduced to Article 161: a reference to the minimum monthly wage was replaced by a lump sum of Rb 10,000. So, transactions are to be made in a simple written form, except for deals which need be notary certified:

1) deals between legal entities and between a legal entity and an individual (as was provided for by the Article before);

2) deals between individuals for the amount which exceeds Rb 10,000, while in cases provided for by the law – regardless of the amount of the deal.

By a general rule, if the Civil Code of the Russian Federation or other Federal Law provides for state registration of deals, legal effects of such deals take place only after registration. A deal which alters conditions of the registered deal is subject to state registration, too (Article 164 of the Civil Code of the Russian Federation). So, a consistent approach which was formed in the judicial practice has now been confirmed by the legislator. A reduced legal limitation has been established in cases where a party to the deal evades state registration or notary certification of the deal: a legal limitation of one year instead of a three-year legal limitation (Article 165 of the Civil Code of the Russian Federation).

New Article 165.1 “Legally Important Messages” was introduced; applications, notifications, notices, requirements and other legally important messages which by the law or under the deal have civil and legal consequences for another person entail such consequences for that person from the day of delivery of a relevant message to that person or his/her representative. A message is regarded as delivered also in cases if it was delivered to the person whom it was sent to (the addressee), but due to circumstances depending on that person it was not handed in or the addressee did not familiarize himself/herself with it. The above rules are applied unless otherwise is provided for by the law or the terms of the deal, nor entails from the custom or practice which were formed in the relations between the parties. Actually, it means that if any legally important message was sent to the addressee, but due to circumstances depending on the addressee it was not handed in to the addressee or the addressee failed to familiarize himself/herself with that message, the message is considered as delivered.

Important amendments and adjustments were introduced to Paragraph 2 on invalidity of deals. So, a deal carried out in violation of the law is recognized now as a voidable one (the grounds for voidability of a deal are completely specified in the Civil Code of the Russian Federation) and not as a null and void deal. A deal can be recognized as null and void only in case of a simultaneous existence of the following three conditions if the deal violates the requirements of the law or other statutory act and infringes upon public interests or rights and the third party’s interests protected by the law and in addition to the above there is no mention in the law that such a deal is a voidable one or other consequences of a violation which are not related to invalidity of the deal should be applied.

The legal limitation as regards claims to apply the consequences of invalidity of a null and void transaction and recognize such a deal as invalid amounts to three years. It is to be noted that the legislator has introduced an important adjustment that the period of legal limitation as regards the above claims starts from the day on which fulfillment of a null and void transaction began, while in case of filing of a claim by a person who is not a party to the deal, from the day that person learnt or was to learn about the beginning of fulfillment of that deal. It is to be noted that the period of legal limitation for a person who is not a party to the deal should not exceed at all events ten years from the day of the beginning of fulfillment of the deal.

At present, the court has the right to apply individually the consequences of invalidity of a null and void deal only in case it is needed for protection of public interests or in other cases provided for by the law (Article 166 of the Civil Code of the Russian Federation). Earlier, it was it was done only on the basis of an application of a party, but not on the initiative of the court. Also, earlier any interested party could demand application of consequences of invalidity of a null and void transaction by judicial means. With amendments introduced, such a claim can be made only by the party to the deal, while other persons are in a position to turn with such claims to a court only in cases provided for by the law.

The right of the party to appeal against the deal (Article 166 of the Civil Code of the Russian Federation) has been limited, in particular, in the following cases:

- the party knew or was to know about the existence of grounds for making of an appeal against the deal and at the same time demonstrated by its behavior the intention to preserve the validity of that deal and then appealed against the deal on those very grounds;
- after finalization of the deal the behavior of the party gave grounds to believe that the deal was a valid one, however, later that party declared that the deal was invalid.

The above rule is aimed at protection of that bona fide party which relied on assurances or behavior of the other party as regards the voidable transaction and acted with intention to fulfill it.

From Article 173 of the Civil Code of the Russian Federation, a mention of the lack of the license as special grounds for invalidity of the deal was excluded. Consequently, deals transacted with lack of the license if such a license was required by virtue of law can be appealed against on the basis of Article 168 of the Civil Code of the Russian Federation as being contradictory to the law because the law established a requirement as regards availability of the license. Also, the list of persons who may demand recognition of the deal as null and void on the basis of Article 173 of the Civil Code of the Russian Federation has changed; excluded from the list are state authorities which carry out control and supervision over activities of the legal person. The only grounds preserved in Article 173 of the Civil Code of the Russian Federation for making an appeal against a deal are inconsistency of the deal with the goals of the legal entity's activities which are definitely limited in the founding documents provided that the counterparty knew or was to know about that limitation. If such goals are limited by the law alone, the above norm is not applied.

Some other articles of the Civil Code of the Russian Federation were revised, too. A deal which was transacted to the detriment of the interests of the represented person can be recognized as invalid if the counterparty acted jointly with the representative or knew (was to know) about the deal's malice (Article 174 of the Civil Code of the Russian Federation) and consequences related to fulfillment of the deal in respect of the property which disposition is prohibited or limited have been determined. The scope of the party's error in *essentia* which serves as grounds for invalidity of deals (Article 178 of the Civil Code of the Russian Federation) has been specified. Fraudulent concealment can be recognized as fraud which factor constitutes grounds for invalidity of deals (Article 179 of the Civil Code of the Russian Federation).

In the Civil Code of the Russian Federation, new Chapter 9.1 "Decisions of Meetings" was introduced; at present its norms are applied by default to any general meetings (from September 2013 Article 181.1 and Article 181.2), that is: decisions of collegial governing bodies of a legal entity; decisions of meetings of creditors in case of a bankruptcy and other. However, establishment in the Civil Code of the Russian Federation of those general provisions on decision of meetings does not exclude application of a special legislation.

So, a decision of the meeting to which the Law attributes civil and legal consequences gives rise to legal consequences – at which the decision of the meeting is aimed at – for all the persons who had the right to take part in that meeting (participants in the legal entity, co-owners, creditors in case of a bankruptcy and other participants in the company), as well as other persons if it is established by the law or stems from the substance of relations. Decisions of the meeting are deemed as passed if they were voted for by a majority of participants in the meeting and at least 50% of the total number of participants of a relevant company took part in the meeting. Decisions of the meeting can be taken by absentee voting (it is to be remembered that such a practice can be prohibited by individual laws). It is to be noted that in the Civil Code of the Russian Federation there is not mention of the fact that a meeting can be held in a mixed form (in person and in *absentia*).

General rules of keeping minutes of a meeting are provided for. An individual decision on each issue on the agenda is to be taken unless otherwise is established by a unanimous decision of the meeting. General requirements to the minutes of the meeting have been set.

Those requirements depend on the form of the meeting. The minutes of the meeting which is held in an in-person format (in the form of joint attendance) should include the following information: date, time and place of the meeting; information on persons who took part in the meeting; the results of voting on each issue on the agenda; information on persons who counted votes and information on persons who voted against the decision and demanded to make an entry about that fact into the minutes. In the minutes on the results of the absentee voting, the following information is to be specified: the date until which the documents which included the information on voting by members of the company were received; the information on persons who took part in voting; the results of voting on each issue of the agenda; the information on persons who counted votes and information on persons who signed the minutes. The minutes are to be executed in a written form.

Unless otherwise is established by the law, the decision of the meeting is null and void in the following cases: a decision was taken on the issue which was not included in the agenda (it is to be noted that the rule does not work if all the participants/members of the relevant body take part in the meeting); the decision was taken in the absence of the required quorum; the decision was taken on the issue which is not within the competence of the meeting; the decision is in conflict with the fundamentals of the rule of law or good morals (the above grounds are new ones). It stems from Article 181.5 of the Civil Code of the Russian Federation that the list of grounds for recognition of meeting decisions as null and void is a closed one. Consequently, decisions of meetings in case of violation of other norms of the law can be appealed against (Article 181.3 of the Civil Code of the Russian Federation).

An important amendment was introduced to Article 186 on a power of attorney; the above amendment eliminates a power of attorney's maximum period of validity of three years. At present, it is established that any period can be specified in the power of attorney. As before, unless a period of validity is specified in the power of attorney it remains in force within a year from the day of its issue.

A notary certification is not required in respect of powers of attorney issued by way of substitution by legal entities and managers of branches and representative offices of legal entities. Prior to introduction of amendments to Article 187 of the Civil Code of the Russian Federation, a lack of notary certification of powers of attorney issued by way of substitution was admissible only in respect of powers of attorney to receive a person's wages or other income and etc (Article 185 of the Civil Code of the Russian Federation).

A representative who delegated authorities to another person by way of substitution does not lose his/her authorities in respect of the original power of attorney, however, otherwise can be specified in the power of attorney or the law (Article 187 of the Civil Code of the Russian Federation). Also, by general rule a subsequent substitution is not admissible, that is, a person who received authorities from the original representative is not in a position to assign them to somebody else. Though otherwise can be provided for only by the law or the original power of attorney, it can by no means be vested in the power of attorney issued by way of substitution. Initiation of bankruptcy proceedings against the represented person (a representative) can constitute grounds for termination of a power of attorney.

It is worth mentioning introduction of new Article 188.1 "Irrevocable Power of Attorney" which is issued for the purpose of fulfillment or enforcement of fulfillment of obligations of the represented person before the representative or persons on whose behalf the representative acts. If such an obligation is related to carrying out of business activities, the represented person may specify in the power of attorney issued to the representative that such a power of

attorney cannot be cancelled before expiry or can be cancelled only in cases provided for in the power of attorney. In any event, such a power of attorney can be canceled after termination of the obligation for which fulfillment or enforcement of fulfillment it was issued and also at any time in case of abuse by the representative of his/her powers, as well as in case of circumstances which explicitly point to the fact that such an abuse of power can take place. An irrevocable power of attorney is to be notary certified.

Also, other amendments were introduced to the Civil Code of the Russian Federation, in particular, amendments of provisions as regards legal limitation (Article 196, Article 200, Article 202 and Article 207 of the Civil Code of the Russian Federation). In particular, in any event the legal limitation cannot exceed 10 years from the day of the beginning of fulfillment of the deal (Article 181 (1) of the Civil Code of the Russian Federation). Earlier, there was no such a limitation in the Civil Code of the Russian Federation. An exception is made only for one case, that is, indemnification of damage caused to the property as a result of a terrorist act. In such a case, legal limitation as regards a claim is set within the limits of the legal limitation of criminal proceedings brought against a person for commission of a crime.

The rules of calculation of legal limitation have been changed as regards obligations whose date of fulfillment was either not determined or determined as the date of demand. At present, legal limitation is calculated from the day of creditor's demand as regards fulfillment of that obligation. Earlier, the beginning of legal limitation was regarded the date on which the creditor has received the right to make such a demand. However, at any event legal limitation cannot exceed 10 years from the day of creation of the obligation.

In addition to a penalty, security or surety, additional requirements include interests. So, with expiry of legal limitation in respect of the main demand the legal limitation is considered expired, too, in respect of interests, including those accrued after the expiry of legal limitation as regards the main demand.

Notes

RUSSIAN ECONOMY IN 2013

Trends and Outlooks

(Issue 35)

Editors: Glavatskaya N., Mezentseva K., Shanskaya A.

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ISBN 978-5-93255-393-0



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