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Editorial Board: *S. Sinelnikov-Murylev (editor-in-chief),
A. Radygin,
N. Glavatskaya*

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The review provides a detailed analysis of main trends in Russia's economy in 2011. 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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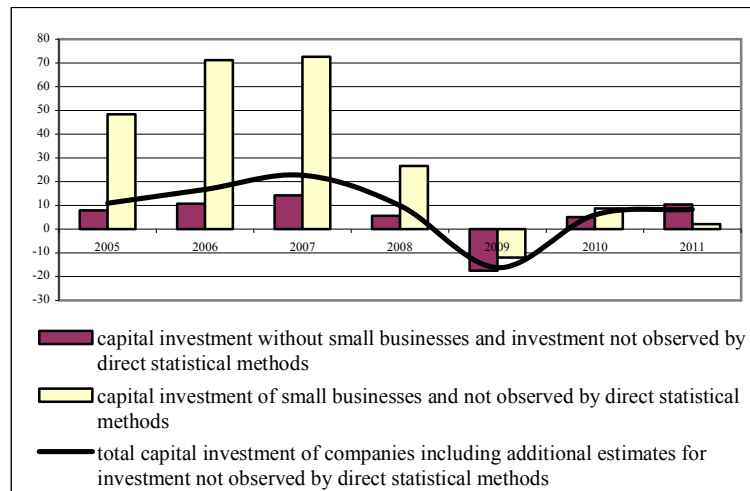
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Domestic capital investment

The crisis of 2008 drastically changed the situation in the investment sector. During the period from 1999 until 2008 the trend of investment demand expansion with the average annual rate of 112.6% was supported by favorable situation both domestically and in foreign markets. This trend was abruptly terminated by acute crisis in construction and investment complex. In 2009 capital investment slowed down by 15.7% while GDP decline was 7.8%, so this slide of investment was much deeper than during 1998 crisis. The specificity of post-crisis recovery after 2008 was demonstrated in extremely slow recovery rates for business activity in the sphere of investment. In 1999–2000 increasing the share of capital investment in the overall GDP structure was the key driver for intensive recovery of GDP and hitting the pre-crisis level of 1997 quite soon shaping the preconditions for dynamic economic growth in the following years. On the contrary, during the three-year period between 2009 and 2011 the share of capital investment in the GDP remained at the same level of 20.4% having led to slow down of recovery after 2008 financial crisis. In 2011 the level of capital investment still did not reach the 2008 level being 3.3% below it.

After financial crisis of 1998 economic recovery was underpinned by active engagement of standby and under-loaded production capacities. This was the key driver of outrunning capital investment rates for major enterprises. However, simultaneously the impeding factors limiting growth were becoming more and more important: high level of fixed assets depreciation and shortage of skilful workforce. Their negative impact was partially compensated by increased economic activity of small and medium sized businesses. Their share of capital investment (in the total volume of capital investment in Russian economy) grew from 10% in 2000 up to 24% in 2008. During this period of time the average annual capital investment growth rates for small and medium sized businesses were significantly exceeding investment performance of major enterprises.

The situation changed drastically in 2009, when in the context of financial and economic crisis the decreased volumes of loans and growing of average weighted interest rate for small and medium sized businesses (up to 20%) led to capital investment in this segment falling down almost by 13.4% versus the preceding year, which negatively impacted the situation in investment sector in general. In 2010 financial support of small and medium sized businesses became of the state priorities: the overall budget appropriations for such support made Rb 17.97bn; capital investment grew by 8.7% versus 2009, and their share in the total volume of investment in the economy grew up to 27.6%. In 2010 the dynamic growth of investment demand in small and medium sized businesses segment compensated the retarded dynamics of capital investment of major companies *Fig. 34*. Unfortunately, these structural changes were rather of opportunistic character and were not supported by the fundamental changes in the overall investment climate of Russia.

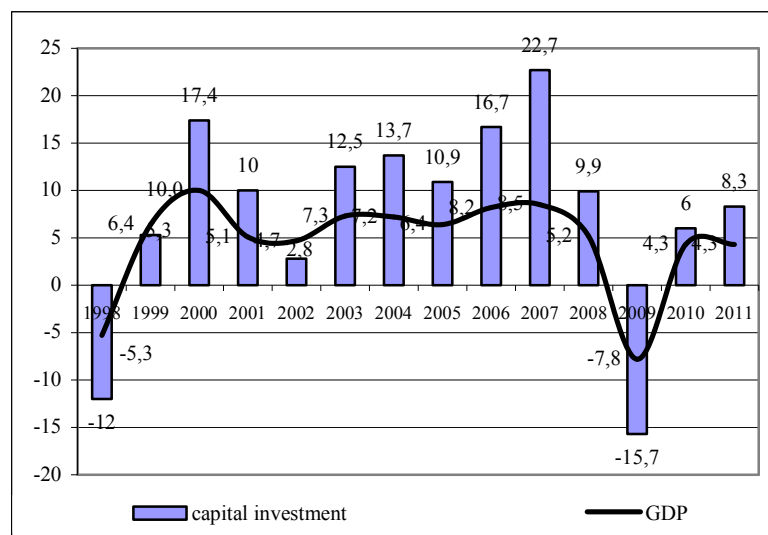


*preliminary estimates.

Source: Federal Statistics Service.

Fig. 34. Dynamics of capital investment for major companies and small businesses in 2005–2011, % to the preceding year

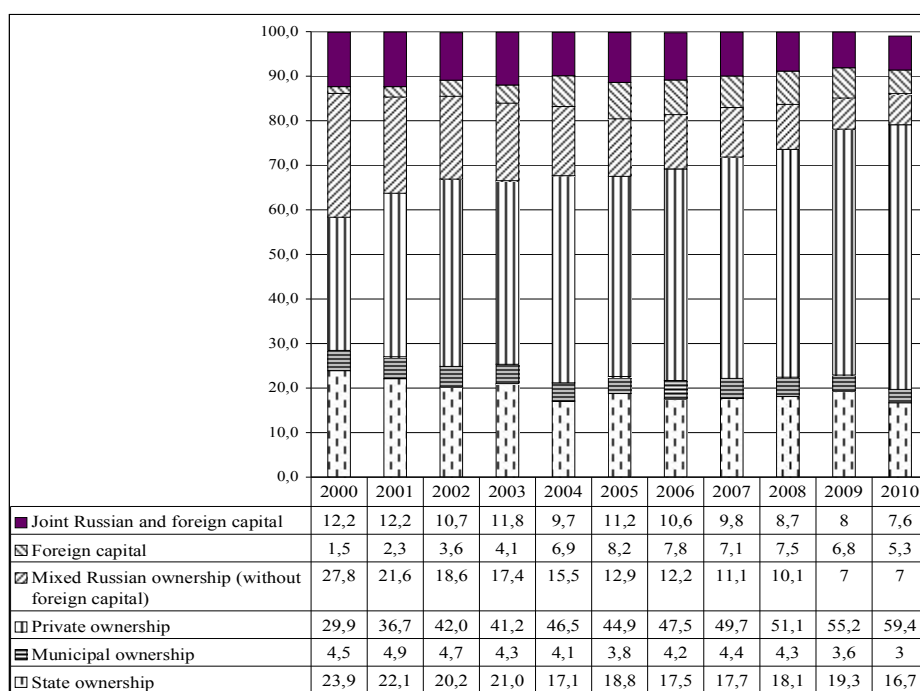
In 2011 the positive dynamics of investment activities in small and medium sized businesses segment was maintained (Fig. 35). Capital investment rates of small businesses in 2011 were 2.3% higher than in the preceding year, which allowed for hitting the pre-crisis level of 2008. In major companies segment the investment dynamics was positively impacted by implementation of a set of measures from the government’s anti-crisis program. In 2010 incremental capital investment for major companies was 5.1%, and in 2011 – 10.1%. Let us note here, that in 2011 increase in capital investment activity by major companies became the driver for improving capital investment growth rates up to 108.3% versus 106.0% in the preceding year (Fig. 35).



Source: Federal Statistics Service.

Fig. 35. GDP and capital investment dynamics in 1998–2011, % to the preceding year

Over the recent decade the profile of investment by forms of ownership has changed (Fig. 36). The major portion of capital investment falls on private enterprises and organizations, their share in total investment grew from 29.9% in 2000 up to 51.1% in 2008 and 59.4% in 2010. Another characteristic feature is increased share of investment by enterprises and organizations with foreign capital. These investments reached their peaks in 2005–2007. In the following years due to lack of systematic measures targeted at investment climate improvement foreign investors suspended their activity.



Source: Federal Statistics Service.

Fig. 36. Capital investment profile in the Russian Federation by forms of ownership, % to the outcome

During the period of 2000–2010 investment profile by funding sources also changed. The share of capital investment at the expense of borrowed funds grew, and at the same time investment funded by equity capital fell down to 40.4% in 2007, and even during the post-crisis development in 2009–2010 it remained below the average level of the preceding years. However, slow recovery rates of domestic market and overall economy income recovery dictated enterprises and organizations using more equity to fund their investment programs in 2011. As of the end of 2011 the share of equity investment in the overall capital investment grew up to 42.7% and exceeded the preceding year indicator by 1.7 p.p. (Table 9).

Table 9

Capital investment profile by funding sources (without small business entities and investment amounts non observable by statistic methods), % to the outcome

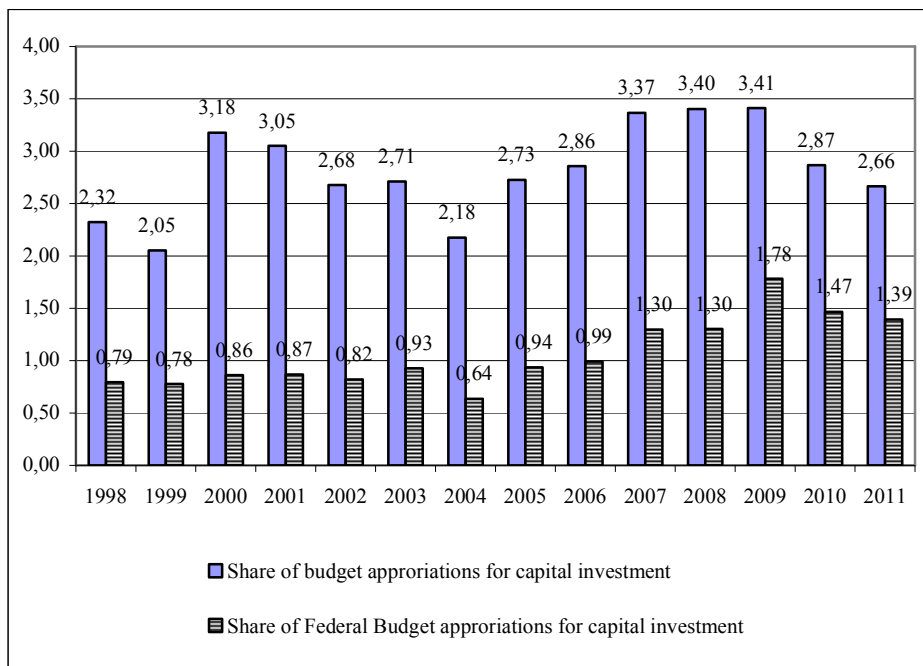
	1999	2000	2005	2006	2007	2008	2009	2010	2011
1	2	3	4	5	6	7	8	9	10
Capital investment, total	100	100	100	100	100	100	100	100	100
Including by funding sources:									
Equity capital	52.4	47.5	44.5	42.1	40.4	39.5	37.1	41.0	42.7

cont'd

1	2	3	4	5	6	7	8	9	10
Withheld profit (accumulation fund)	15.9	23.4	20.3	19.9	19.4	18.5	16.0	17.1	17.2
Borrowed funds	47.6	52.5	55.5	57.9	59.6	60.5	62.9	59.0	57.3
including:									
Bank loans	4.2	2.9	8.1	9.5	10.4	11.8	10.3	9.0	7.7
Including loans by foreign banks	...	0.6	1.0	1.6	1.7	3.0	3.2	2.3	1.5
Borrowing from other organizations	5.6	7.2	5.9	6.0	7.1	6.2	7.4	6.1	5.0
Budget funds	17.0	22.0	20.4	20.2	21.5	20.9	21.9	19.5	18.8
including:									
Funds from the Federal Budget	6.4	6.0	7.0	7.0	8.3	8.0	11.5	10.0	9.8
Funds from sub-national budgets (RF constituents)	9.6	14.3	12.3	11.7	11.7	11.3	9.2	8.2	7.9
Extra-budgetary funds	8.6	4.8	0.5	0.5	0.5	0.4	0.3	0.3	0.2
Others	12.2	15.6	20.6	21.7	20.1	21.2	23.0	24.1	25.6
including:									
Superior organizations funds			10.6	12.5	11.3	13.8	15.9	17.5	20.2
Funds received from share participation in construction (from organizations and individuals)			3.8	3.8	3.7	3.5	2.6	2.2	1.9
Including funds from the citizens				1.3	1.5	1.9	1.3	1.2	1.1
Funds from issuing corporate bonds			0.3	0.04	0.1	0.1	0.1	0.01	0.0
Funds from capital stock issues	0.7	0.5	3.1	2.3	1.8	0.8	1.0	1.1	1.0
Within overall capital investment – foreign investment		4.7	6.6	6.9	5.4	4.3	4.3	3.8	3.1

Source: Federal Statistics Service.

Change of the borrowed funds volumes and shares in the overall funding sources profile was accompanied by some structural change. The demand for products and services of Russian enterprises on behalf of the government was supported by implementation of the planned investment projects in transportation, ICT and some other spheres within the framework of federal target programs and Federal Targeted Investment Program (FTIP), as well as by implementation of major infrastructure programs of the Investment Fund. In accordance with the government investment priorities such funds were mostly channeled for modernization and development of strategically important production infrastructure sites, implementation of investment projects focused on introduction of state-of-the-art technology to improve competitiveness of Russian mechanical engineering products, as well as improvement of industrial safety in energy, transportation, waters and forests management. In the crisis environment the government provided incentives for introducing innovations through implementation of “producible” federal target programs. Appropriations for such programs were either maintained at the previously planned level, or immaterially reduced. The share of budget appropriations channeled into capital investment made 3.1% of GDP in 2009 versus 2.54% of GDP in 2007, including Federal Budget appropriations making 1.62% of GDP in 2009 versus 0.98% of GDP in 2007. In 2010 the share of budget funds used as capital investment grew even more and made 2.87% of GDP, and then immaterially decreased in 2011 making 2.66% of GDP. Similar dynamics was observed for investment at the expense of the Federal Budget – 1.47% of GDP and 1.39% of GDP respectively (*Fig. 37*). In 2010–2011 the ratio between the Federal Budget and regional budgets appropriations channeled to investment changes. In the overall amount of investment at the expense of budget appropriations the Federal Budget share in 2011 was increased up to 52.2% versus 38.2% in 2008.



Source: Federal Statistics Service.

Fig. 37. Share of budget appropriations for capital investment during the period of 1999–2011, % to GDP

In 2011 it was planned to channel Rb 895.0bn from the Federal Budget to construction, re-vamp, technical re-equipment and acquisition of facilities, as well as to implement major integrated investment projects included into Federal Targeted Investment Program, including budget investment of Rb 769.6bn (subsidies – Rb 125.4bn)¹.

As of the end of 2011 taking into account all the changes actual Federal Budget funds allocated for construction and measures within Federal Targeted Investment Program constituted Rb 946.0bn (1.74% of GDP) exceeding 2010 level by Rb 181.6bn.

In 2011 Rb 573.8bn (60.7% of total FTIP investments) were allocated for projects included into federal target programs (program element of FTIP). Rb 372.2bn were allocated for construction of facilities and implementation of measures beyond federal target programs (39.3% of total FTIP investments). Rb 160.2bn were reserved within FTIP for funding specialized work associated with State defense order in 2011 (16.9% of total FTIP investments).

According to the Federal Statistics Service (Rosstat), the level of budget appropriations for FTIP construction sites and facilities (without account of special facilities included into state defense procurement) monitored by Federal Statistics Service in January-December 2011 made Rb 504.6bn, i.e. 70.9% of the annual limit (Table 10).

In accordance with the Federal Targeted Investment Program for 2011 as amended by January 1, 2012, budget appropriations were made for construction and acquisition of 3842 sites with 2226 sites to be commissioned. In reality 500 sites were commissioned in 2011: 425 – at

¹ Starting from 2011 Federal Targeted Investment Program includes not only Russian Federal property and property of legal entities not being state or municipal institutions / unitary enterprises, but also capital construction property of the RF constituents (regional governments) and municipal property co-funded out of the Federal Budget.

full capacity, 75 – partially. As of January 1, 2012, technical availability for 876 sites was within the range from 51.0% to 99.9%.

Table 10

**Sites included into FTIP and CAPEX funded out of the federal budget объемы
in 2011 (without account of sites included into state defense procurement)**

	Number of sites in 2011		Commissioned in 2011		Limit of state CAPEX for 2011		Funded out of Federal Budget	Utilized investment from all funding sources in 2011
	total	Including those with commissioning deadline in 2009	at full capacity	partially	total	Including funded out of the federal budget		
	sites				Rb bn			
Total	3842	2226	425	75	771.4	711.6	504.6	515.6
including: transport complex	1110	532	127	11	295.3	276.9	248.9	237.7
agricultural complex	184	107	49	13	8.6	8.4	7.7	6.8
special complex	753	545	111	14	55.3	50.4	31.0	31.9
social complex	1611	966	131	34	362.6	332.8	186.2	214.0
Other sites	184	76	16	3	49.5	43.0	30.8	25.2

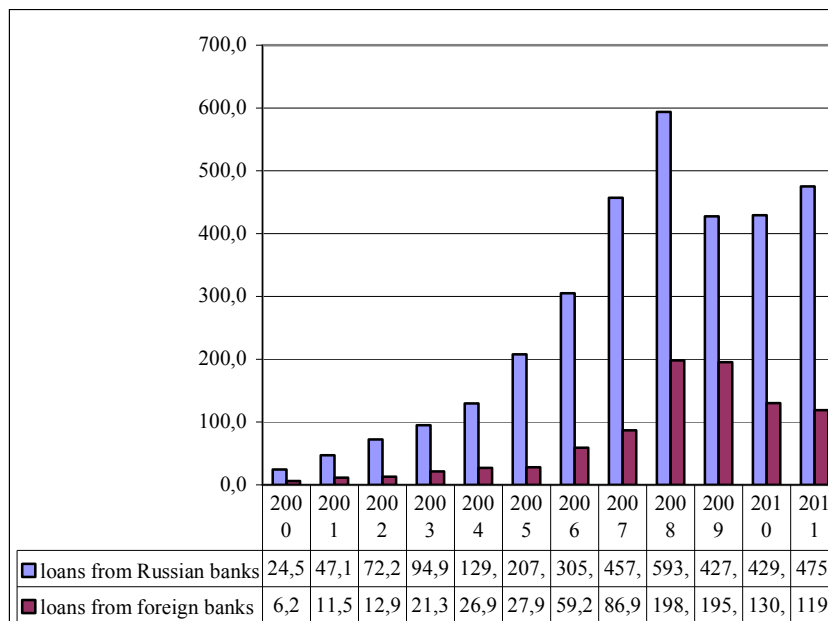
Source: Federal Statistics Service.

At the expense of annual limit in 2010 Rb 504.9bn were allocated out of the Federal Budget (70.9% of total annual appropriations) and Rb 51.0bn were allocated out of regional budgets (69.4% of the overall funds of regional budgets). In January-December 2011 state customers utilized Rb 515.5bn of state CAPEX, i.e. 66.8% of the annual limit of construction appropriations. The level of budget funding utilization of the total actual appropriations at the expense of all funding sources made 92.8%.

Prior to 2008 crisis the amount of borrowed funds for investment was growing due to increased activity of the banking sector, growth of citizens' investment into housing construction and intensive in-flow of foreign capital. In 2009 absolute shrinkage of bank loans for investment purposes was registered. The key factors suppressing further deepening of the crisis at the investment market during that period were: growth of loans from foreign banks and active borrowing from other companies¹. The share of loans from foreign banks for capital investment in the overall banks' loans made 31.4% and reached its maximum over the last decade.

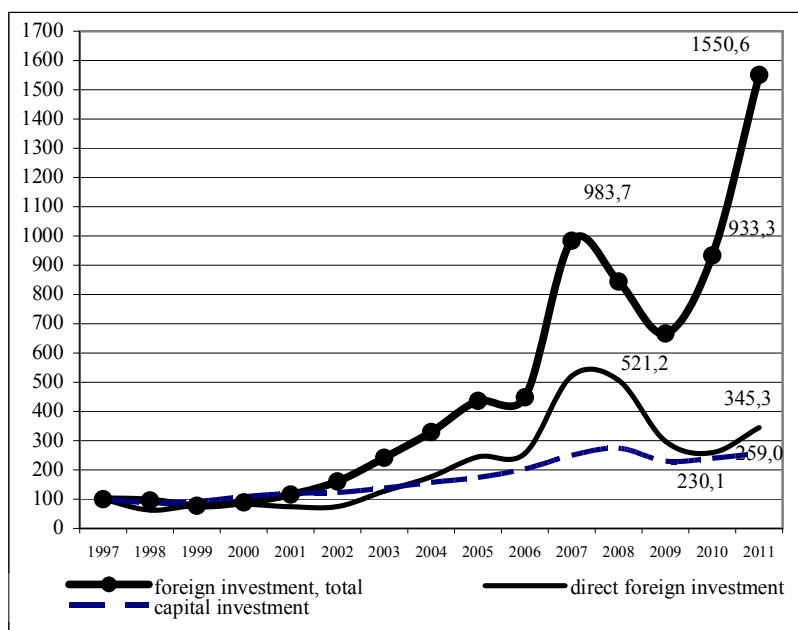
In 2010 the trend of decreasing the share of bank capital and borrowed funds in the overall capital investment started to decrease: out of Rb 2,769.0bn of total borrowed funds Rb 559.2bn fell on bank loans, i.e., 14.8% versus 18.4% in 2008. In this context in 2010 given the trend for stabilization of loans for capital investment issued by Russian banks, loans from foreign banks decreased by Rb 62.5bn and determined the aggregate decrease of bank loans share in the overall funding of capital investment. In 2011 growth of loans from Russian banks fully compensated for decrease of loans from foreign banks. During one year period incremental loans for capital investment issued by Russian banks made Rb 46.0bn (Fig. 38)

¹ According to the Methodology Regulations for Statistical Indicators in Construction and Capital Investment (Order by the Federal Statistics Service No.37 issued on March 11, 2009) borrowed funds for capital investment include: bank loans, share sale revenues, charity donations and other contributions, funds from superior joint-stock companies (holdings, industrial and financial groups) on a grant basis; funds borrowed from other organizations including loans from the government on a pay-back basis, loans from foreign investors, bonded debt, loans from institutional investors: equity funds and investment companies, insurance companies, as well as promissory notes and other funds. See,



Source: Federal Statistics Service.

Fig. 38. Bank loans for capital investment in 2000–2011, Rb bn



Source: Federal Statistics Service.

Fig. 39. Indices of capital investment, foreign investment and direct foreign investment during 1998–2011, % of 1997 level

During the period of 1998–2007 foreign investment into Russian economy increased 9.8 times, including direct foreign investment growth of 5.2 times. This resulted in increased share of foreign investment and loans from foreign banks in funding capital investment. Foreign in-

vestment share in the overall capital investment into Russian economy grew from 4.7% in 2000 up to 5.4% in 2007.

2008 crisis featured greater decrease of foreign investment into Russian economy versus domestic investment. Besides, net capital flight (disinvestment) reached its historic maximum of \$ 133.9bn in 2008 fully offsetting the positive trends of the preceding two years (*Table 11*).

In 2009–2011 the foreign investment profile transformed due to sharp decline of the amount and share of direct investment and increase of other investment. In 2010 foreign investment into Russian economy constituted 94.8%, and direct foreign investment constituted 49.7% of 2007 level. At the same time domestic investment decreased by 1.8%. In 2011 direct foreign investment grew by 33.3%, but they still constituted only 2/3 of the pre-crisis level of 2007–2008. The situation was aggravated by the trend to capital flight which persisted during the last three years. Net private capital export in 2009 was making \$ 56.9bn, and in 2011 – \$ 84.2bn. Eventually the share of foreign investment in the total capital investment fell down to 3.1% in 2011 versus 3.8% in 2010.

Table 11

Net private capital import/export as per balance of payments, \$ bn

	Net capital import/export in private sector	Net capital import/export by banks	Net capital import/export in other sectors
1998	-21.7	-6	-15.7
1999	-20.8	-4.3	-16.5
2000	-24.8	-2	-22.8
2001	-15	1.3	-16.2
2002	-8.1	2.5	-10.6
2003	-1.9	10.3	-12.2
2004	-8.9	3.5	-12.4
2005	-0.1	5.9	-6
2006	41.4	27.5	13.9
2007	81.7	45.8	35.9
2008	-133.9	-56.9	-76.9
2009	-56.9	-30.4	-26.5
2010	-33.6	15.9	-49.5
2011	-84.2	-26.2	-57.9
Q1	-20.1	-7.7	-12.5
Q2	-7.3	-2.6	-4.7
Q3	-19.0	-8.5	-10.4
Q4 (estimate)	-37.8	-7.5	-30.3

Source: Central Bank of Russia.

In 2009 we can observe a turning point of such trend in the sphere of housing construction. After pretty sustainable growth of housing construction during the period of 2001–2008, in 2009–2010 housing commissioning declined by 8.9%, including commissioning of housing funded by citizens and borrowed funds – by 6.9% versus the pre-crisis level of 2008.

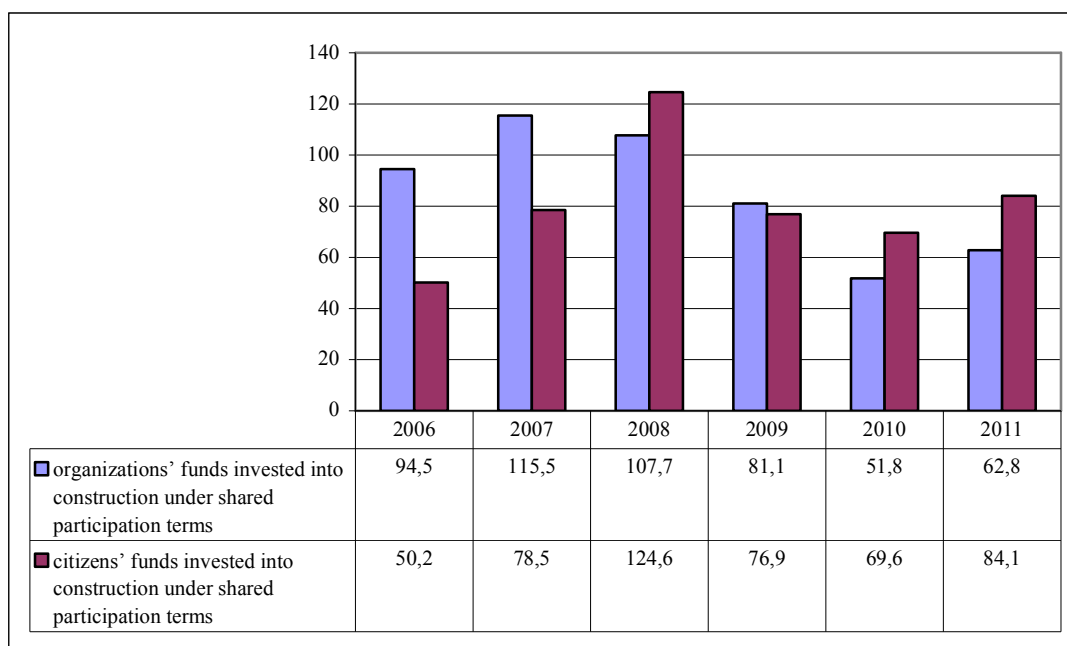
In H1 2011 the decline in housing commissioning was making 3.7% versus similar period of the preceding year. The situation changed in Q3 2011, when housing commissioning grew by 15% versus similar period of the preceding year, and as a result as of the end of the year the increment of commissioned housing made 6.6% of 2010 level. At the same time 26.7m sq. m was commissioned in 2011 at the expense of citizens funds and borrowed funds, which exceeds the level of the preceding year by 1.4m sq. m. As for housing commissioned at the expense of companies/organizations' funds, it demonstrated growth by 3.5m sq. m.

The share of individual housing construction in the overall housing commissioned declined and in 2011 made 42.9% versus 43.7% in 2010 and 47.7% in 2009. Investment activity of the population in 2011 was supported by growing demand for loans in the context of decreasing

the interest rates. However, the impact of this growth on the dynamics of housing commissioning is determined by the time lags within the construction cycle and is visible beyond the preceding year. The amount of issued residential loans in 2011 made Rb 749.2bn (1.38% of GDP) versus Rb 418.2bn (1.28% of GDP) in 2010, including Rb 693.8bn in mortgages (0.93% of GDP) versus Rb 346.6bn (0.77% of GDP) one year before.

Absolute growth of investment into housing construction (by Rb 25.5bn) was observed in 2011, including growth by Rb 14.5bn at the expense of citizens funds invested into construction under shared ownership terms (*Fig. 40*). However, in the overall capital investment in the economics the share of investment into housing construction in 2011 went down to 1.9% versus 2.2% in 2010 and 3.5% in 2008.

In the capital investment profile by types of fixed assets the share of housing construction expenses decreased in 2011, while the share of expenses for non-residential construction was decreasing (*Table 12*). Total area of non-residential buildings grew in 2011 by 9.9% versus the preceding year. Along with the increase of share of expenses for industrial construction the share of investment into machines and equipment acquisition was also growing. Let us notice that in 2011 given the unstable dynamics of domestic capital goods production, the share of investment into acquisition of imported machines, equipment and transportation vehicles (without small business entities) in the total investment into machines, equipment and transportation vehicles made 18.6% versus 18.0% in 2010.



Source: Federal Statistics Service.

Fig. 40. Funds channeled to construction under shared ownership terms in 2007–2011, Rb bn

Purchasing foreign equipment is more profitable for a number of reasons: its relative price, high quality and post-sale maintenance support. Purchasing foreign equipment became the major type of innovation activities of industrial enterprises.

Table 12

Capital investment by types of fixed assets in 2008–2011 (without small businesses and informal activities), % to the outcome

	Rb bn				% to the outcome			
	2008	2009	2010	2011	2008	2009	2010	2011
Capital investment, total	6272.1	5769.8	6413.7	7701.2	100	100	100	100
Including:								
housing	467.2	343.5	372.3	361.8	7.5	6.6	5.7	4.7
buildings (without residential) and facilities	3286.8	3221.2	3495.8	4172.5	52.4	53.8	53.6	54.3
machines, equipment, transportation vehicles	2071.3	1798.2	2109.6	2644.3	33.0	32.2	33.4	34.3
other	446.8	406.9	436.0	522.6	7.1	7.4	7.3	6.8

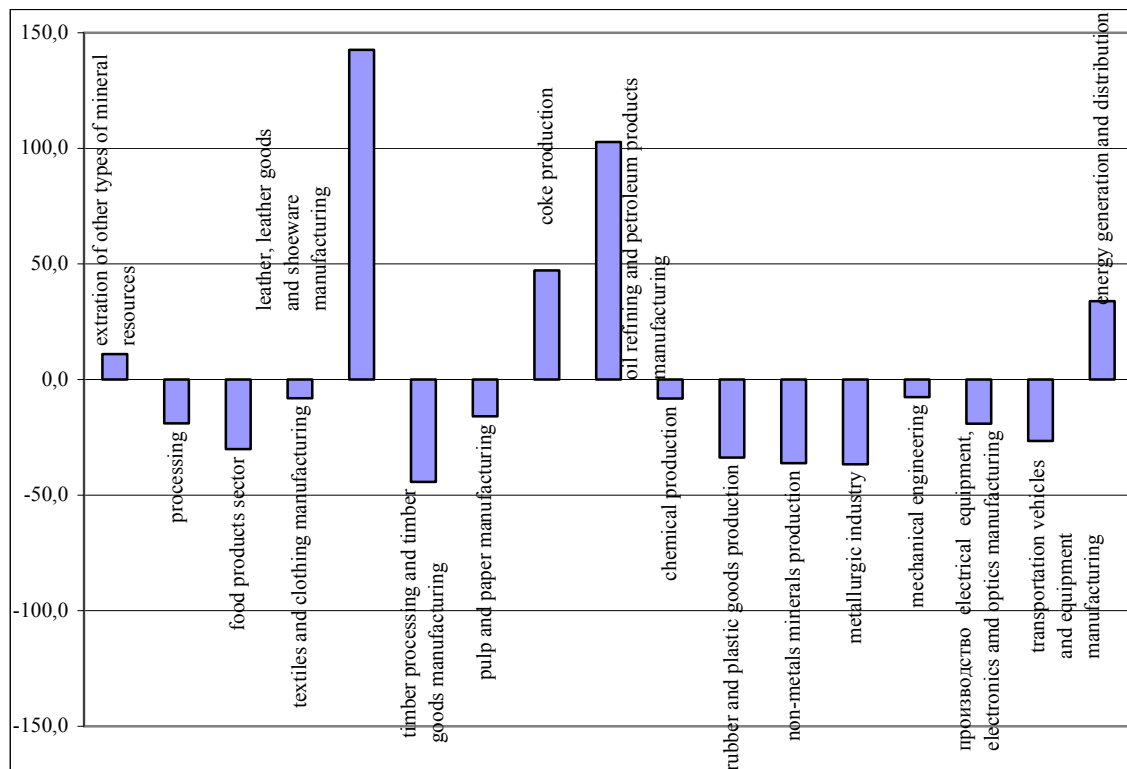
Source: Federal Statistics Service.

The major portion of capital investment during 2010–2011 was channeled to purchasing new machines and equipment. According to Federal Statistics Service, 32–46% of companies/organizations invested into improving the efficiency of production (automation or mechanization of the existing processes, introduction of new technology, reduction of production costs, energy savings); 32% of companies/organizations were seeking increase of production capacity without changing the product slate, and 29% of companies/organizations were striving for increasing production capacity with simultaneous expansion of the product slate. Changes in the capital investment profile by types of business over the last two years allow for identifying the most characteristic features of investment demand transformation. In 2009–2011 an immaterial increase of the industry share in the total capital investment was observed (without small businesses). At the same time quite significant differentiation of capital investment rate by types of business was observed. The post-crisis recovery was determined by both higher growth rates in mineral resources extraction sector and higher growth dynamics of demand for investment in this sector. It also needs to be taken into account that capital investment sagging in mineral resources extraction sector, in generation and distribution of energy, gas and heat was not as deep as in processing. In 2011 capital investment in mineral extraction sector grew by 13.8% versus the preceding year, in generation and distribution of energy, gas and heat – by 8.1% and in processing sector – by 6.3%. Capital investment in mineral extraction sector exceeded 2008 level by 9.4% and in generation and distribution of energy, gas and heat – by almost one third.

In 2011 capital investment growth in processing was observed in the majority of areas, however, the crisis manifestations persisted. Total capital investment in processing made 81.0% versus 2008 (*Fig. 41*).

The most prominent growth of investment among processing industries was registered in timber processing and timber items production (148.4% of 2010), in chemical production (123.4%), coke and petroleum production (115.5%). Stable high level of investment activity in textile manufacturing and leather production during the preceding three years needs to be highlighted. The key driver here is the change in customs regulations with regard to importing equipment and raw materials.

Slow recovery of demand for capital goods and structural materials determined the volume of investment in metallurgy and commercial metal goods production, which remained at 2010 level. At the same time investment into commercial metal goods production declined by 22% versus the preceding year.



Source: Federal Statistics Service.

Fig. 41. Capital investment by sectors of industry in 2011, % of 2008

Investment activity in mechanical engineering is recovering a lot slower than in other businesses. In 2011 the share of capital investment in mechanical engineering constituted 2.3% of total investment into economy and 13.5% of investment into processing. Investment into machines and equipment manufacturing increased by 13.0% in 2011, while in transportation vehicles and equipment manufacturing the investment went down by 3.8% versus the preceding year.

The share of investment into transportation development in 2011 went up to 25.3% of total capital investment into the economy. Investment into transportation and communication grew 1.3 times versus 2008, which is connected with intensive implementation of pipeline transportation investment programs during 2009–2011 (*Table 13*).

Investment into social sphere development is still below the pre-crisis level.

Growth of investment into research and development was registered during the last three years. Between 2009 and 2011 investment into R&D grew 1.7 times and in 2011 made 1.0% of total capital investment into economy.

The conditions of material resources and facilities remain the key factor of successful functioning of R&D sector. Despite positive quantitative characteristics of GDP dynamics, capital investment, labor market and state budget, Russian economy is still lagging behind many developed economies judging by many qualitative parameters. Labor productivity makes only 2/3 of the level of EU countries, and capital investment share in GDP is still insufficient to modernize the economy and intensive progress of scientific research and development.

Table 13

**Amount and dynamics of capital investment in 2008-2011 by types of business
(without smaller businesses and informal activities parameters)**

	Rb bn				% to the preceding year			
	2008	2009	2010	2011	2008	2009	2010	2011
Total	6272.1	5769.8	6413.7	7701.2	105.6	82.5	105.1	110.4
including:	243.0	192.6	190.9	251.3	95.7	75.2	88.9	110.9
agriculture, hunting and forestry								
mineral resources extraction	1040.9	967.8	1109.8	1312.2	103.9	88.3	108.9	113.8
including:	950	893.5	1021.5	1187.5	104.8	89.1	108.7	112.3
production of fuel and energy reserves								
processing industry	1034.0	881.9	993.7	1172.3	107.8	78.2	103.3	106.3
generation and distribution of energy, gas and water	558.2	585.6	786.3	918.5	111.3	99.8	124.1	108.1
Construction	91.7	162.7	194.1	165.1	91.7	66.1	117.3	89.9
wholesale and retail	168.7	138.4	158.4	171.7	95.6	75.7	108.9	88.4
transportation and communications	1628.0	1624.6	1696.1	2223.7	112.4	99.1	109.0	120.6
including communications	257.4	180.6	207.3	274.7	95.1	66.6	108.6	113.4
financial activity	74.7	74.6	77.2	124.3	95.6	99.4	107.1	142.2
transactions with real property, leasing and provision of services	733.8	558.2	658.3	607.1	100.9	70.8	92.8	94.9
including R&D	31.9	48.9	62.8	74.1	101.9	131.9	114.4	112.5
government administration and defense; mandatory social insurance	128.2	133.0	120.5	131.5	109.7	89.5	87.0	108.4
Образование	162.9	117.4	142.9	170.2	96.9	78.7	113.7	111.3
healthcare and social services	188.0	145.7	161.3	175.9	116.0	82.1	105.6	104.1
other communal, social and personal services	128.8	168.6	185.8	239.9	127.9	85.1	102.8	117.7

Source: Federal Statistics Service.