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## Political and economic results of March 2007

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One of the main outcomes of March 2007 were the regional parliamentary elections, including in Russia's second and third largest constituent entities – Moscow Region and St Petersburg. The less time remains till the 2007-2008 federal elections, the more reason there is to consider regional elections as a rehearsal for those (with the exception of turnout figures, which at regional elections are usually half of those at federal polls).

The main outcome of the elections is the unprecedented level of vote rigging and machinations committed by the authorities. For example in Dagestan, the top candidate on the party list of candidates for Patriots of Russia was attacked and seriously wounded, while one of the people at the top of the SPS (Union of Right Forces) list of candidates went missing. There was a mass desertion of candidates from the Communist Party and the SPS lists of candidates (in the end SPS was banned from the race because the local legislation requires it that a party is removed from an election race if members of the same district branch leave its list of candidates). As votes were being counted, the turnout was announced at 80 per cent (! an unheard-of figure, even for a presidential election), with 65 per cent of the vote won by United Russia. Interestingly, according to preliminary estimates, the Communist Party of the Russian Federation, which throughout the 1990s was a political leader in the republic, failed to overcome the threshold altogether.

Similar cases were registered in other regions, too. For example in St Petersburg, the only party that opposed Valentina Matviyenko's re-appointment as the governor, Yabloko, was banned from running in the election on the grounds of an alleged excess of unverified signatures submitted in its support. As a result the St Petersburg and the central electoral commissions refused to register Yabloko for the election, although the party had provided notarized statements from signatories and some of the latter even presented themselves at the commission in person. The Russian Supreme Court humiliated Yabloko by refusing to contest that ruling, alleging that the latter was outside its jurisdiction (curiously, on other occasions the Supreme Court considered that cases of other parties' removal from election races were under court jurisdiction). In Moscow Region<sup>1</sup> data were entered in the GAS-Vybory electronic vote counting system significantly differed from those recorded in observers' protocols and the SPS list of candidates that was disagreeable to the region's governor Boris Gromov got an improbable 6.9 per cent.

The above suggests a simple conclusion: even registered parties in Russia are no longer guaranteed either access to running in elections or a relatively fair vote counting. One has to fight to achieve those: to be able to arrange for pressure on the Russian authorities both abroad and inside the country, primarily by way of mass protests. In that respect both SPS and Yabloko, putting it mildly, were less than impressive: the SPS rally to protest against vote-rigging in Moscow Region gathered not more than several dozen people, while the Yabloko leader did not do anything at all, not even issued a statement. The form of protest proposed by the St Petersburg branch of Yabloko – spoiling ballot papers by ticking all the parties – was supported by only 3 per cent of voters. Although it is worth noting that in its hope for a favourable ruling of the Supreme Court, the party did not spend much on publicizing the protest.

In terms of the breakdown of votes, the results shown by the parliamentary parties A Just Russia and SPS are of most interest. United Russia got more than 50 per cent of votes in Dagestan, Omsk and Tyumen regions and nearly reached this threshold in Moscow Region. At the same time in those regions where the party was in steep competition with part of the regional elite which had joined the other party of Putin's supporters – A Just Russia – United Russia's results were far less impressive: in St Petersburg it got 37 per cent, in Leningrad Region – 35 per cent, in Komi – 36 per cent, in Samara Region – 33 per cent, while in Stavropol Territory, where the party's branch is led by a Communist Party defector, governor Aleksandr Chernogorov, United Russia lost the election to A Just Russia, led by Stavropol mayor Dmitriy Kuzmin, 23.9 to 37.6 per cent. In addition, United Russia lost the by-election in single-seat constituencies in the Republic of Tyva, where even arbitrariness of the courts hasn't ensured it a majority in the regional parliament.

The results of A Just Russia, which has the ambition of becoming the alternative party of power, are rather controversial. On the one hand, the Stavropol triumph and successful performance in other regions show the party's high potential in those regions where its list of candidates is led by well-known regional opposition figures opposing the governor. The party's results in St Petersburg (21 per cent), where - in Yabloko's absence - the party positioned itself as an opposition one, were also quite good, although that was also where substantial finance resources were focused. At the same time, the party's human resources and financial re-

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<sup>1</sup> As well as in Leningrad and Orel regions.

sources are clearly not enough. Thus, having put forward in Moscow Region<sup>2</sup> a list of candidates comprised of absolutely unknown people and not having spent enough funds or proposed any intelligible election manifesto, the party hardly overcame the 7-per-cent threshold (8.7 per cent). In Omsk Region the party failed to overcome the threshold altogether. Incidentally, with time the newcomer effect will evaporate, whereas questions of why, for example, the party, even having won the election, cannot remove an unfriendly governor from their post and what its opposition consists in will only become more and more acute. In addition, it is A Just Russia (as well as the Communist Party and SPS) that can suffer from a possible campaign by opposition organisations for a boycott of elections. On the other hand, one cannot rule out the possibility that the process of consolidation of regional elites under this brand that cannot be removed from elections and their radicalization will increase, thus adding their own valuable contribution to Sergey Mironov's election successes.

The Communist Party achieved a passable outcome of 12-18 per cent (in Dagestan and Tyumen Region it got only 8 per cent, while the party's best results were in those regions where the Communist Party positioned itself as the governor's main opponent: in Omsk and Orel regions, with 22.4 and 23.8 per cent, respectively), which shows that it still retains the 2003 potential.

United Russia's main ally – Liberal Democratic Party leader Vladimir Zhirinovskiy – overcame the threshold almost in all regions (with the exception of Moscow and Omsk regions), having received about 10 per cent of votes.

SPS, which used the election technology of a mass recruitment of canvassers and rather dodgy slogans, in some regions (Komi, Stavropol, Tomsk, Samara) managed to overcome the threshold, thus showing that the brand is not quite hopeless yet. At the same time, on the whole its result could be described as a bitter defeat. The party that previously used to position itself as a party of intellectuals, came last, with 5.2 per cent, in St Petersburg (where it had the most financial resource and enjoyed a tolerant approach from the city authorities). Thus the fundamental truth of political technologies – that the technology of mass recruitment of canvassers does not work in large cities – has once again been substantiated. The last nail in the coffin of the SPS list of candidates in St Petersburg came in Yabloko's appeal not to vote for SPS because it had become a pro-government party and the local branch leaders' too eager readiness to ingratiate themselves with governor Valentina Matviyenko. In Moscow Region, Boris Gromov's administration openly falsified the party's results, which – coupled with the party's ban from running in Pskov Region, Dagestan and Vologda Region – contradicts the hope that the Kremlin is allegedly interested in allowing liberals to enter parliament. It is worth bearing in mind that if a fifth party makes it to the State Duma, United Russia risks not securing a simple majority of votes, which may result in a sharp rise in the costs of coalition politics.

As a result of the election results, the head of the Central Electoral Commission (CEC), Aleksandr Veshnyakov, lost his post. President Putin did not include Veshnyakov in the presidential list of CEC candidates, which the latter had hoped for till the very last. Liberal Democratic Party's Vladimir Churov became the new CEC chairman. He does not have a law degree but instead has experience of having worked in the St Petersburg mayor's office. One is least of all tempted to exonerate Veshnyakov, but in the last year he showed that his behaviour had some boundaries at least, which the new CEC leadership are unlikely to have.

In March the situation surrounding Health and Social Development Minister Mikhail Zurabov became tense again. Arrests of his subordinates on corruption charges as well as a crisis in the system of additional medicine supplies (suspension – on a massive scale – of the process of supplying free prescription medicine to benefit recipients in the second half of 2006 and the accrual of a budget debt to suppliers of the system of additional medicine supplies to the amount of up to 30bn roubles) provoked United Russia to voice public criticism of Zurabov and raise the issue of his resignation. The idea of Zurabov's resignation was supported by Sergey Mironov and the Communists; it began to be debated on state TV channels. However, after Zurabov's meeting with United Russia MPs and State Duma speaker Boris Gryzlov it became clear that United Russia's declarations were not more than a farce. Zurabov is under no threat of dismissal for two reasons: first, he reports not to parliament or some benefit recipients but to Putin himself and second, even if – for electoral purposes - the ruling gang decides to give him up, that needs to be done right before the election.

In March Yukos assets began to be auctioned off. Rosneft, already in considerable debt, borrowed 22bn dollars from a consortium of Western banks (ABN Amro, Barclays, BNP Paribas, Calyon, Citibank, Goldman Sachs, J. P. Morgan Chase and Morgan Stanley, some of which have close links to Rosneft manage-

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<sup>2</sup> In terms of its structure, we believe Moscow Region to be very close to average Russian figures: the 2003 election results there hardly differed from the federal ones.

ment). The first auction was held on 27 March, at which 9.44 per cent of Rosneft shares and Yuganskneftegaz promissory notes were bought out by Rosneft at 7.6bn dollars, that is almost at the starting price. One can expect that Rosneft will buy (otherwise what was the point of taking out such a large loan?) Yukos's remaining production and distribution assets (Tomskneft, Samaraneftegaz and others), while Gazprom will end up with only 20 per cent of Gazpromneft and minor gas assets – Arktikgaz, Urengoil Inc. The auctions are of course set in such a way so as to make sure that Rosneft and Gazprom obtain the assets with minimum competition and as cheaply as possible (huge lots, high deposit and so on). The above deals testify to a further strengthening of the positions of Rosneft and its owners, especially Igor Sechin. In effect, there is a trend to make Rosneft as powerful as the gas monopoly.

March saw some significant events in the electricity sector. The RAO UES board of directors approved yet another draft of the company's reform. This time it is nearer to the initial draft and tries to take into account shareholders' interests (which have already been considerably affected by the additional issues of shares of wholesale generation companies (OGK) and territorial generation companies (TGK)). The government will not itself be selling TGK and OGK shares. As a result, in the majority of TGKs и OGKs, state-owned blocks of shares will end up belonging to the FSK federal grid company and the HydroOGK federal hydrogeneration company; thus the state's share in the former will exceed 75 per cent and in the latter, 50 per cent. Then FSK и HydroOGK will assist in raising investment by selling TGK and OGK shares. The spin-off of the system operator Inter RAO, OGK-5 and TGK-5 will be carried out following the basic mechanism, i.e. all shareholders, including the state, will receive their blocks of shares directly. In parallel, an additional issue of OGK-3 was conducted. Most minority shareholders did not want to preserve their share in the company, thus Norilsk Nickel became OGK-3's largest shareholder (over 45 per cent). We shall see how successful its experience will be against the reality of the state regulation of prices. At the same time political influence on energy companies in the interests of the Gazprom management is increasing. RAO UES was forced to agree to purchase over one-third of its gas at market prices (the rest Gazprom will deliver on long-term contracts).

The general meeting of the Russian Academy of Sciences has turned out to be one of the few public institutions that had courage enough to oppose the Russian government. The scientists approved the academy's charter in which they refused to create a supervisory board comprised of representatives of the bodies of power and which was meant to assume the academy's administrative and financial functions<sup>3</sup>. Their – quite plausible – reasons for that were that the handover of the right to run the academy's considerable real estate assets to government officials threatened academicians' interests and did nothing to further the state of academic science. At the same time however, they refused to set in the charter the project (grant-based) principle of funding the academy, which can be seen as a clear sign of a struggle for the existing and not always justified system of privileges

*S. Zhavoronkov*

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## **Budget and tax policies**

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By the results of preliminary execution, in January - February 2007 the revenue level of the RF federal budget amounted to 21.2 % of GDP, the expenditure level of the RF federal budget - to 13.1% of GDP, while budget surplus was 8.2 % of GDP. By the results of January - February 2007, the revenues of the RF consolidated budget amounted to 31.5 % of GDP, consolidated budget expenditures – to 14.5 % of GDP, and budget surplus – to 17.0 % of GDP. As of 1 March 2007, the amount of the RF Stabilization Fund was 2, 708.8 billion roubles, as compared to 2, 647.2 billion roubles as of 1 February 2007, which constitutes 10.8 % of GDP and 11.0 % of GDP, respectively, against annual GDP and accumulated GDP.

### **The status of the state budget**

In *Table 1*, the dynamics of the main parameters of the RF federal budget in 2004 – 2007 is displayed. In accordance with the preliminary estimates made by the RF Ministry of Finance concerning the budget's execution in cash terms in January - February 2007, the federal budget was executed in respect to its revenues in the amount of 888.68 billion roubles (or 21.2 % of GDP), and in respect to its expenditures - in the amount of 547.64 billion roubles (or 13.1 % of GDP). Federal budget surplus amounted to 341.04 billion roubles (or 8.2 % of GDP).

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<sup>3</sup> The Russian Education Ministry has already promised that the government will reject the document, although until it is adopted everything remains as it used do be, so academicians are not concerned by the delay.

In absolute terms the federal budget revenues in February of this year were found to be somewhat higher than the corresponding index of last year (875.83 billion roubles), while as a percentage of GDP they were lower (26.2 % of GDP in 2006). The federal budget expenditure in January - February 2007 was also somewhat higher than the corresponding index of 2006 (825.59 billion roubles), but at the same time lower as a percentage of GDP (14.5 % of GDP in 2006). Such a dynamic of revenue and expenditure of the federal budget resulted in a decrease of the budget surplus both in absolute terms and as percentage of GDP against the corresponding indices of last year (390.84 billion roubles, or 11.7 % of GDP).

If we compare the dynamic of federal budget revenue and expenditure during the first two months of the current year with the corresponding indices of the previous years, it can be seen that revenue became slightly higher than in 2004, while expenditure went down to its historic low of the whole period under consideration.

*Table 1.*

**The main parameters of the RF federal budget (in % of GDP)**

	2004	2005	Feb. 2006	2006	Feb. 2007
<b>Revenue</b>	20.1%	23.7%	26.2%	23.5%	21.2%
<b>Expenditure</b>	15.8%	16.2%	14.5%	16.2%	13.1%
<b>Deficit (-)/ Surplus (+)</b>	4.3%	7.5%	11.7%	7.4%	8.2%

The structure of revenues in the period under consideration is shown in *Table 2*.

*Table 2.*

**The RF federal budget revenues (in % of GDP, budget execution in cash terms)**

	2005	Feb. 2006	2006	Feb. 2007
Taxes and other payments administered by Federal Tax Service	12.33 %	13.97%	11.27 %	10.08%
Taxes and other payments administered by Federal Customs Service	9.73%	11.14%	10.76 %	10.25%
Revenues administered by Federal Agency for Management of State Property	0.27%	0.24%	0.26%	0.13%
Revenues of federal budget administered by other federal bodies	1.35%	0.86%	1.25%	0.76%
<b>Total revenues</b>	<b>23.7%</b>	<b>26.21%</b>	<b>23.54 %</b>	<b>21.22%</b>

As can be seen from this table, the structure of tax revenues and other types of revenue, by department, in January - February 2007 somewhat changed against the indices registered during the previous periods. Thus, as of the end of February of the current year, the shares of taxes and other payments administered by the Federal Tax Service and by the Federal Customs Service became nearly similar (10.08 % of GDP and 10.25 % of GDP, respectively), but at the same much lower as compared both to the same indices of last year and to the actual execution of the federal budget in 2006. The customs revenue for the first time became higher than the revenues from taxes and payments. It is this substantial fall in tax revenues that became one of the key reasons for the declining aggregate federal budget revenue. The volume of revenues administered by the Federal Agency for the Management of State Property in February 2007 became nearly two times lower than the same index in 2006 (0.24% of GDP) and amounted to 0.13 % of GDP. And finally, the volume of the federal budget revenues administered by other federal bodies, by the results of the first two months of 2007, was seen to have also become somewhat lower than last year's indices (0.86 % of GDP), and amounted to 0.76 % of GDP.

The preliminary data on the financing of federal budget expenditures in January - February 2007, submitted by the RF Ministry of Finance, are presented in *Table 3*.

It can be noticed that the aggregate value of financed expenditures demonstrated rather substantial fluctuations, depending on a period under consideration. Thus, while as of the end of 2006 it was approximately 16.4 % of GDP, by the results of January - February it went up to 23.69 % of GDP. At the same time, against last year's index, financed expenditures became noticeably lower (27.25 % of GDP as of the end of February 2006).

The rise in expenditures against the resulting indices of the year 2006 was caused by the increased amounts of federal budget expenditures under many items of the functional classification. The highest growth rate was seen under sections "General State Issues" (from 2.19 % to 3.49 % of GDP), largely due to

the increased cost of government debt servicing (from 0.65 % to 1.18 % of GDP), “National Defense” (from 2.57 % to 3.32 %), “National Security and Law-Enforcement Activity” (from 2.08 % to 3.42 % of GDP), and “Interbudgetary Transfers” (from 5.68 % to 9.37 % of GDP). At the same time, some other expenditure sections demonstrated a decrease of their share in GDP.

Table 3.

**The volumes of financing of the RF federal budget expenditures (in % of GDP)**

	2005	Feb. 2006	2006	Feb. 2007
General state issues	2.58%	4.32%	2.19%	3.49%
of these, servicing of state and municipal debts	1.06%	2.02%	0.65%	1.18%
National defense	2.71%	4.96%	2.57%	3.32%
National security and law-enforcement activity	2.05%	3.59%	2.08%	3.42%
National economy	1.17%	0.94%	1.31%	0.94%
Housing and utilities system	0.04%	0.01%	0.20%	0.16%
Environment protection	0.02%	0.04%	0.03%	0.03%
Education	0.73%	1.00%	0.78%	0.95%
Culture, cinematography and mass media	0.22%	0.22%	0.21%	0.12%
Public health care and sports	0.42%	0.69%	0.56%	0.82%
Social policy	0.88%	1.50%	0.81%	1.07%
Interbudgetary transfers	5.77%	9.98%	5.68%	9.37%
<b>Total expenditures</b>	<b>16.58%</b>	<b>27.25%</b>	<b>16.40%</b>	<b>23.69%</b>

Table 4.

**The execution of the RF consolidated federal budget in 2003 - 2007 (in % of GDP)**

2003												
	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
Taxes*	25.6%	24.4%	25.6%	27.4%	27.1%	26.0%	26.1%	25.7%	5.0%	5.0%	5.1%	25.2%
Revenues	32.0%	30.3%	31.5%	33.4%	33.6%	32.2%	32.2%	31.6%	0.9%	0.8%	0.7%	31.1%
Expenditures	20.7%	25.3%	27.7%	28.8%	28.8%	28.6%	28.7%	28.5%	8.2%	7.8%	7.9%	29.7%
Deficit / Surplus	11.3%	5.0%	3.8%	4.5%	4.7%	3.5%	3.6%	3.1%	7.7%	0.0%	7.8%	1.4%
2004												
	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
Taxes*	6.1%		21.8%	27.4%	27.4%	26.6%	27.2%	27.1%	26.4%	26.5%	26.9%	26.8%
Revenues	30.6%	28.2%	29.8%	32.9%	32.9%	32.5%	33.1%	32.9%	31.9%	32.0%	32.3%	32.3%
Expenditures	18.5%	22.8%	25.4%	27.3%	26.9%	27.0%	27.0%	26.9%	26.0%	25.9%	26.1%	27.8%
Deficit / Surplus	12.1%	5.4%	4.4%	5.6%	6.0%	5.5%	6.1%	6.0%	5.9%	6.1%	6.2%	4.5%
2005												
	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
Revenues	48.8%	40.3%	40.3%	40.8%	38.8%	38.2%	37.6%	37.0%	36.0%	35.9%	35.8%	36.1%
Expenditures	22.2%	23.3%	24.9%	27.1%	26.5%	26.6%	26.7%	26.6%	27.2%	26.1%	25.9%	28.1%
Deficit / Surplus	26.5%	17.0%	15.4%	13.7%	12.3%	11.6%	11.0%	10.5%	8.8%	9.8%	10.0%	7.9%
2006												
	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
Revenues	36.2%	34.4%	37.9%	37.1%	37.2%	36.8%	36.6%	36.5%	35.4%	35.1%	34.8%	35.5%
Expenditures	17.6%	21.0%	24.2%	25.4%	24.7%	25.5%	25.3%	25.1%	24.8%	24.7%	25.1%	27.8%
Deficit / Surplus	18.7%	13.4%	13.6%	11.7%	12.5%	11.3%	11.3%	11.4%	10.6%	10.4%	10.7%	7.7%
2007												
	I	II	III	IV	V	VI	VII	VIII	IX	X	XI	XII
Revenues	31.5%											
Expenditures	14.5%											
Deficit / Surplus	17.0%											

\* without the single social tax

However, if one analyses these changes by comparison with the indices of February 2006, it can be seen that expenditures have increased under some sections, while other sections are demonstrating a downward trend. Thus, growth was seen under sections “Housing and Utilities” (from 0.01 % to 0.16 % of GDP) and “Public Health Care and Sport” (from 0.69 % to 0.82 % of GDP). On the contrary, expenditures became lower under the section “General State Issues” - from 4.32 % to 3.49 % of GDP; under the section “National Defense” – from 4.96 % to 3.32 % of GDP; “Culture, Cinematography and Mass Media” – from 0.22 % to 0.12 % of GDP; “Social Policy” – from 1.50 % to 1.07 % of GDP; and “Interbudgetary Transfers” - from 9.98 % to 9.37 % of GDP. The expenditures under other items of expenditure were negligible.

By the results of January 2007, the RF consolidated budget’s revenue amounted to 31.5 % of GDP, as compared to 36.2 % of GDP in January 2005. Consolidated budget expenditure also noticeably decreased, as compared to the same period of 2006, and amounted to 14.5 % of GDP (17.6 % of GDP in 2006). The consolidated budget surplus in January 2007 was 17.0 % of GDP, or somewhat lower than the index of 2006 (18.7 %). Thus, as seen by the results of January 2007, there was a decrease of both the revenue and expenditure of the RF consolidated budget in % of GDP, against the corresponding indices of 2006, which resulted in the RF consolidated budget surplus also becoming lower. Besides, in March the Federal Treasury published the information concerning the execution of the RF general government’s budget in January 2007. According to this information, the revenue of the general government, by the current year’s first month’s results, amounted to 34.8 % of GDP, the expenditure – to 16.4 % of GDP, while budget surplus - to 18.5 % of GDP.

As of 1 March 2007, the amount of the RF Stabilization Fund was equal to 2, 708.8 billion roubles, as compared to 2, 647.2 billion roubles as of 1 February 2007, which against annual GDP constitutes 10.8 % of GDP and 11.0 % of GDP, respectively.

## **The main developments in the budget sphere**

According to the information published by the RF Ministry of Finance, from the year 2008 onward the state budget will be formed with due regard for balance unrelated to the prices of oil and gas. According to RF Minister of Finance A. S. Kudrin, the introduction of amendments to this effect into the Budget Code will make it possible, from 2008, to divide revenues into those from oil and gas and those not dependent on the prices in the oil and gas sector, as well as to determine the amount of transfer that will become a fixed figure in respect to GDP in the long-term perspective. It was noted that, by the results of 2006, the “oil and gas” revenues of the RF federal budget amounted to 11.6 % of GDP, while the other revenues – to 12 % of GDP. It is forecasted that by the results of 2007 the “oil and gas” revenues will go down to 8.5 % of GDP, although this decrease will mostly influence the amounts of deductions to the Stabilization Fund. According to the plans of the RF Ministry of Finance, all revenues generated by oil and gas will be transferred to a single account and then divided into three parts: current transfer, replenishment of the reserve fund and replenishment of the future generations fund. In this connection, the amount of the current transfer to the federal budget can constitute approximately 4 % of GDP, while it is planned that the size of the reserve fund should be at the level of 10 % - 13.5 % of GDP. It is intended that the monies from the reserve fund should be invested in assets with higher liquidity, which thus will produce lower yields, but can be sold whenever necessary. On the contrary, the resources of the future generations fund can be invested in relatively more risky assets, i.e., corporate bonds of high credit quality, which will result in a higher yield in a longer term.

Another problem faced by the budget unrelated to oil and gas prices is the potential reduction in the tax load imposed on the economy. Thus, according to A. S. Kudrin, the discussion of this issue has been adjourned until next spring. By that time, the Ministry of Finance intends to complete the analysis of all possible scenarios, and in particular, the lowering of the rate of VAT to 10 %, or its replacement by the sales tax. The Minister expressed his very negative attitude to such declarations. He said that the decision-making concerning any changes in the size of the tax load would depend on other decisions that would have to be made, in particular the reforming of taxation in the gas sector. It should be borne in mind that presently the possibility of raising the rate of the excise on gas is being discussed, and the corresponding decision can be adopted within 1 – 1.5 months. Besides, such decisions should be made with due regard for the needs of the pension system. According to available estimates, by 2015 the Pension Fund’s deficit will amount to 2 % of GDP, and by 2020 – to more than 3 % of GDP. Therefore, appropriate methods for dealing with such disbalances should also be determined.

On 22 March the government discussed the main parameters of the budget for 2008 – 2010. According to the information released by the RF Ministry of Finance, federal budget revenue in 2008 will amount to 6.673 trillion roubles (or 19.1 % of GDP), budget expenditure – to 6.5 trillion roubles (or 18.6 % of GDP), including the revenues established as a fixed percentage of GDP in the amount of 188.5 billion roubles (or 0.5 %

of GDP) and the revenues not established as such in the amount of 6,311.8 trillion roubles (or 18.1 % of GDP). The budget surplus in 2008 will amount to 173 billion roubles (or to 0.5 % of GDP). Federal budget revenue in 2009 will be 7.421 trillion roubles (or 18.8 % of GDP), budget expenditure – 7.361 trillion roubles (or 18.6 % of GDP), including the revenues established as a fixed percentage of GDP in the amount of 213 billion roubles (or 0.5 % of GDP) and the revenues not established as such in the amount of 6.964 trillion roubles (or 17.6 % of GDP). The budget surplus in 2009 will be approximately 0.2 % of GDP. It was noted that in 2009, for the first time, the federal budget would contain arbitrarily approved expenditures, amounting to 0.5 % of GDP and to 2.5 % of the total expenditure of 2009. The amount of these arbitrarily approved expenditures will be 184 billion roubles. According to the RF Minister of Finance, neither the government nor the State Duma will be able to distribute these funds, because they are earmarked for covering the potential rise in salaries, social obligations and the implementation of other programs. As noted by the Minister, the federal budget revenue in 2010 will amount to 8.035 trillion roubles (or to 18.1 % of GDP), budget expenditure – to 7.998 trillion roubles (or to 18 % of GDP), including the revenues established as a fixed percentage of GDP in the amount of 247 billion roubles and the revenues not established as such in the amount of 7.351 trillion roubles. The arbitrarily approved expenditures in 2010 will amount to 399 billion roubles, or to 5 % of the total revenue of 2010. The budget surplus will be 36.5 billion roubles (or 0.1 % of GDP). Thus, it has been planned that by 2010 an adequate balance of revenue and expenditure will be achieved, that is, the budget will be drawn without surplus.

*D. Polevoi*

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## Monetary policy

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In February 2007, the inflation rate in Russia (+ 1.1 %) decreased both as compared to January (+ 1.7 %) and to the corresponding period of last year (+ 1.7 %). In February – March the growth of gold and foreign currency reserves continued, their volume becoming equal to \$ 321.7 billion, as did that of money supply (+ 1.9 %). In late February the RF Central Bank for the first time published a report on the structure and results of the management of gold and foreign currency reserves in the first half of last year.

The consumer price index in February amounted to 1.1 % (as compared to 1.7 % in February 2006, see *Fig. 1*). The highest contribution to the growth in consumer prices early in the year was made, as usual, by the growing prices of commercial services to the population, which increased in February, on the average, by 2.6 % (+ 1 % in February 2006). The highest growth rates in February were demonstrated by the prices of communication services (+ 10.3 %), passenger transport services (+ 4.2 %), services in the sector of physical culture and sport (+ 1.4 %), and housing and utilities services (+ 1.3 %). No decreases in prices were seen in any of the categories of services in February.

The prices of foodstuffs were growing in February at a much slower rate than those of commercial services, the country's average growth rate being 0.8 % (+ 3 % in February 2006). Besides, the growth rate of the prices of foodstuffs became much lower than last year. This resulted, first of all, from the much less prominent growth of the prices of fruit and vegetable products (+ 3.6 % against + 12.6 % in February 2006) and the decreased prices of granulated sugar (–1.7 % against + 30.3 % in February 2006).

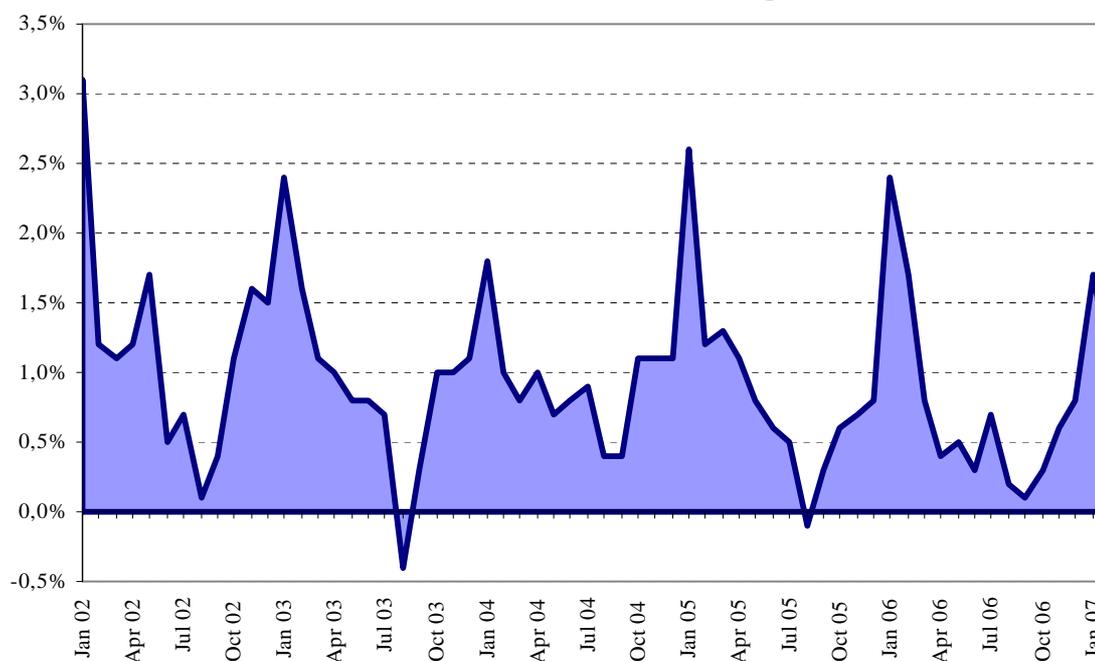
The prices of non-food commodities in February were also rising, their prices increasing on the average by 0.3 % (+ 0.5 % in February 2006). The growth of prices of non-food commodities was the result, first of all, of the increased prices of tobacco products (+ 0.9 %) and construction materials (+ 0.7 %). It is noteworthy that the fall in the prices of motor petrol in February amounted to 0.6 %.

The growth in the base consumer price index<sup>4</sup> in February 2007 was 0.5 % (having been 1.2% in the same period of the preceding year). It should be noted that, according to the IET's monthly bulletin of modeled short-term forecasts of socio-economic indices in the RF, the CPI in March 2007 was 0.5 %.

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<sup>4</sup> The base consumer price index reflects the inflation level on the consumer market less the seasonal factor (prices of vegetable and fruit products) and the administrative factor (tariffs on regulated services, etc.); it is calculated by the RF Statistics Service.

**The Growth Rate of the CPI in 2002 - 2006 (% per month).**



*Figure 1. Growth rate of CPI in years 2002 – 2007 (monthly %).*

Source: the RF Statistics Service.

During February 2007, the monetary base (in a broad sense<sup>5</sup>) was reduced by 24.2 billion roubles, to 3,714.4 billion roubles (– 0.6 %). The broad monetary base as of 1 February 2007 was 3,738.6 billion roubles. Below we are going to discuss the changes in each of the components of the broad monetary base.

The cash-in-circulation volume, including the cash balances of credit institutions, as of 1 March 2007, was 2.88 trillion roubles (+ 2 %, as compared to 1 February), the correspondent accounts of credit institutions with the Bank of Russia – 400.1 billion roubles (– 6.1 %), mandatory reserves – 210.5 billion roubles (– 8.2 %), banks’ deposits with the Bank of Russia – 57.6 billion roubles (– 48.2 %), while the value of the Bank of Russia’s bonds held by credit institutions – 164.1 billion roubles (+ 11.4 %)

The decrease, in February of the current year, of the cash-in-circulation volume (+ 2 %), with a simultaneous decrease in mandatory reserves (– 8.2 %), resulted in the expansion of the narrow monetary base (cash + mandatory reserves)<sup>6</sup> by 1.9 % (see Fig. 2). At the same time, the gold and foreign currency reserves of the RF CB grew in February by 3.5 % and amounted as of 1 March to \$ 314.5 billion. During the first three weeks of March they increased by another 2.3 % and reached the level of \$ 321.7 billion. A considerable portion of the liquid funds flowing into the country was being accumulated in the RF Stabilization Fund, the volume of which, as of 1 March 2007, became 2,708.9 billion roubles (+ 61.7 billion roubles, as compared to 1 February 2006). During the corresponding period of the previous year the volume of the Stabilization Fund’s volume increased by 103.6 billion roubles. The lower growth rate of the Fund’s reserves can be explained by the deteriorating foreign economic situation early this year, and primarily by the declining oil prices.

It should be noted that, according to the IET’s monthly bulletin of modeled short-term forecasts of socio-economic indices in the RF, the accumulated gold and foreign currency reserves are to exceed the level of \$ 327 billion by the end of April 2007.

<sup>5</sup> The RF’s monetary base in a broad sense, in addition to the cash-in-circulation issued by the Bank of Russia, and the residuals, on the accounts, of mandatory reserves of the funds in the national currency attracted by credit institutions and deposited with the Bank of Russia, includes the funds in corresponding accounts with credit institutions and bank deposits placed with the Bank of Russia.

<sup>6</sup> It should be remembered that the monetary base in a broad sense is not a money aggregate; it is a characteristic of the Bank of Russia’s liabilities denominated in the national currency. The monetary base in a narrow sense is a money aggregate (being one of the characteristics of the money supply volume), fully controlled by the RF Central Bank.

## Changes in the Monetary Base and in the Gold and Foreign Currency Reserves in 2005 - 2006.

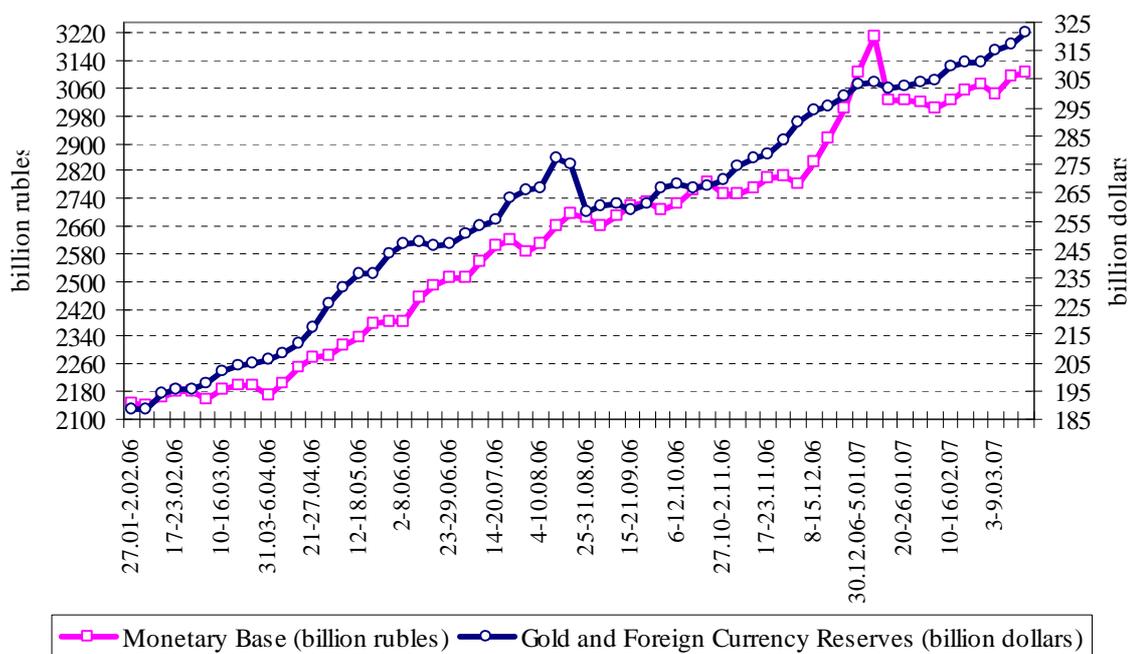


Figure 2. Changes in monetary base (in a narrow sense) and gold and foreign currency reserves of RF in years 2006 – 2007.

Source: RF CB.

According to the information published by the RF Federal Treasury, payments against the government external debt in February of this year amounted to \$ 552 million. The costs of debt redemption proper amounted to \$ 522.2 million, the costs of debt servicing – to \$ 29.8 million. In this connection, \$ 29 million was earmarked for the redemption of Russia’s debt, \$ 40.8 million – for the redemption of the IBRR’s and the EBRR’s loans, \$ 0.2 million - for the redemption of bond loans, and \$ 482 million – for the redemption of the debt to the Paris Club.

In late February the RF Central Bank for the first time published a report on the structure and results of the management of gold and foreign currency reserves in the first half of 2006. In our opinion, the most interesting part of the report is the information concerning the results of the management of this country’s gold and foreign currency reserves. According to the report, in the first half-year 2006 the Bank of Russia’s assets denominated in reserve currencies increased by \$ 68.9 billion, including those generated by received interest and revaluation of securities in the sum of \$ 3.4 billion (5 % of the total growth). Thus, in the present situation of a substantial inflow of foreign currencies into this country, the interest payments represent an insignificant factor of changes in the amount of gold and foreign currency reserves. However, in an event of a worsening foreign economic situation and declining capital inflow, the role of the reserves’ management will, no doubt, become much more important.

In the report it is suggested that, for purposes of estimating the results of the RF CB’s activity, the so-called normative portfolios should be applied, which, in fact, represent the indices of those markets where the investments are being made. It should be noted that the application of normative portfolios in order to compare their yields with the actual yields is on the whole quite consistent with the best international practices of estimating the portfolio management efficiency.

Within the assets of the Bank of Russia denominated in foreign currencies the operational and investment portfolios are separated. It is evident that the purpose of the operational portfolio is to maintain a high liquidity level of the reserve assets, which is necessary for the RF CB to perform the functions relating to its monetary and foreign-currency policy. The investment portfolio, as follows from its name, has been created for purposes of investing the funds contained therein in less liquid but more risky assets. So, it appears to be rather strange that the yields on the operational portfolios denominated in USD, euro and pound sterling were lower than the yields on the investment portfolios denominated in the same currencies. In the report this is explained by the growth of interest rates in the first half-year 2006, resulting from which the funds of

the investment portfolio invested in long-term securities demonstrated lower yields. However, in our opinion, this situation still testifies to a certain mismanagement of assets.

On the whole, the publication of the report can be regarded as a positive event, because regular disclosure of the information concerning the results of the management of gold and foreign currency reserves is conducive to greater confidence of economic agents in the policies being pursued by the RF CB. At the same time, the report does not contain any figures relating to the yields received on all the instruments applied in investing by each individual currency. This information could make it possible to estimate more fully the results of managing the reserve assets.

*P. Trunin*

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## Financial markets<sup>7</sup>

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Throughout March, the situation on the Russian financial markets was characterized by rather negative trends, which only toward the month's end became somewhat better, and so the resulting main indices demonstrated a rise on the previous month's level. The quotations of eurobonds were changing in different directions, with weak responses to the behavior of US bonds, which represented a benchmark for the whole international debt market. The activity on the market of rouble-denominated bonds during the greater part of the month was relatively low due to significant lack of liquidity in the banking sector. The levels of demand were to a certain degree restored at the month's end. As for the share market, for nearly the whole month the prices of shares were decreasing in response to the decline on the international markets. Only in late March, due to the growing international oil prices, as well as the growth at the world trading floors, the share market began to demonstrate substantial growth, thus producing overall positive results of the month.

### The government securities market

As seen by the March results, the quotations of Russian eurobonds exhibited multidirectional changes. Early in the month, the substantial decline of the US share market as a result of a fall on the Chinese stock market urged investors to look for less risky assets, traditionally represented, first of all, by US treasury bonds. Therefore, the yields on US treasuries went down to 4.45 % per annum, but this did not promote any growth of the domestic eurobonds, because the growth of US market was caused by investors' reorientation to less risky assets, while the bonds of the developing markets, including Russia, cannot be characterized as such. During the month's second week the prices of US securities became somewhat lower, having responded to the released information concerning the labor market, which was rather favorable and demonstrated stable economic growth, and thus the probability of the basic rate becoming reduced was judged as low. As for Russian securities, they, on the whole, demonstrated only slight growth, while remaining, as before, among the most underestimated assets of all the developing markets.

In the beginning of the month's second week, the volatility of quotations on the US debt market became higher, alongside growing yields. A new negative factor in terms of pricing became the news of problems arising in the high-risk segment of mortgage crediting in the USA. In the existing economic situation, these groups of borrowers were no more capable of servicing their previously taken mortgage credits, which now may result in defaults of mortgage companies and thus lead to problems in the US financial sector. Besides, investors were waiting for the results of the meeting of the US Federal Reserve System (FRS), at which the interest rate was to be established, and so their activity on the market was rather limited. As for Russian eurobonds, they, having been actually withdrawn from the dynamic of the world markets, remained sufficiently stable and displayed weak responses to the behavior of basic assets. Also, Russian eurobonds have been granted a credit rating by the Japanese Credit Rating Bureau and may very soon be supported by an inflow of funds from Japanese investors.

The dynamic of prices during the penultimate week in March was largely determined by the situation on the US market. The US FRS decided to leave the interest rate unchanged, while replacing its previous commentary by a new one, from which it cannot be clearly understood whether the rate would later be raised again, or, on the contrary, investors should expect its decline. As a result, the volatility of the market for US treasury bonds remained at a sufficiently high level, and yields became somewhat lower only toward the weekend. However, this produced little response on the part of Russian eurobonds, which once again con-

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<sup>7</sup> When preparing this overview, the author used, as sources, the analytical materials and reviews issued by the "Zenit" Bank, the IC "ATON", the MICEX and the RF CB, as well as the official web sites of Russian companies - issuers of securities.

firmed the overall trend of March – that they were nearly entirely independent of the situation on the US market.

As of March 23, the yields to maturity of Russian eurobonds RUS-30 amounted to 5.61 % per annum, those of RUS-18 – to 5.72 % per annum. As of the same date, the yields to maturity of Russian eurobonds were as follows: Tranche 8 of the Minfin bonds – 4.4 %, Tranche 7 of the Minfin bonds – 5.47 %, Tranche 5 of the Minfin bonds – 5.63 %, RUS-07 – 5.90 %.

FIGURE 1.

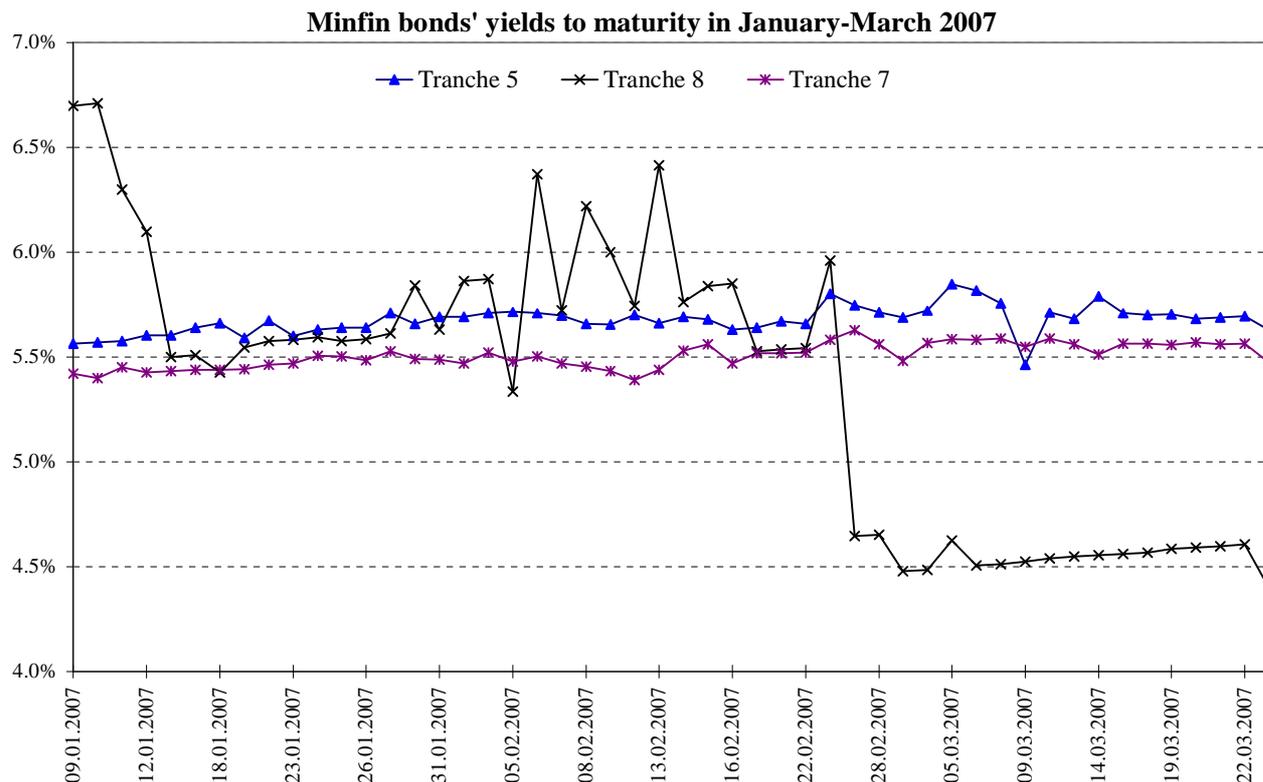
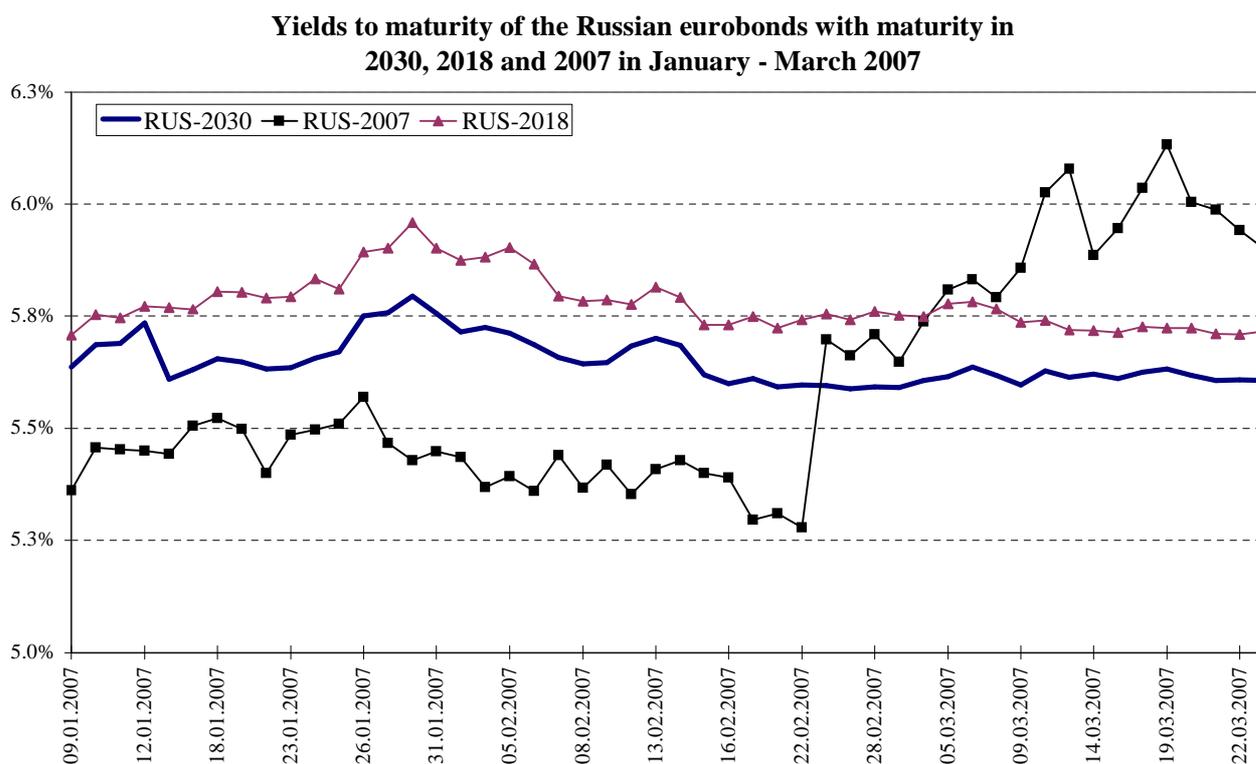


FIGURE 2.



Early in the month, the situation on the government rouble-denominated debt market remained moderately negative. Noticeable problems with liquidity in the banking sector, as well as the rouble's weakening in respect to the USD, coupled with the forthcoming placements on the primary market, were all conducive to growing yields on the government bonds. The quotations remained relatively stable until mid-month, which, as before, was due to the problems with liquidity. The low trading activity was explained by the expectation of the primary auctions. The placements of OFZ were rather successful, nearly without any premium for the secondary market, which was the evidence of stability on the market of rouble-denominated government debt and of its possible growth after the improvement of the rouble's liquidity. Only toward the month's end the situation became somewhat improved, and the yields on government securities grew higher. At the same time, no obvious factors responsible for such growth could be seen; growth, most probably, was caused by the return of certain non-residents onto the Russian market, because the liquidity level was far from favorable.

In the period between 1 and 23 March, the aggregate turnover on the GKO-OFZ secondary market amounted to approximately 147.7 billion roubles, the daily average turnover being at the level of 9.2 billion roubles (having amounted to about 57.96 billion roubles, with the daily average turnover at the level of 3.62 billion roubles, in February). During February, two auctions for additional placements of OFZ were held. Thus, on 14 March, there were auctions for the placement of OFZ-AD, series 46018 and 46020, in the sums of 12 and 13 billion roubles, respectively. The actual sums placed were 12.94 and 11.98 billion roubles, respectively, with the weighted average yields at the level of 6.64 % and 6.91 % per annum.

As of 23 March, the GKO-OFZ market volume amounted to 940.95 billion roubles in face value and 939.77 billion roubles – in market value. The GKO-OFZ market portfolio's duration was 2066.35 days.

## **The corporate securities market**

### **The situation on the share market.**

By the results of March, the Russian stock market demonstrated slight growth, because the dramatic fall of late February – early March when, after a new historic high had been achieved by the RTS (1970.77 points), it began to decline rapidly.

At the very beginning of the month, Russian shares fell dramatically. The main cause of this dramatic slump on the market was the fall on the Chinese stock market after the official declaration of the Chinese authorities as to the possibility of introducing control over the transactions with the shares in Chinese companies, which, in their opinion, could reduce the probability of the appearance of a “stock bubble” on the market. In response to this declaration, investors began to withdraw their assets from the Chinese market, and then also from the markets of other developing countries, Russia including. As a result, the RTS index fell by more than 7% during the first week of March. During the next week, this trend was curbed, and the market managed to compensate for the fall to a certain degree. The quotations were sustained by oil prices, which were remaining sufficiently high, as well as the rehabilitation of the world markets. Besides, a certain role was played by technical factors: many shares, after their prices had fallen, became rather attractive in the medium and short term, and so cautious purchases were observed on the market. However, the positive adjustment was short-lived, and early in the second half of the month priority roles were once again taken over by external factors, which were not conducive to market growth. Thus, the international markets were once more displaying a downward trend, as well as oil prices. The growing prices of nickel and some other metals were supportive only for metallurgical companies. The uncertainty on the market associated with the expectations of the decision to be made by the US FRS concerning the level of the interest rate was producing a restrictive influence on the prices of assets. However, after the FRS's meeting where the interest rate was left unchanged, while the commentary suggested a possible lowering of the rate in the future in view of the problems faced by the economy, the global markets displayed growth, which also promoted the rehabilitation of the Russian market. An additional support to Russian shares was rendered by oil prices, which approximated the level of \$ 60 per barrel toward the month's end. Among the corporate news, noteworthy is the extremely successful placement of the additional issue of OGK-3, which was bought out by “Norilskii Nikel” at a price higher than the market one. This resulted in a noticeable growth of the shares of the “RAO ‘UES of Russia’”, which produced a noticeable influence on the dynamic of stock indices.

FIGURE 3.

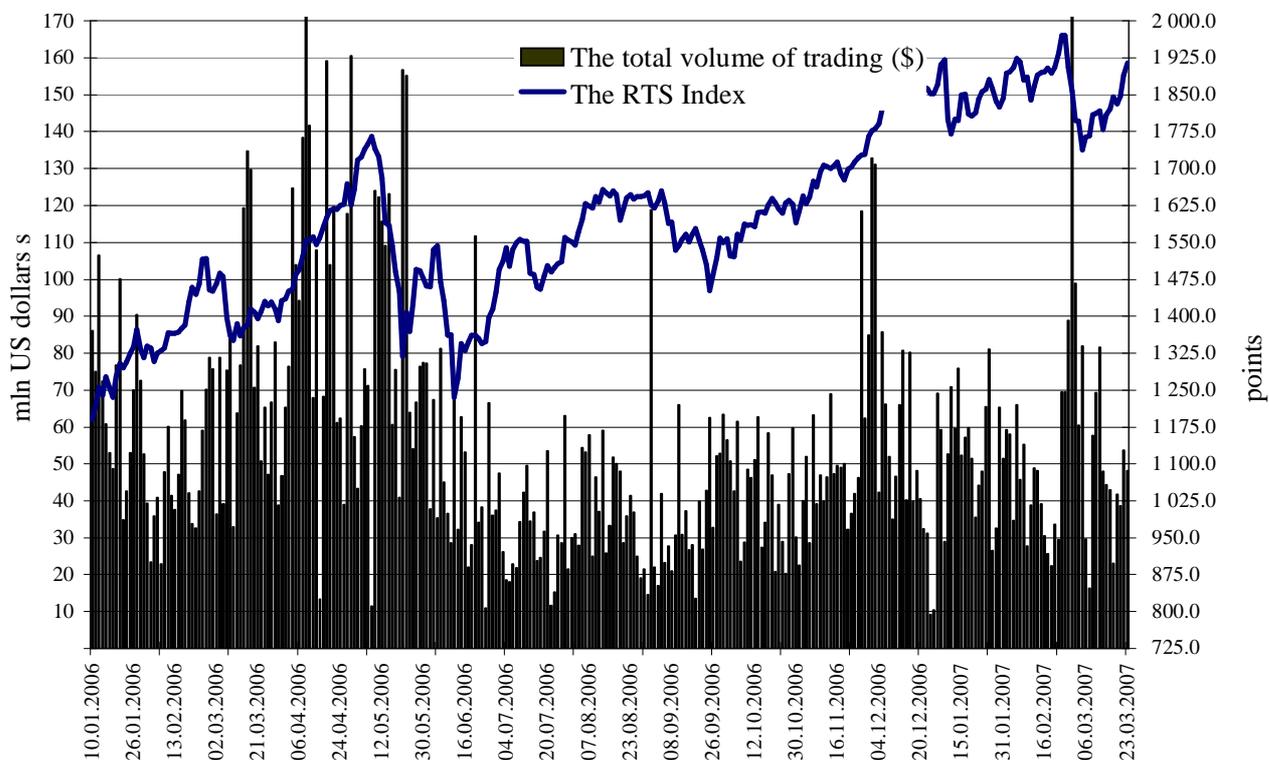
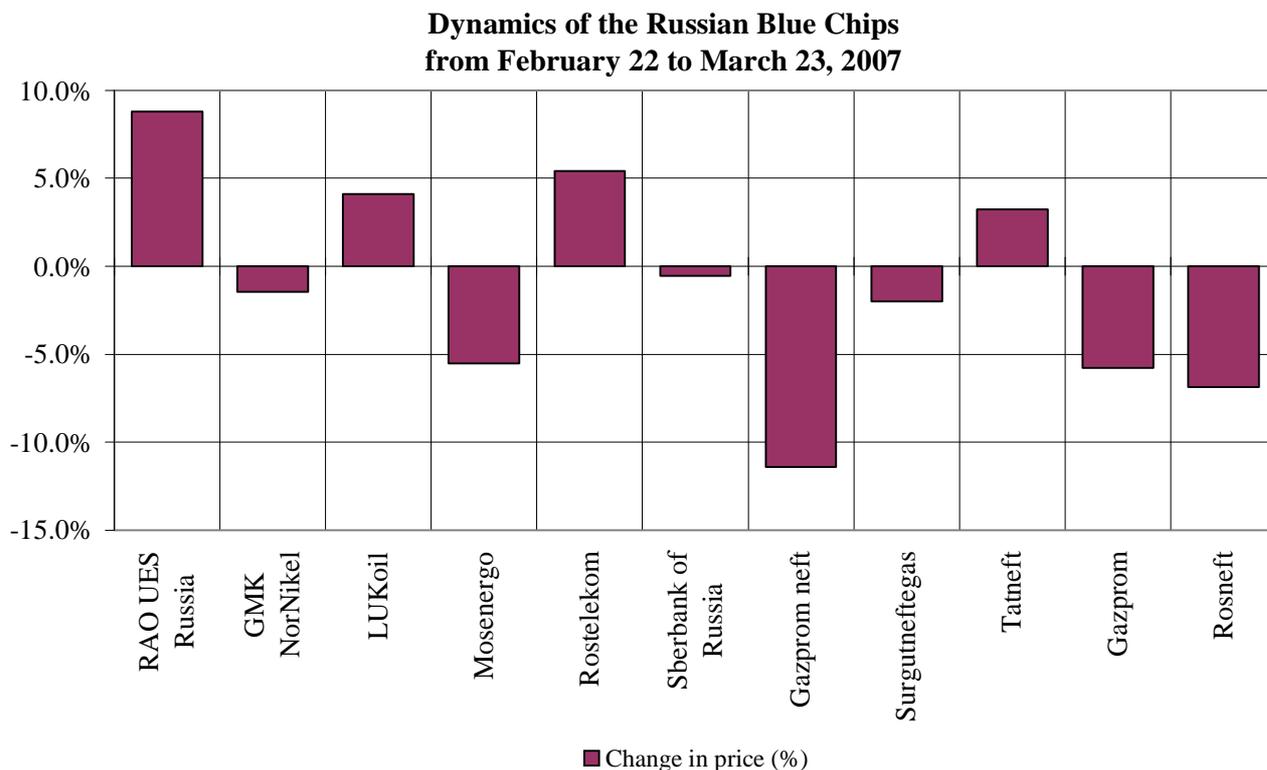


FIGURE 4.



On the whole, in the period between 1 and 26 March, the RTS index grew by 6.53 %, which in absolute terms amounts to approximately 117.37 points. During the same period, the turnover volume of the shares incorporated in the RTS index was about \$ 835.8 million, the average daily turnover being at the level of \$ 52.24 million (against approximately \$ 732.01 billion, with the average daily turnover at the level of \$ 43.06 million, in February). Thus, the investor activity on the stock market in March became noticeably higher

than in the previous month. The indices of maximum and minimum turnovers in the trade system in March were \$ 98.8 million (on 1 March) and \$ 16.18 million (on 7 March), respectively.

As seen by the month's results (from 22 February through 23 March), the rates of nearly all "blue chips" were demonstrating a decline in their market value. Thus, the leaders in terms of price decline were the shares in "Gazprom neft", whose price fell by 1.41 %, followed by those in "Rosneft" ( - 6.87 %), "Gazprom" ( - 5.77 %) and "Mosenergo" ( - 5.51 %). Somewhat lower rates of decline in prices were demonstrated by the shares in "Surgutneftegas" ( - 1.98 %), "Norilskii Nikel" ( - 1.45 %) and the Sberbank of Russia ( - 0.54 %). The shares in "Tatneft", on the contrary, grew by 3.22 %, those in "LUKoil" – by 4.1 %, and those in "Rostelekom" – by 5.41 %, while the leader in growth became the shares in the "RAO 'UES of Russia'", whose price increased by 8.8 %.

In March, the group of leaders in the RTS turnover<sup>8</sup> was as follows: the RAO "UES of Russia" (41.1 %), the Sberbank of Russia (11.9 %), "Gazprom" (10.1 %), "Norilskii Nikel" (7.7 %), and "LUKoil" (5.6 %). The aggregate share of the transactions involving the shares in those companies amounted to approximately 76.5 % of the RTS's total turnover of shares.

As of 23 March, the five leaders in terms of capitalization on the domestic share market were as follows<sup>9</sup>: "Gazprom" - \$ 241.74 billion, "Rosneft" - \$ 87.19 billion, "LUKoil" - \$ 71.09 billion, the RF Sberbank – \$ 68.97 billion, the "RAO UES of Russia" - \$ 55.56 billion, and "Surgutneftegas" – \$ 43.56 billion.

#### *The futures market*

In March, the investors' activity on the RTS futures market (FORTS) became noticeably higher, as compared to the previous month. Thus, during the period from 1 through 23 March, the aggregate turnover of the RTS futures and options market amounted to approximately 382.95 billion roubles (673.02 thousand transactions, 1,007 million contracts), against 247.25 billion roubles (509.79 thousand transactions, 6.25 million contracts) in the corresponding period in February.

The highest demand displayed by the market participants was, as before, for futures: the volume of trade in futures during the period under consideration amounted to 349.1 billion roubles (656.12 thousand transactions and 9.069 million contracts). Options were in much lesser demand – the volume of trade in them amounted to approximately 33.84 billion roubles (16.89 thousand transactions and 998.05 thousand contracts). The peak trade volume on the futures market was 34.74 billion roubles (on 13 March), while the lowest trade volume amounted to 15.5 billion roubles (on 7 March).

#### *The corporate bonds market*

The quotations of corporate bonds, as demonstrated by the results of March, remained virtually unchanged, though the dynamic during the month was rather variable. Thus, early in the month, against the backdrop of a dramatic fall in quotations on the share market, the prices of corporate bonds were also under pressure due to increased demand, caused by the desire of some of the investors to withdraw their assets from the developing markets, the problems with liquidity in the banking sector, which could in part be the result of the forthcoming placement of the shares issued by the Sberbank of Russia (whose aim is to attract funds in the amount of approximately 250 billion roubles), and by the changes on the domestic foreign-currency market, where the USD had become somewhat stronger in respect to the rouble. Difficulties with liquidity were also observed in mid-month, and therefore the quotations of corporate and subfederal securities remained at their achieved levels. The market was supported only by the slight strengthening of the rouble against USD, as well as by the relatively favorable situation on the Russian eurobond market. The approaching deadline for tax payments eliminated any probability of the revival of activity on the corporate debt market and the improvement in the market situation, and this slump continued till the third decade of March. Later on, the reestablished level of demand for government bonds was followed by a similar demand revival in the corporate segment, which made it possible for securities to compensate for the fall in their prices during the most part of the month. The factors of improvement could be the FRS's decision not to change the interest rate, the granting of a credit rating to Russia by the Japanese Credit Rating Bureau, as well as the slight improvement of liquidity in the banking sector. Despite the sufficiently high level of rates on the interbank credit market, their decline at the month's end, coupled with the very substantial residuals on the correspondent accounts at the RF CB, could be conducive to the rehabilitation of demand.

Between 1 and 23 March, the price index of the corporate bonds tradable on the MICEX<sup>10</sup> went down by 0.01 points ( - 0.01 %), whereas the index of the ten most liquid bonds of the corporate sector increased by 0.

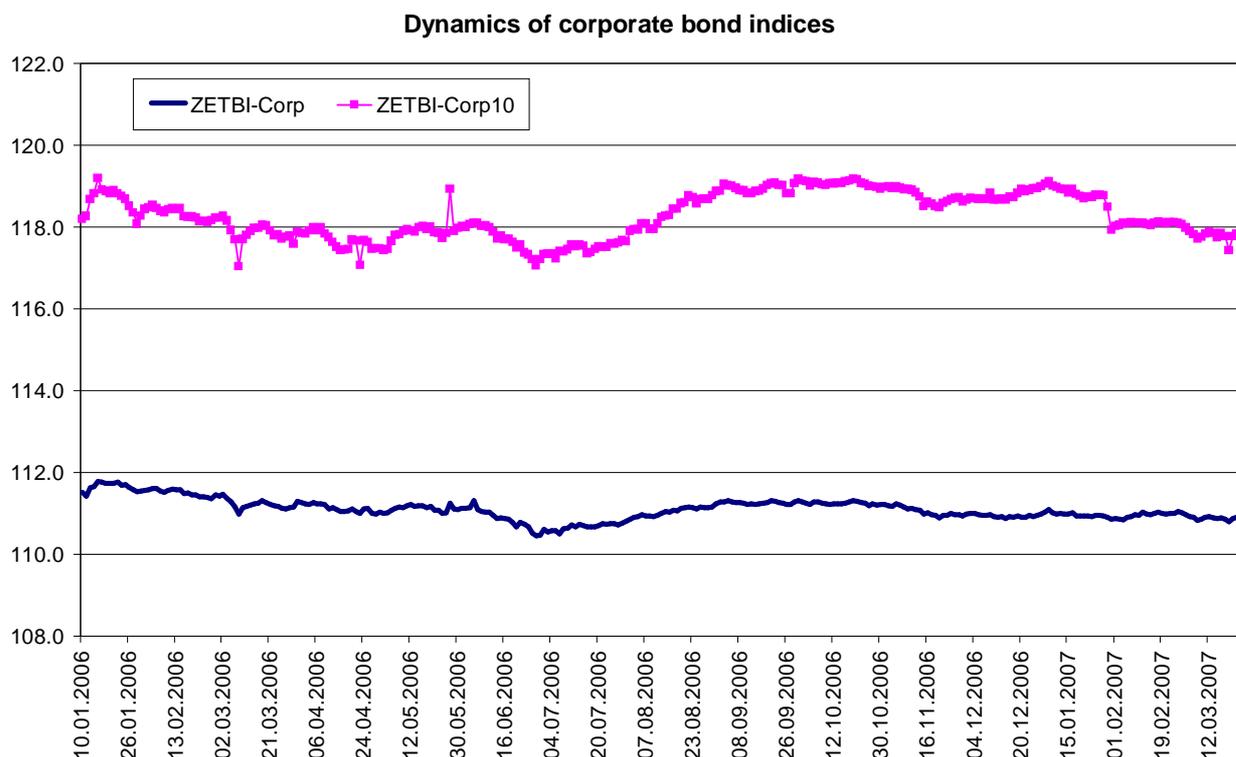
<sup>8</sup> On the classical share market.

<sup>9</sup> According to the RTS' data.

<sup>10</sup> This was calculated on the basis of the indices of the corporate bonds tradable on the MICEX, generated by the "Zenit" Bank.

04 points ( or 0.03 %). During the same period, the aggregate turnover in the corporate bonds section of the MICEX amounted to approximately 36.26 billion roubles, with the average daily turnover being at the level of 2.26 billion roubles (as compared to approximately 32.9 billion roubles, with the average daily turnover of 2.059 billion roubles, during the corresponding period in February).

FIGURE 5



### The external factors influencing the changes on the Russian stock market

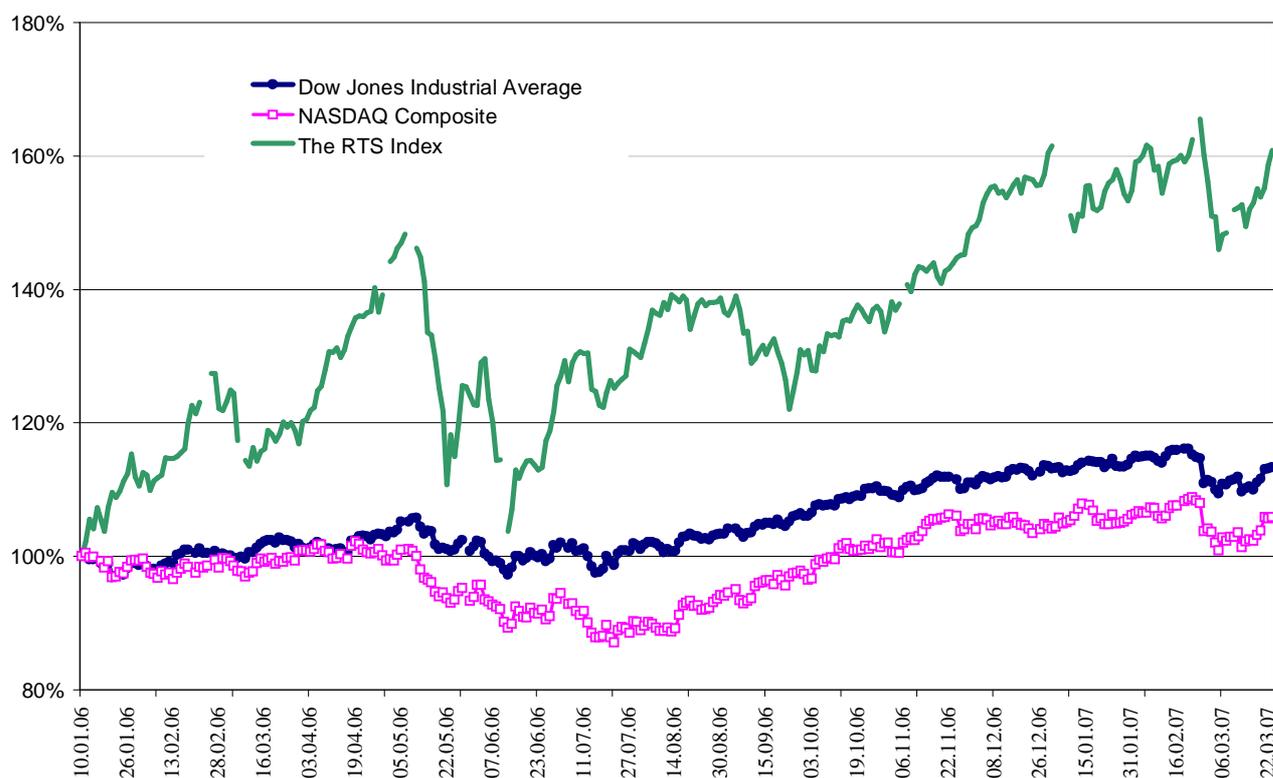
During March the oil prices on the international market remained sufficiently stable and below \$ 60 per barrel, while in certain periods going above that level. Early in the month, the prices demonstrated a slight decline, explained by the downward trend of the Chinese stock market, which gave rise to concerns about the prospects of stable economic growth in China, and, as a result, of the level of demand for oil, since the PRC is one of the largest consumers of “black gold”. The decline continued, which can be explained by the beginning of a warmer season in the USA and the consequent fall in the demand for fuel, as well as by the unchanged official quotas of the OPEC, the corresponding decision having been made at the last summit meeting of its member countries. However, toward the month’s end the prices demonstrated a marked growth, caused by increased demand for oil products, and in particular for motor petrol in the USA in expectation of the summer season, because US refineries have not yet reached their peak production level.

The situation on the international stock markets in March was, as before, rather favorable (see Table 1). The majority of stock indices in developed and developing countries during that month were growing. The exceptions were represented by the Brazilian index Bovespa (- 0.14 %) and the South Korean index Seoul Composite (- 4.4 %).

The month’s beginning on the markets of developed and developing countries was marked by a considerable deterioration of the market situation, influenced by a variety of factors. First of all, in early March former director of the US FRS, Alan Greenspan, forecasted a possible slowdown in US economic growth by the end of 2007. Secondly, the Chinese authorities, fearing the emergence of “a bubble” on the stock market, spoke in favor of toughening the control over the transactions with Chinese assets, which resulted in a withdrawal of investors’ monies from Chinese shares, followed by their withdrawal from the markets of other developing countries, including Russia. During the month’s second week, the situation became somewhat stabilized, and the main stock indices were able to compensate for some of the effects of their fall; however, in the month’s second half, some rather unfavorable data concerning the US mortgage crediting sector were released. A certain slowdown in economic growth resulted in one rather numerous group of borrowers being unable to service their mortgage credits, which was fraught with increased risks of instability in the US financial sector. The quotations of US shares could not remain unresponsive to such negative news, and as a

result the stock indices once again began to decline. Only at the end of March the US FRS's decision to leave unchanged the basic interest rate, as well as the commentary to that decision, from which it followed that the rate's lowering was still probable in the event of the trend of a slower economic growth being preserved, resulted in growing quotations of shares on the stock market in the USA and other countries.

FIGURE 6.



## Corporate news

### Open-End Joint-Stock Company “GMK “Norilskii Nikel””

In February, the Open-End Joint-Stock Company “GMK [Mining and Metallurgic Company] “Norilskii Nikel”” concluded the transaction of the purchasing of the nickel business formerly owned by OM Group, Inc. (“Nickel Business”). As a result, GMK “Norilskii Nikel” acquired a nickel refinery at Harjavalta (Finland), an enterprise for the extraction and leaching of nickel ore at Cawse (Western Australia), 20 % of shares in MPI Nickel Pty. Ltd. - a company developing the nickel mines “Black Swan” and “Silver Swan”, and implementing the Honeymoon Well project, as well as 11.1 % in the company Talvivaaran Kaivososakeyhtiö, in the form of ordinary shares and convertible liabilities.

This transaction will make it possible for GMK “Norilskii Nikel” to continue the international expansion of its production activities at the international level by adding new sites in Australia and Finland, and to strengthen its position within the global mining industry. The group “Norilskii Nikel” will increase its nickel-refining capacities by 60,000 tons of nickel per annum, while its own annual production of refined nickel (with the exception of materials being processed by tolling) will grow by approximately 35,000 – 40,000 tons. The company highly values its new prospects for gaining access to the industry’s best operational skills and the technology of high-pressure acid leaching (HPAL) of laterite raw material, as well as for the addition of nickel salts and briquettes to their product scale.

On 26 March the Group “Norilskii Nikel” announced that it had completed the acquisition of a part of an additional issue of shares of the Open-End Joint-Stock Company “OGK – 3” (“Society”) in the amount of 17,836,343,101, at a placement price of 4.54 roubles ( or \$ 0.175) per share. The total transaction volume was 80, 976, 997, 679 roubles (or \$ 3, 121, 360, 043). The total volume of the additional issue of “OGK – 3”’s shares was 18 billion of ordinary shares, of which 163, 656, 899 shares were acquired by persons with preferential rights for purchasing the shares at their placement price. Thus, after the transaction’s completion, “Norilskii Nikel” now owns 46.2 % of the total amount of ordinary placed shares of the Open-End Joint-Stock Company “OGK – 3”, while the “RAO UES of Russia”’s stake has decreased to 37.1 %, and minority shareholders control 16.7 % of the Society’s shares. In accordance with RF legislation, within 35 days from the purchase of “OGK – 3”’s shares “Norilskii Nikel” is going to put forth to “OGK – 3”’s share-

holders the proposal concerning its acquisition of the Society's securities at a price no lower than the purchasing price of the last additional issue of shares.

#### **“RAO UES of Russia”**

On 19 March, the “RAO UES of Russia” published its financial reports for the first 9 months of 2006, prepared in accordance with the International Accounting Standards. The aggregate assets of the “RAO UES of Russia” in the first 9 months of 2006 increased by 73,557 billion roubles and as of 30 September 2006 amounted to 1,291.456 billion roubles. The profit of the “RAO UES of Russia” from its main activity in the reporting period increased by 24.524 billion roubles against the same period of 2005 and amounted to 68.629 billion roubles. The amount of profit before deduction of the profits tax and the minority share was 57.459 billion roubles, having increased by 25.816 billion roubles. The Group's net profit in the first 9 months of 2006, by comparison with the same index of last year, decreased by 1.233 billion roubles and amounted to 11.994 billion roubles. This is explained by the additional deduction of the carried forward profits tax in the amount of 22 billion roubles, as well as by the share in the losses of dependent companies having increased by 0.2 billion roubles.

#### **Open-End Joint-Stock Company “Sberbank of Russia”**

On 7 March, the bank's representatives announced the results of the placement, among shareholders, of an additional issue of its ordinary nominal book-entry ordinary shares. Between 22 February and 5 March 2007, the bank's shareholders had an opportunity for realizing their preferential right of the acquisition of shares. Earlier, “Sberbank of Russia”'s Supervisory Council had established a single placement price for all investors – 89,000 roubles per share. At this rate, the bank's shareholders paid for 1,643,489 shares the sum of 146.3 billion roubles (99 % of submitted applications). The Bank of Russia, as the main shareholder, purchased 892,601 shares for the sum of 79.4 billion roubles. A total of 1,332 applications were accepted, of which 1,096 applications ( or 82. 3 %) had been submitted by physical persons. The placement of these shares among persons without the preferential right for the acquisition of shares took place from 8 March 2007 through 21 March 2007.

*Table 1.*

#### **Behavior of world stock exchange indices**

<b>Data as of 23 March</b>	<b>Index value</b>	<b>Change in month (%)<sup>11</sup></b>	<b>Change from year's beginning (%)</b>
RTS (Russia)	1914.47	-1.02%	6.44%
Dow Jones Industrial Average (USA)	12481.01	-1.32%	0.14%
NASDAQ Composite (USA)	2456.18	-2.34%	1.69%
S&P 500 (USA)	1436.11	-1.04%	1.26%
FTSE 100 (UK)	6339.4	-0.97%	1.91%
DAX-30 (Germany)	6899.06	-1.34%	4.58%
CAC-40 (France)	5634.75	-1.43%	1.68%
Swiss Market (Switzerland)	9089.8	-1.82%	3.46%
Nikkei-225 (Japan)	17480.61	-3.89%	1.48%
Bovespa (Brazil)	45533	-1.05%	2.38%
IPC (Mexico)	28272.03	-0.82%	6.90%
IPSA (Chile)	2954.35	1.18%	9.70%
Straits Times (Singapore)	3205.82	-3.16%	7.37%
Seoul Composite (South Korea)	1447.38	-1.53%	0.90%
ISE National-100 (Turkey)	43408.71	-0.42%	10.97%
Morgan Stanley Emerging Markets Free Index	923.444	-1.79%	1.17%

<sup>11</sup> In respect to the indices as of 26 January 2007.

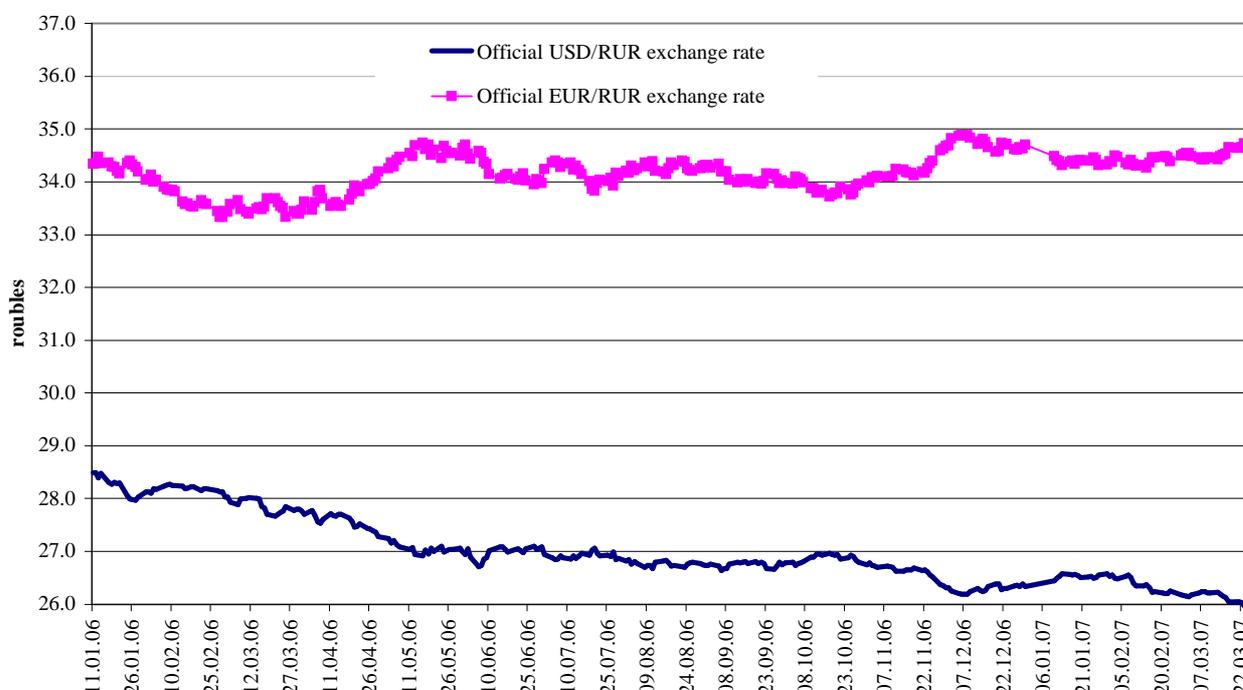
### The currency market.

As seen by the month's results, between 1 and 23 March the USD/rouble exchange rate went down noticeably - by 0.137 roubles (or - 0.53 %) by comparison with the level registered at the month's beginning, and amounted to 26.01 roubles per USD. The total volume of trade in the USD in the SELT electronic trading system during the same period amounted to approximately \$ 67.52 billion, the average daily turnover being \$ 4.22 billion (as compared to approximately \$ 44.87 billion, with the average daily turnover of \$ 2.8 billion, in February). Thus, in March the trading activity of the participants in currency trade became markedly higher, as compared to the previous month. The peak volume of trade in USD during that period was registered on 20 March and amounted to approximately \$ 7.98 billion, the lowest - \$ 2.03 billion on 12 March.

The rouble's liquidity in the banking sector in March became noticeably higher than in February: the average amount of residuals on the correspondent accounts of credit institutions with the Bank of Russia in March was approximately 574.77 billion roubles, as compared to approximately 404.88 billion roubles in February. Nevertheless, a part of the funds was reserved for the participation in the additional placement of "Sberbank of Russia"'s shares and in the auction for the sale of the assets of "Yukos", and therefore the actual volume of resources in the banking system in March was noticeably lower, which determined growing supply of USD on the currency market, as well as had a negative effect on the other segments of Russia's financial market.

FIGURE 7.

Dynamics of the Official USD/RUR and EUR/RUR Exchange Rates in 2006-2007



Between 1 and 22 March, the euro's exchange rate on the international market went up by \$ 0.007 (or 1.54 %), to 1.329 USD for 1 euro. Against this background, March saw a slight growth of the euro/rouble exchange rate. In the period from 1 through 23 March, the euro/rouble exchange rate went up by 0.136 roubles (0.39 %) - from 34.54 to 34.68 roubles for 1 euro. The total turnover of trade in euro in the SELT between 1 and 23 March was about 1,388.65 million euro, the average daily turnover being at the level of 49.1 million euro (as compared to about 737.39 million euro, with the average daily turnover of 48.8 million euro, during the corresponding period in February). Thus, the activity of trading in foreign currencies on the Russian currency market increased noticeably by comparison with the previous month. The maximum volume of trade in the euro during the period under consideration was registered on 22 March at the level of 127.1 million euro, the minimum volume - 58.1 million euro on 12 March.

FIGURE 8.

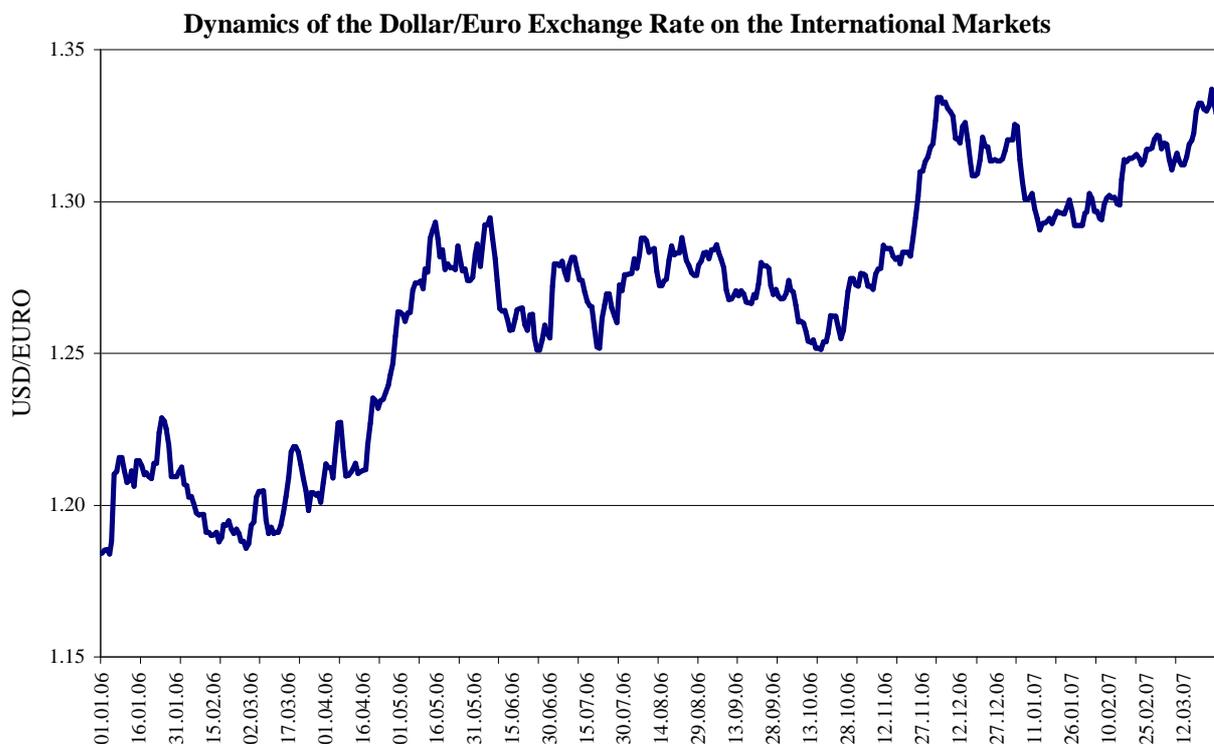


Table 2

**Indices of financial markets**

Month	November	December	January	February	March*
monthly rate of inflation	0.6%	0.8%	1.7%	1.1%	0.7%
estimated, annual rate of inflation in accordance with the tendency in given month	7.44%	10.03%	22.42%	14.03%	8.7%
refinancing interest rate of RF CB	11%	11%	10.5%	10.5%	10.5%
average yield to maturity of OFZ, all issues (% per year)	5.97%	5.93%	6.58%		
turnover of GKO-OFZ market for given month (bn. roubles)	16.95	45.64	27.83		
yield to maturity of Minfin bonds by end of month (% per year):					
Tranche 5	5.38%	5.47%	5.69%	5.71%	5.6%
Tranche 7	5.42%	5.41%	5.49%	5.56%	5.5%
Tranche 8	5.30%	5.57%	5.63%	4.65%	4.5%
yield to maturity of eurobonds by end of month (% per year):					
2007	5.28%	5.04%	5.45%	5.71%	5.9%
2010	5.43%	5.70%	5.71%	5.22%	5.4%
2018	5.69%	5.64%	5.90%	5.76%	5.7%
2028	6.03%	5.96%	6.18%	6.05%	6.1%
2030	5.52%	5.50%	5.76%	5.59%	5.6%
MBK- MIACR rate (% per year by end of month) on credits for 1 day	7.21%	3.65%	5.24%	6.15%	3.0%
official rouble/USD exchange rate by end of month	26.3147	26.3311	26.5331	26.1599	26.0
official rouble/euro exchange rate by end of month	34.6775	34.6965	34.3896	34.5180	34.70
rise in official rouble /USD exchange rate during month (%)	-1.62%	0.06%	0.77%	-1.41%	-0.6%
rise in official rouble / euro exchange rate during month (%)	1.91%	0.05%	-0.88%	0.37%	0.5%
Turnover of stock market in RTS in given month (million USD for shares included in list for calculating RTS index )	1175.61	1094.42	929.19	993.46	1050
value of RTS-1 index by the end of month	1776.68	1921.92	1842.93	1858.14	1940
changes of RTS-1 index during given month (%)	10.11%	8.17%	-4.11%	0.83%	4.4%

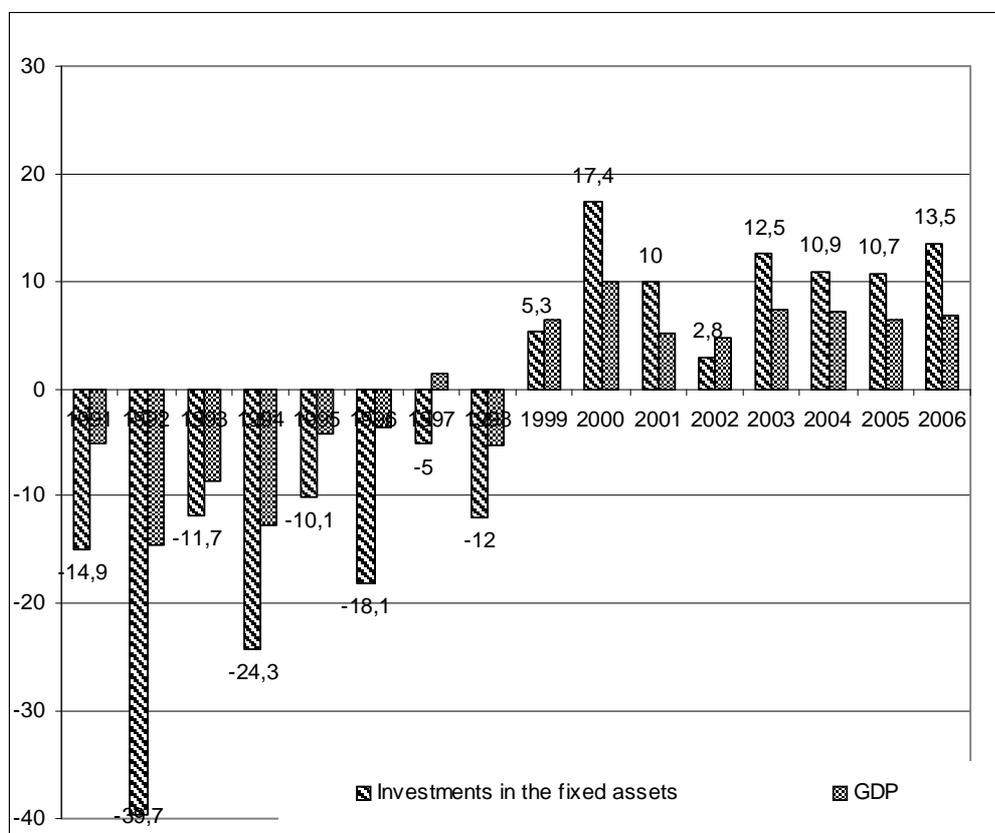
\* Оценка

D. Polevoi

## Investments in the Real Sector of the Economy

As a result of 2006 the amount of the investments in the fixed assets increased by 13.5% as compared with the previous year and was equal to RUR 4482.7 bln. or 16.8% of GDP. The fundamentally new feature of the economic growth over the period of 2003-2006 was the shift from the investment financing by enterprises' and organizations' own funds to the expansion of borrowed funds participation. The characteristic feature of 2006 was the overcoming of the trend for the decrease of the share of the investments in minerals extraction, which was observed since 2002. As a result of 2006 the increase in the investments in the fossil fuels extraction was equal to 25.1% against the decrease by 2.6% in the previous year. Over January-February 2007 the investments in the fixed assets increased by 21.2% as compared with the corresponding period of the previous year and were equal to RUR 522.1 bln.

The trend for anticipating growth of the investments in the fixed assets as compared with the dynamics of GDP has been observed from 2000 in the Russian economy. Over the period of 2000-2006 the investments in fixed assets increased by 2.16 times, GDP growing by 1.68 times. In 2006 the amount of the investments in fixed assets increased by 13.5% against 10.7% in the previous year.



Source: Federal State Statistics Service.

*Fig. 1. The GDP and Investments in the Fixed Assets Growth Rates in 1991–2006, as percentage to the preceding year*

However the influence of economy earnings from foreign economic activity on the economy growth rates being positive, their influence on the dynamics of the investment activity was limited by the trend for the decrease in transformation level of the gross national savings into investment expenditures. The share of gross national savings in GDP in 2003-2006 was on average equal to 33.1%, of investments in the fixed assets – 16.6%.

Since 2005 the trend for the increase of the budget funds share in the investments in fixed assets financing sources has retrieved. In 2005 RUR 540.1 bln. of the investments in the fixed assets were financed by budget funds, which was equal to 20.1% of the total amount of the investments in the fixed assets throughout the economy, including 6.7% by the federal budget funds. In 2006 RUR 700.1bln of the investments in the fixed assets were financed by budget funds, including by federal budget funds – RUR 242.1 bln.

Table 1

## Structure of Investments in the Fixed Assets as per Financial Sources, Percentage to the Total

	2000	2001	2002	2003	2004	2005	2005*	2006*
Investments in fixed assets - total	100	100	100	100	100	100	100	100
including a break-down by sources of investment:								
Own capital	47.7	49.4	48.0	46.2	46.8	47.7	45.1	44.3
of which:								
profit	23.4	24.0	20.5	17.2	18.3	22.4	20.6	20.2
Inflow of funds	52.5	50.6	52.0	53.8	52.6	52.3	54.9	55.7
of which:								
bank credits	2.9	4.4	4.8	5.2	7.3	6.5	8.3	8.9
including foreign bank loans	0.6	0.9	0.5	0.8	1.3	1.0	1.0	1.5
loans from other organisations	7.2	4.9	6.0	8.6	7.3	7.3	7.4	5.4
Budget funds:	22.0	20.4	19.6	18.8	17.4	20.1	20.7	19.8
Federal Budget funds	6.0	5.8	6.0	6.5	5.1	6.7	7.1	6.9
Funds from the Subjects of the Russian Federation budgets and local budgets	16.0	14.6	13.6	11.5	11.3	12.4	12.5	12.0
Share of foreign investments in total investments in fixed assets	4.7	4.5	4.1	4.7	5.0	4.8	5.2	6.1

\* small enterprises and informal activity parameters excluded.

Source: Federal State Statistics Service.

The characteristic feature of 2005 and 2006 was the change in Federal budget funds vs. budgets of the Subjects of the Russian Federation funds ratio, allocated for the investments. The share of the budget funds, which was used for the investments in fixed assets, was 2.63% of the GDP in 2006 against 2.5% of GDP in 2005 and 2.32% of GDP in 2004, including the Federal budget funds being, respectively, 0.91% against 0.83% and 0.68%. In 2006 the amount of the public investments grew by 0.3 p.p. of the GDP in comparison with 2005.



Source: Federal State Statistics Service.

Fig. 2 Structures of the Investments in the Fixed Assets Financing at the Expense of the Budget Funds in 2004-2006, as percentage to the total

Fundamentally new feature of the economic growth in the period of 2003-2006 was the shift from the investments in fixed assets financed at the expense of the business' and organizations' own capital to the expansion of borrowed capital share. This was a graphic evidence of qualitative changes in investment development mechanism, which is orientated on investment resources flow rationalization. As a result of 2006 the share of inflow funds was 55.7% of total amount of investments in fixed assets.

In contrast to 2005 the increase in banks' share of investment financing from 8.3% to 8.9% was observed in investment crediting. The trend for the increase of insurance, investment, industrial and trade companies as well as foreign investment participation in investment activity financing sustained. In 2005 net inward investments were equal to USD 1.3 bln., in 2006 – USD 41.6 bln. Foreign banks credit share in investments in fixed assets financing has grown up to 1.5% against 1.0% in 2005, foreign investment ratio being 6.1% against 5.2%.

Low real value of the credit resources under the average level of profitability existing in the economy accounted for the expansion of enterprises debtors sector. Among the factors that positively affect the credits dynamics and other borrowed funds the growth of the organized forms of the population savings can be distinguished. The share of funds, directed towards share holding in construction was equal to 3.4% from the total amount of the investments in the fixed assets.

The increase in the investment activity in branches of infrastructure and the increase in demand for these branches' service is the indicator of growth potential, the investment policy in this sector being orientated towards the solution of long-term problems.

Table 2

**Structure of Investments in the Fixed Assets by Types of Economic Activities**

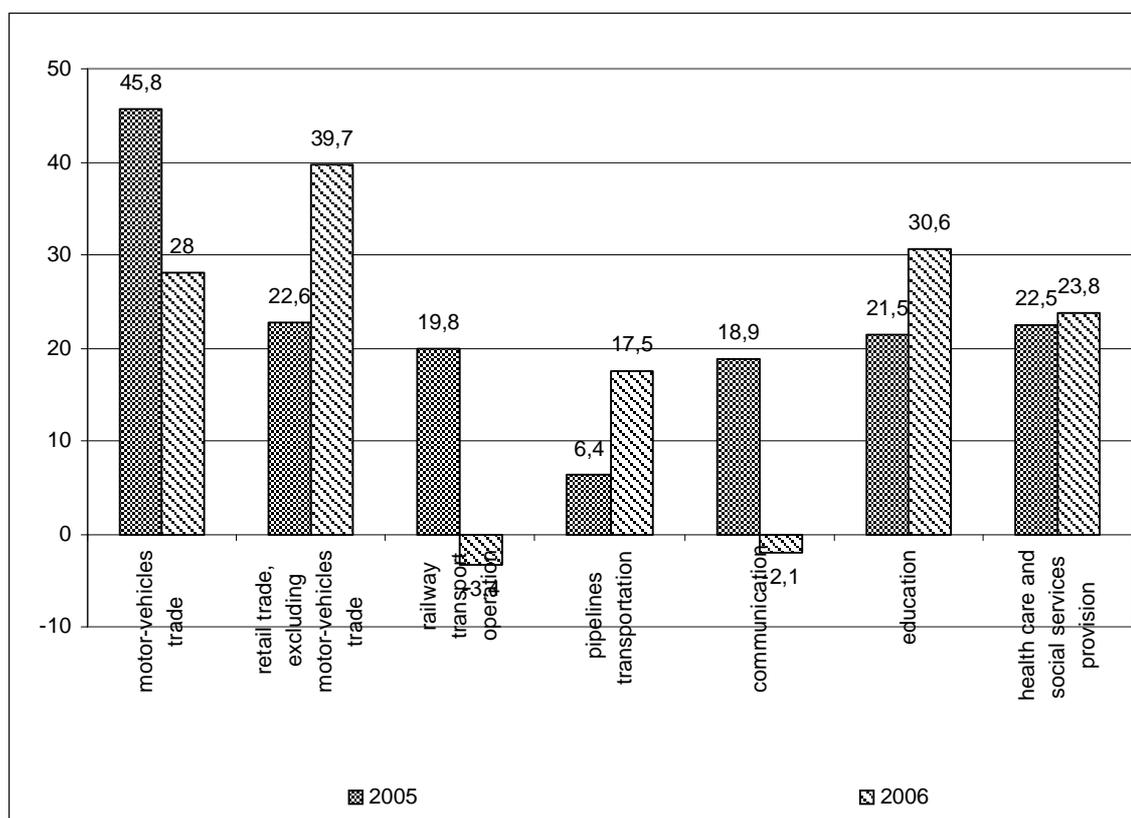
	2000	2001	2002	2003	2004	2005	2005*	2006*
Total	100	100	100	100	100	100	100	100
Including break down by types of economic activity:								
Agriculture, hunting and forestry	3.0	4.0	4.6	4.1	4.1	4.0	3.2	4.0
Industry	40.4	40.4	38.6	38.1	38.3	36.8	40.6	41.5
of which								
Minerals extraction	18.1	19.0	16.9	15.9	14.8	13.4	15.2	17.3
including fossil fuels extraction	16.7	17.5	15.5	14.4	13.4	11.8	13.5	15.8
Manufacturing industries	16.3	15.9	15.9	15.6	16.5	16.8	17.6	16.4
Electricity, gas and water production and distribution	6.0	5.5	5.8	6.6	7	6.6	7.8	7.8
Construction	6.4	5.2	5.4	4.9	3.6	3.5	2.9	3.3
Whole sale and retail trade; motor-vehicles, motorcycles, household appliances and articles of private use service	2.7	2.9	3.6	3.5	3.6	3.9	2.8	2.9
Transportation	18.5	19.2	15.1	17.5	17.6	20.4	22.1	21.3
Communication	2.7	3	3.4	4.8	5.6	5.5	6.7	5.5
Financial activity	0.8	0.8	1	1.2	1.4	1.3	1.3	1.1
Operations with real estate, renting, provision of services	15.2	14.7	18.1	17.7	17.6	16.6	11.5	10.6
Education	1.3	1.5	1.5	1.4	1.5	1.5	1.8	2.1
State administration, military safety security; compulsory social security	1.5	1.5	2	1.6	1.5	1.5	1.8	1.8
Health care and provision of social services	2.6	2.4	2	2	2.2	2.2	2.3	2.5
Provision of utilities, social and personal services	3.9	3.5	3.8	2.6	2.5	2.4	2.6	2.9

\* excluding small enterprises and informal activity parameters.

Source: Federal State Statistics Service.

In 2006 the trend for the growth of investments in the fixed assets in transportation and trade, as well as in the kinds of activities, orientated to the provision of social services – education, health care - sustained. Characteristic feature of the investment process in the transportation was the change in the structure of investments by kinds of economic activity. The dynamic growth of the pipeline transportation was supported by the increase of its share in investment expenses up to 39.9% of the total amount of the investments into transportation (34.8% in 2005). In 2006 the reduction of the scale of the investments in railway transport and communication, for which the period of the restoration growth of 1999-2005 was characterized by the growth of the investment activity, was observed.

It should be noted that against the background of the steady growth of the demand for trade services redistribution of the investments by kinds of activities is proceeding in the environment of retail trade and motor vehicles trade material and technical basis expansion, the increase in investments into which was equal, respectively, to 149.7 and 128.0% against the level of 2005.



Source: Federal State Statistics Service.

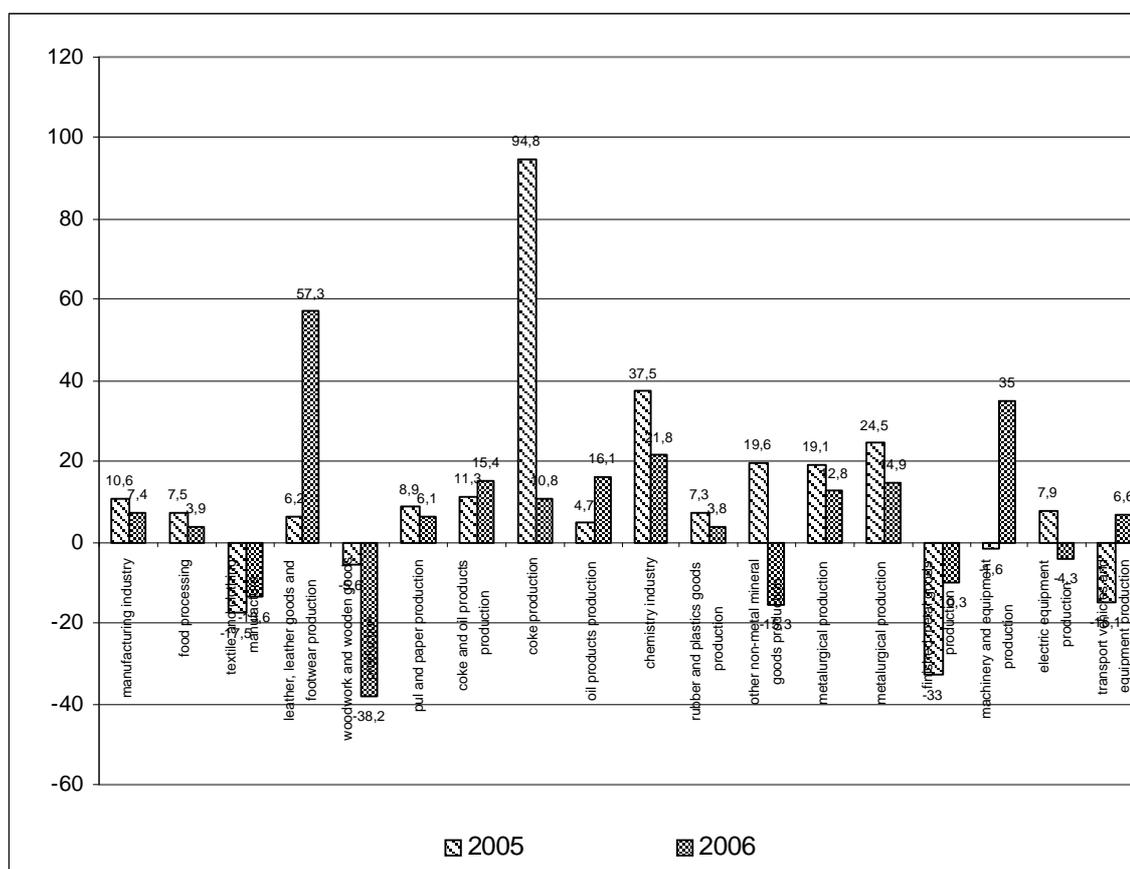
*Fig. 3. Change in the Investments in Fixed Assets Growth Rates by Kinds of Services Provided in 2005 and 2006, as percentage to the preceding year*

The share of the investments in the fixed assets in goods production by kinds of activities in 2006, exceeded the level of the previous year by 4.3 p.p., which was due mainly to the growth acceleration of the investments in industry and agriculture. The increase in agriculture investments in 2006 was equal to 40.6%, and its share in investments in fixed assets structure increased up to 4.0%, increase in comparison with the preceding period being 0.8 p.p.

It was fuel and energy production that traditionally had the most significant impact on the dynamics and structure of the investments into the industry. The characteristic feature of 2004–2005 was unstable dynamics of investment activity in fuel industry, which is accounted for to a great extent by the factors of the market situation. The proportion of the fuel fossils production in 2005 was 11.8% of the total investment volume against 15.5% in 2002. The decrease of the impact of the fuel industry in the investment process was initiated by the decrease of oil production industry in the total amount of the investments from 12.7% in 2001 to 7.0% in 2004 and 5.3% in 2005.

The characteristic feature of 2006 was the overcoming of the trend for the decrease of the share of the investments in minerals extraction, which was observed since 2002. As a result of 2006 the increase in the investments in the fossil fuels extraction was equal to 25.1% against the decrease by 2.6% in 2005 in the preceding year.

The growth of 2.2% against the decrease by 0.4% was observed in 2006 in electricity, gas and water production and distribution. The overcoming of the decrease in the investment activity in this kind of economic activity was accounted for by the increase in investments in power industry by 8.3% in comparison with the previous year. The dynamics of gas production and redistribution was considerably influenced by the priority shifts in investment activity towards pipeline net development. Consequently, as a result of 2006 the decrease in investment amount in gaseous fuel production and distribution was equal to 38.1% against the growth of 17.4% in 2005.



Source: Federal State Statistics Service.

*Fig. 4* The Change in the Investment in Fixed Assets Growth Rates by kinds of Economic Activities in 2005 and 2006, as percentage to the preceding year

In 2006 the investments in fixed assets growth rates deceleration down to 7.2% against 10.6% in 2005 was observed for manufacturing industries. The share of the manufacturing industries in the structure of the investments in the fixed assets throughout the economy was equal to 16.4% in 2006 against 17.6% in the preceding year. The incomes concentration remaining traditionally high within export-orientated productions and mechanisms of interindustry capital transfer being weakly developed it could have been hardly expected that the investments rates would accelerate and nature of the capital reproduction would change fundamentally. The analysis of the investments dynamics and structure demonstrates that the trend to decrease in the share of the investments in the machine-building production is characteristic for the Russian economy. The share of the enterprises producing investment goods was equal to 2.2% in 2006 against 2.7% in 2002. Under the existing age, technological and reproduction structure of the fixed assets low rates of investments in the machine-building were the factors restricting the production development rates of final and intermediate goods output. The structure of capital goods production being what it is the import that remains one of the main sources for capital renewals, production reconstruction and modernization.

Whereas the investment activity in food production as well as textile, clothing and tanning industries was determined by the increase in the domestic market demand, the metallurgical and chemistry industries were considerably influenced by the increase in demand of the external market. For instance, in 2006 the trend for anticipating growth of the investments in the metallurgical industry retrieved once again (112.8% against 2005) against the background of the decrease in the investment activity in the final metal goods production (89.7%), which lead as a result to the decrease in the final goods export.

It should be noted that against the background of high world prices for hydrocarbons low transformation and diversification of export incomes towards the investments in the production reconstruction and modernization had a negative impact on the figures of the economy growth.

*O. Izryadnova*

## Foreign Investments

In 2006 USD 55.1 bln. of foreign investments flowed in the Russian economy, which exceeded by 2.7% bln. the corresponding figure of 2005

*Table 1*

**Structure of Foreign Investments in the Russian Economy**

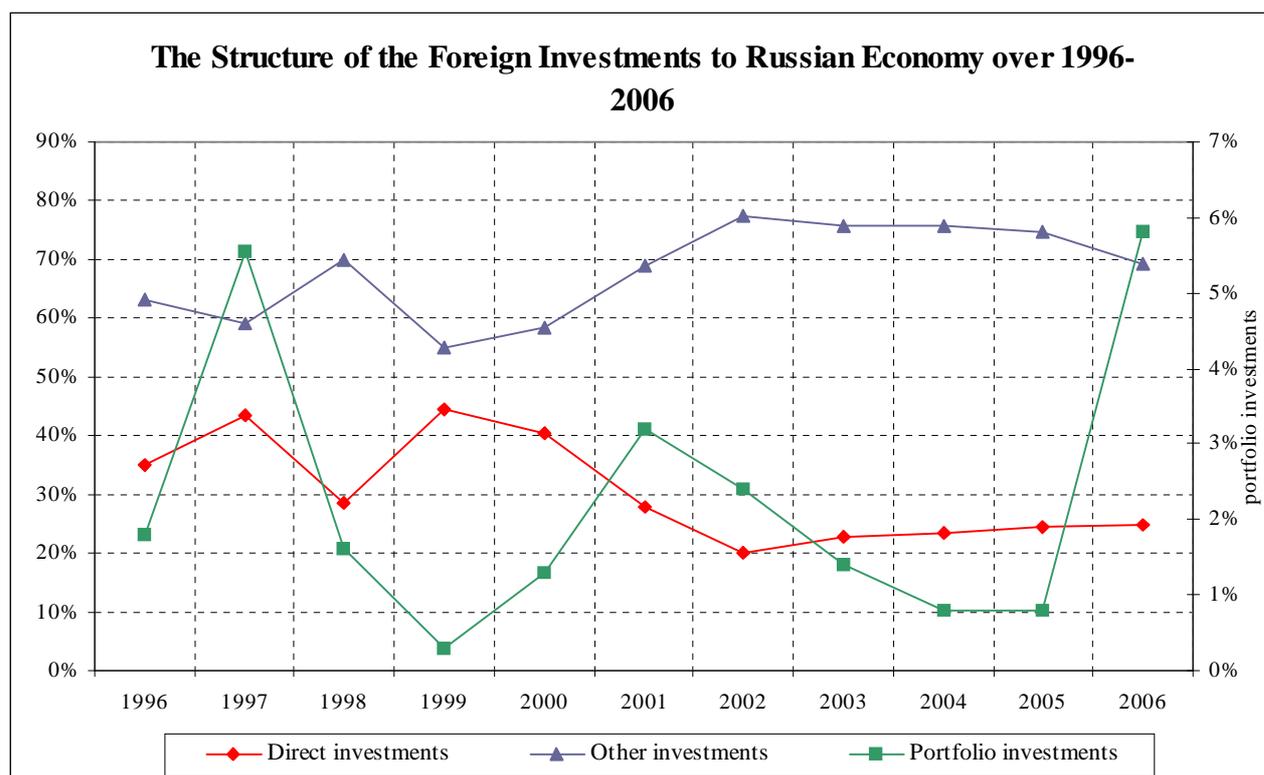
	As USD mln				Increase as percentage to the previous year			
	Total	Direct	Portfolio	Others	Total	Direct	Portfolio	Others
2002	19 780	4 002	472	15 306	38.7	0.6	4.7	55.8
2003	29 699	6 781	401	22 517	50.1	69.4	-15.1	47.1
2004	40 509	9 420	333	30 756	36.4	38.9	- 17.0	36.6
2005	53 651	13 072	453	40 126	32.4	38.8	36.3	30.5
2006	55 109	13 678	3 182	38 249	2.7	4.6	by 7 times	- 4.7

Source: Federal State Statistics Service.

The total volume of foreign investments made to Russian economy in 2006 increased due to the growth of direct and portfolio investments. And the biggest growth at that is observed in the segment of portfolio investments, which increased up to USD 3.2 bln. 90.8% of portfolio investments are accounted for stocks and shares.

Against the background of slight growth of the foreign investments in the Russian economy a considerable increase in capital withdrawal should be mentioned. Thus, in 2006 USD 37.9 bln. was withdrawn as the incomes of foreign investors transferred abroad as well as interest rates payment for credit usage and credit repayments, which exceeds by 29.8% the figure of 2005. The most significant capital outflow was observed in the third quarter of 2006 (96.1% of the foreign investments made during this period). Over 2006 on the whole 68.7% of the foreign investments made were withdrawn (in 2005 – 54.4%). At the same time the increase in the withdrawn capital in real terms exceeds the corresponding figure of the foreign investments made to Russian economy by six fold.

The growth of direct and portfolio investments against the background of the decrease in other investments led to the changes in the structure of foreign investments to Russian economy.



Source: Federal State Statistics Service.

In 2006 the concentration of foreign investments in trade and industry sustained, though as a result of the year there was a decrease in the foreign investments in trade by 36.0% as compared with 2005. The highest foreign investments growth rates in 2006 were observed in the operations with the real estate and financial

activity. The distribution of foreign investments with regard to the main branches of the Russian industry is presented in table 2.

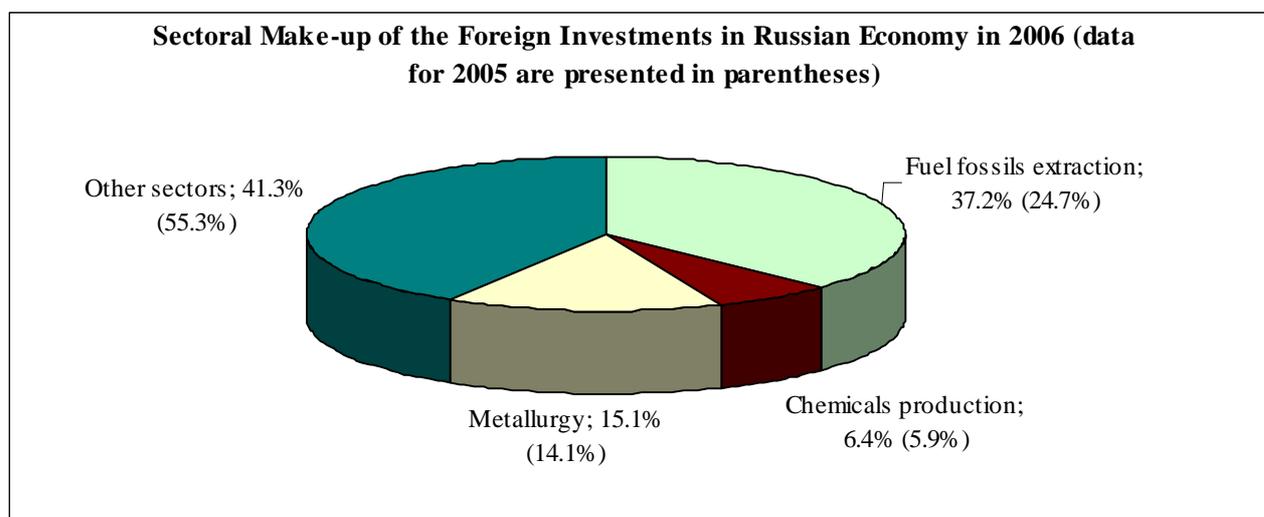
Table 2

**Sectoral Make-up of the Foreign Investments in Russian Economy over 2004-2006**

	As USD mln			Changes as percentage to the preceding year			As percentage to the total		
	2004	2005	2006	2004	2005	2006	2004	2005	2006
Industry	20 170	24 318	24 607	63.6	20.6	1.2	49.8	45.3	44.7
Transport and communication	2 033	3 840	5 297	87.7	88.9	37.9	5.0	7.2	9.6
Whole sale and retail trade; motor-vehicles, motorcycles, household appliances and articles of private use service	13 037	20 461	13 089	24.0	56.9	- 36.0	32.2	38.1	23.8
Real estate operations, renting and provision of services	2 572	2 602	5 998	- 24.4	1.2	by 2.3 times	6.3	4.8	10.9
Financial activity	1 001	1 813	4 698	56.4	81.1	by 2.6 times	2.5	3.4	8.5
Other industries	1 697	617	1 420	- 1.7	- 63.6	by 2.3 times	4.2	1.2	2.5

Source: Federal State Statistics Service.

The biggest growth of foreign investments (+52.5% to 2005) was fixed in fuel industry (in 2005 the decrease by 39.6% as compared with 2004 was observed). Foreign investments in manufacturing industry over the period under consideration decreased by 15.8% (in 2005 a growth of 75.7% was observed). In manufacturing industry the investments in chemistry production and metallurgy increased by more than 9.0%, reaching the figures of USD 1.6 bln. and USD 3.7 bln., correspondingly.



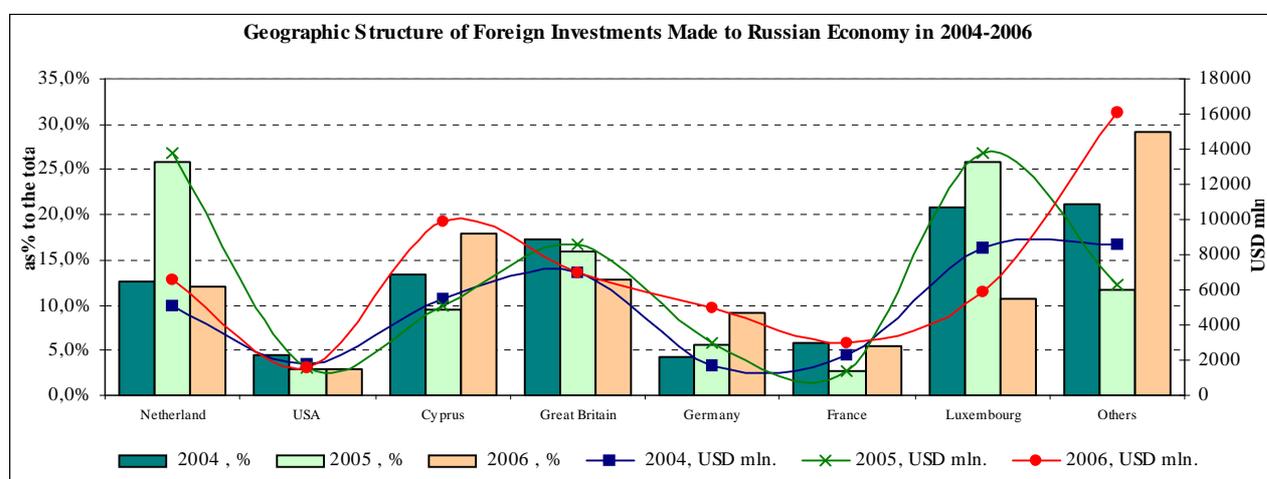
Source: Federal State Statistics Service.

The share of the direct investments in the industry diminished from 41.8% in 2005 to 29.2% in 2006, the proportion of other investments increased over this period from 56.8% to 66.7%.

In the structure of the investments by sectors of industry the changes were also observed. In the field of minerals extraction the share of other investments increased by 2.4 times as compared with 2005 up to 50.6% (in 2005 – 32.4%). The share of direct investments in extraction, which growth is estimated as 12.5%, decreased down to 49.4% (66.8% in 2005).

The direct investments in manufacturing industry decreased as compared with 2005 by 56.8%, which led to the decrease of their share in the total investments in these branches of industry from 33.5% to 17.2%. In contrast, the share of other investments in manufacturing industry increased from 65.8% to 76.8%.

As for geographic structure, leading position in the structure of foreign investments is held by Cyprus, which is 17.95 of the total amount of the investments, made to the Russian economy over this period (9.5% in 2005), the Great Britain comes second – 12.7% of the total amount (16.0% in 2005).



Source: Federal State Statistics Service.

During 2006 the biggest decrease in investments was fixed for the investments from Luxembourg - - 57.3% as compared with 2005 (the growth in 2005 was equal to 64.2%). The investments from the Netherlands decreased by 25.9% down to USD 6.6 bln., from the Great Britain - by 18.2% down to USD 7.0 bln. At the same time the investments from France increased by 2.1 times up to USD 3.0 bln. Cyprus increased its investments in the Russian Federation by 92.1% up to USD 9.9 bln., Germany - by 66.2% up to USD 5.0 bln..

The differences in the investments dynamics led to the change in the geographic structure of the foreign investments made to Russian economy. The proportion of Luxembourg decreased from 25.8% in 2005 to 10.7% in 2006, of the Netherlands - from 16.6% to 12.0%. France and Germany increased their shares from 2.7% and 5.6% to 5.5% and 9.1%, correspondingly. The share of the USA at the same time changed but negligibly, remaining at the level of 3.0%.

In 2006 the shift of sectoral priorities of the foreign investments sustained.

The investments from the Great Britain in manufacturing industries decreased from 37.0% in 2005 to 22.2% in 2006. It is the sphere of the trade that remains the preferable for the British investors, 52.1% of the total investments to the Russian Federation from the Great Britain is directed to it (38.6% in 2005), 9.1% being invested in coke and oil production.

In the structure of the investments to the Russian Federation from the Netherlands the share of minerals extraction increased from 42.7% in 2005 to 55.2% in 2006. In 2006 25.1% (5.5% in 2005) of the total amount of the investments from the Netherlands was made to transport and communication.

For Cyprus investors it is manufacturing industries that are the most attractive, they invested 39.1% of the total investments from Cyprus to the Russian Federation to it (31.4% in 2005). The share of financial activities, operations with the real estate in the structure of Cyprus investments increased from 11.0% and 10.1% in 2005 to 14.0% and 26.4% in 2006.

Table 3.

### Accumulated Foreign Investments as broken down by Main Countries-Investors

	Accumulated by 01.01.2007, USD mln				Changes by 01.01.2006, %			
	Total	Direct	Portfolio	Others	Total	Direct	Portfolio	Others
USA	7 698	4 588	507	2 603	12.5	5.2	25.5	25.2
Germany	12 260	3 320	1 692	7 248	26.1	22.3	by 58 times.	3.8
France	3 699	1 058	0	2 641	-5.6	16.9	0.0	-12.3
Great Britain	11 801	2 907	169	8 725	-7.5	42.2	17.4	-17.4
Cyprus	32 276	22 796	1 358	8 122	67.4	63.8	53.8	81.3
Netherlands	23 451	19 234	62	4 155	24.0	19.3	100.0	50.9
Luxembourg	22 870	587	203	22 080	9.0	30.2	by 200 times	7.5
Other countries	28 871	13 397	911	14 563	48.6	45.1	121.7	49.0
Total	142 926	67 887	4 902	70 137	27.8	36.5	157.6	16.5

Source: Federal State Statistics Service.

According to the situation at the end of 2006 the accumulated foreign capital not taking into account the bodies of monetary and credit regulation, commercial and savings bank, including ruble investments, con-

verted to US dollars, was equal to USD 142.9 bln., which exceeds the corresponding figure for 2005 by 28.7%.

As a result of 2006, in the total amount of the accumulated foreign investments, made to the Russian economy, the leading positions are still held by Cyprus, the Netherlands, Luxembourg, Germany and the Great Britain, whose share was more than 70%, similarly to 2005. At the same time the share of the leading five countries-investors in the segments of direct and portfolio investments increased up to 71.9% (70.9% in 2005) and 71.0% (57.2% in 2005). In the structure of other investments it decreased down to 71.8% (75.3% in 2005).

In the structure of foreign investments accumulated by the end of December 2006 other investments prevail, whose share was 49.1% (44.5% in 2005). Corresponding figure for direct investments was equal to 47.5% (53.8% in 2005).

One of the biggest investors to the Russian Federation is the European Bank for Reconstruction and Development. The amount of the investments of the European Bank for Reconstruction and Development in the Russian economy in 2006 was equal to euro 2.2 bln. Over the all years of European Bank for Reconstruction and Development presence, euro 7.5 bln. was invested in the projects fulfillment. At present the Bank allots credits for Russian projects fulfillment up to the sum of 80% of the total amount of project costs for the period up to 15 years. Besides, European Bank for Reconstruction and Development is ready to invest in the Russian Fund for Middle-sized Business Development up to USD 35 mln. The World Bank also intends to continue its collaboration with Russia.

One of the main guiding lines for the new investors to come to the Russian market and for already operating investors to wish to increase the amount of the investments is the rating of the world agencies Fitch, Moody's and S&P. At the end of July 2006 Fitch agency, first among the leading world agencies, increased sovereign rating of Russia up to the level BBB+. At the beginning of September 2006 Standard&Poor's rating agency also increased the Russian rating up to the level of BBB+. Moody's long-term rating is one position lower than Fitch and Standard&Poor's new rating.

*E. Ilukhina*

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## **Real Economy Sector: Trends and Factors**

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The index of the industrial production over January-February 2007 was equal to 108.7% to the corresponding figure of the previous year, agriculture production – 101.2%, the amount of work in construction – 125.4%. The acceleration of the domestic market development was accompanied with the change in proportions of investment and consumer demand. The increase in the investments in fixed assets was equal to 21.7% against 2.7% in January-February 2006, retail trade turnover having increased, respectively, by 13.4% against 10.4%.

High consumer demand growth rates were supported by the increase in real disposable incomes of the population by 12.7% and real wages by 17.5% as compared with January-February 2006.

Macroeconomic situation at the beginning of the current year was formed under the influence of the trends, developed in 2006. Under the extremely favorable situation at the world markets of minerals resources and raw materials it was a dynamic growth of the domestic demand that had the prevailing impact on the structure of the economic growth. The index of the industrial production over January-February 2007 was equal to 108.7% to the corresponding figure of the previous year, agriculture production – 101.2%, the amount of work in construction – 125.4%.

The acceleration of the domestic market development was accompanied with the change in proportions of investment and consumer demand. Since the second half-year of 2006 the construction took the leading positions in the structure of the economic growth, pressing the dynamically developing trade. The increase in the investments in fixed assets was equal to 21.7% against 2.7% in January-February 2006, retail trade turnover having increased, respectively, by 13.4% against 10.4%.

At the beginning of 2007 the market of the paid services to the population is developing at higher rates than last year. Anticipating growth rates are sustained in rather sensitive to the changes in population incomes kinds of services. Still more than 50% of the total amount of population expenditures for services is spent on the services of compulsory nature, not elastic towards population incomes (housing and communal services, some kinds of passenger transportation and public services). The increase in the amount of the paid services for the population in January-February of the current year was equal to 9.7% against 7.5%, public services 9.6 and 3.2%, medical services – 11.6 and 8.5%. It is such kinds of services as technical services and transport vehicles, machinery and equipment repair services and construction and redcoration of hous-

ing and other buildings that are developing most dynamically and whose share in the amount in the public services comprises more than 50% that develop most.

High consumer demand rates were sustained by the real disposable population's income growth, real wages growth being anticipating, as well as by the sustention of of high bank activity at the market of consumer crediting. The increase in real disposable incomes was equal to 12.7% as compared January-February 2006, in real wages - 17.5%. The growth rates of these indices in January-February 2007 exceeded their level in the corresponding period of the preceding year by 5.7 p.p. and 7.1 p.p., respectively.

In 2006 the increase in consumer prices for the first time over the several years did not exceed the planned figure of 9%. In January-February 2007 the inflation was equal to 2.8%, whereas in the corresponding period of 2006 this index was at the level of 4.1%. As a result of the first quarter the anticipating growth of prices will be 3.5% against 5.0% in 2006.



Figure 1. The Changes of Production Rates by kinds of Activities in 2005-2007 as percentage to the corresponding period of the previous year.

Structural shifts in the industry proceeded against the background of anticipating growth of the manufacturing industries as compared with extraction industries, which is characteristic for the growth of Russian economy over the last three years. Though the ratio of growth rates of kinds of economic activities suffered quite considerable fluctuations, on the whole it demonstrates a gradual shift from the growth, based on the exploitation of traditional factors of natural resources potential, which is orientated predominantly to the external market, to the formation of the internal market development resources. The beginning of 2007 was characterized by the acceleration of the dynamics of extraction and manufacturing industries against the background of reduction in production and distribution of electricity, gas and water due to an exceptionally warm winter. In January-February 2007 the increase of manufacturing industries was 15.7%. In extraction industries rates acceleration by 3.4 p.p. as compared with January-February 2006 was caused by the increase in oil production by 4.4% against 1.6%. Electricity production over January-February 2007 was equal to 97.9% of the previous year's figure, including heat power plants – 94.6% and hydro power plants – 118.4%.

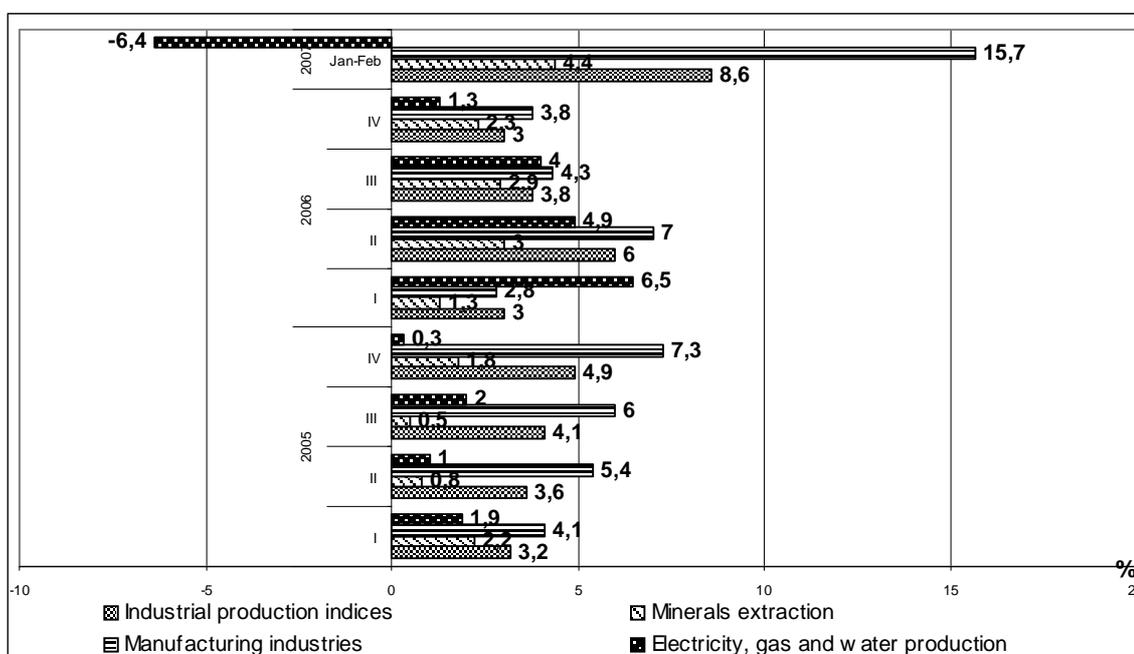


Figure 2. Changes in Industrial Production Growth Rates by kinds of Production in 2005-2007, as percentage to the previous year

In the environment of the investments demand growth the positions of the machine-building in the structure of the Russian economy do not seem favorable enough from the point of view of the short-term forecast. Analyzing the trends of machine-building development, it is the anticipating machines and equipment import growth rates as compared with the dynamics of the domestic machine-building that is notable. Though in January-February 2007 the acceleration by 14.8% in machinery and equipment production was observed this is mainly due to the low base of the previous year, when in this kind of activity a drop of 25.6% was fixed. Output of machinery and equipment in January-February 2007 increased by 16.0% against 9.0% in the corresponding period of the previous year. The output of passenger cars in January-February 2007 increased by 18.6% against 3.7%. The competitiveness of domestic motor engineering being low, the growth of the demand for foreign brands of cars both imported and produced in the territory of Russia was observed.

In production of consumer goods the positive trends of development sustain. The analysis of industry development demonstrates that serious quality changes in technology and the structure of consumer goods production lacking existing level of the industry development will not let sustain high growth rates for a long time. An important tool for the production expansion in 2006 was the abolition of customs duties for import technological equipment. In October 2005 the Government granted domestic companies of light industry the right of duty-free import of 45 kinds of equipment for 9 months. According to the data of the Ministry of Industry and Energy of Russia this enabled enterprises to purchase 160.9 thou. units of modern equipment and save RUR 122 mln. In 2006 RUR 3.0 bln. was invested in textile and clothing industry, RUR 1.0 bln – in tanning and footwear industry. Positive influence of modernization process was supported by the change in the regulations of duty-free import by individuals and reinforcement of the control for customs institution. As a result of 2006 the textile and clothing production demonstrated positive dynamics (107.3%), as well as leather, leather goods and footwear production (116.7%). However as production output in these kinds of activities comprise approximately 20–23% of the level of pre-reform 1991, this did not have considerable impact on the domestic demand. The share of the domestic goods in the retail trade resources of the non-food market in 2006 decreased down to 44.3% against 45.7% in 2005 and 51.6% in 2000. On one hand, the discrepancy of material and technological basis and labor qualification with the market criteria determined the decrease in domestic non-food goods competitiveness as compared with import, on the other – under the existing exchange rates it led to the expansion of niches for import goods. Russian producers of light industry hold one of the least attractive for foreign investors position. By the beginning of 2007 the accumulated amount of the foreign investments into the industry was equal to USD 155 mln. as compared with USD 5294 mln. in food industry.

The competitiveness of the domestic foodstuffs producers was supported by active investment policy and existing mechanism for import quotas for some kinds of goods. However this created potential was not sufficient for the sustention of the steady production growth rates, labor efficiency and productivity. The slow-

down in the food production as compared with the dynamics of the retailed trade turnover was observed in 2003-2004. In 2005–2006 as a result of investment support strengthening the foodstuffs productions growth rates acceleration was also observed. The growth index in 2006 was equal to 105.4% against 104.3% in 2005 and the minimum over the last 8 years level of 2.9% in 2004. In January-February 2007 the increase in foodstuffs production was equal to 17.4% against 0.5% in the corresponding period of the previous year.

The dynamics of the intermediate demand goods production has been in the area of the positive values since 2002. The nature of metallurgical, chemistry and woodworking industry functioning was determined by the level of internal and external demand.

Chemistry complex is the basic segment of the Russian economy. Its proportion in the industry structure by the amount of goods produced comprises about 5.5%, the enterprises secured about 5.4% of the All-Russian currency earnings. Over 2000-2006 the chemicals production output increased by 1.45 times. In January-February 2007 the increase in chemistry production was equal to 13.1% against the decrease of 0.7% in the corresponding period of the previous year, while the production of rubber and plastic goods increased by 25.2% against 11.7%. The capacity of the domestic market for chemistry production being quite high, key factors that limit the functioning of chemistry complex are: high extent of the equipment wear and tear, technological backwardness; the anticipating growth rates of prices and tariffs for natural monopolies production; problems with industry's enterprises provision with the main kinds of raw materials; and scantiness of investment resources;

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### **Business Survey in March 2007**

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First estimations of the dynamics of the main business indices by the industrial enterprises will probably make corrections to the forecasts of the Russian economy development in 2007. If extremely positive results of first two months were not enough for it, March data will add optimism both to Forecasts and for Government.

According to the data of the Federal State Statistics Service the trend for industrial growth sustained this year. In February, according to the Center for Macroeconomic Analysis and Short-Term Forecasting information, the high value of the industrial production index to the corresponding period of the previous year sustained – 108.7%. The main factor that accounted for such a growth rate was the effect of “low base” – last February the value of the corresponding index was only 101.0%.

Latest estimations of the dynamics of the main business indices by the industrial enterprises will probably make corrections to the forecasts of the Russian economy development in 2007. If extremely positive results of first two months were not enough for it, March data will add optimism both to Forecasts and for Government.

At first, the demand for industrial production picks up growth rates. In March initial, not cleared from seasonality, data demonstrated the increase in growth intensity up to 38 balance points, which is an absolute maximum over the whole period of monitoring and exceeds by twofold the results of March 2006. Exclusion of seasonal factor demonstrated the growth with the intensity of 24 balance points, which is also an absolute maximum and exceeds by 3 points the previous maximum, which was observed in January 2007. The demand is growing in all branches of industry, being especially intensive in fuel, metallurgic, food and machine-building industries. 2/3 of Russian industrial enterprises are satisfied with the volumes of sales. In power industry, fuel and metallurgic industry, the satisfaction with the demand exceeds 90%. In food processing it is equal to 80%, in chemistry and petrochemistry – to 76%, in machine-building – 65%. The lowest level of satisfaction with the demand is preserved in light industry (44%).

Second, high demand growth rates and increasing resources limitations for output force more and more enterprises to use the stocks of finished commodities to satisfy new customers. It is not possible now to replenish the stocks to the level of surplus that was usual one or two years ago: the production goes to customers straight from the workshops. As a result the balance of stocks estimations in 2007 is only +2..+3 b.p. A year ago it was in the range of +11..+14 b.p.

Third, good growth rates and the decrease in the finished commodities stocks enable enterprises to sustain high output growth rates. In March data, not cleared from seasonality, demonstrated production growth with the intensity of 54 b.p., which is an absolute maximum and exceeds the results of March 2006 by 12 b.p. After exclusion of the seasonal factor the output growth rates in March were equal to 31 b.p., which is a second –rank result from 1992. The best result was observed in 2007.

Fourth, the availability of credits for Russian industry continues to expand. In I quarter 2007 already 76% of the enterprises had a normal access to borrowed funds (a record value for 2000-2007). In fuel industry this index is equal to 100%, in power industry – to 86%, in metallurgy and machine-building – to 79%.

Fifth, high growth rates of demand and output contribute to the improvement of enterprises' financial and economic situation. In I quarter 2007 17% of enterprises estimated their situation as “good”, which is the absolute record value. There are 37% of such enterprises in metallurgy, 24% - in chemistry and petrochemistry, 13% - in machine-building. Only 11% of producer estimate their position as bad, which is an absolute minimum over 1993-2007, in 2005 there were 15% of such enterprises. Main part of the enterprises (72%) regards their situation as satisfactory.

However the increase in production output due to the creation of the new kinds of products still confronts serious obstacles that did not principally change over the last seven years. Only 72% of enterprises have the intentions to develop and release new products. This is the worst result over the period of monitoring, began in 2000. The maximum inclination to new products development was registered by surveys in 2005-06, when 82% of enterprises intended to develop products, which were new for them. So, this index lost 10 p.p. over two years - more than a serious problem for the economy, which does not experience the excess of innovation activity in the industry. The plans for the creation of new products differ considerably in regard to the branches of industry. New products are most likely to be created in machine-building (87% of enterprises declared such intentions) and ferrous metallurgy (81%). Second echelon is occupied by chemistry and petrochemistry (68%), light (67%) and food (62%) industries. Most modest plans are demonstrated by construction industry (45%), non-ferrous metallurgy (43%) and timber industry (43%, in purely furniture production this index is equal to 76%). Certainly, bigger enterprises have more possibilities to create new products.

The decrease in intensity of plans for new products creation in next two years is accounted for by the whole complex of causes observed in the process of monitoring. None of the obstacles is cited nowadays less frequently than two years ago. Moreover, the citation of four limitation factors either sustained at or reached the maximum level. 20% citation of competitors' advantage due to possession of the unique sources of energy, raw materials, technology, patent and licenses seems especially alarming. It is obvious that from this list enterprises are most worried about energy and raw materials. Patents and licenses are not essential attributes of modern Russian industry.

It is “high costs that are necessary to start production” that are considered by enterprises the main obstacle for the creation of new products (see table). The frequency of this obstacle citation on the whole in the industry is 65% (maximum - 73% - fell on 2001-2002). “Impossibility to reach the scale of output which secure profit” always holds the second place (2007-2008 – 43%, maximum was observed in 2003-2004 – 47%). Low prices at new markets, which do not defray costs, are traditionally cited at the third place. The combination of these three interrelated reasons (low investment activity of the majority of the enterprises and high costs of investment resources) with the fact that the credits in industry are used mainly to replenish floating assets (59% of the enterprises) and only 38% of producers attract them to modernize the production, which proves serious and sustaining obstacles for innovation way of Russian industry development.

*Table. 1*

**Obstacles for Development of New Products in 2001-2008 (as percentage to the number of respondents)**

	2001-02	2003-04	2005-06	2007-08
1. no information on the situation at new markets	21	20	13	16
2. low prices, which do not defray costs, at new markets	25	31	27	29
3. saturation of new sales markets and apprehension on drop in prices	13	16	12	17
4. rigid resistance of traditional producers	11	16	11	16
5. support of traditional producers by local administration	5	12	3	4
6. attachment of suppliers and customers to traditional producers	12	13	13	13
7. high costs necessary to start new production output	73	72	63	65
8. high transportation costs	15	20	7	11
9. impossibility to reach scale of sales and production which secure profits quickly	46	47	38	43
10. advantages of the competitors due to possession of unique primary materials, energy, technologies, patents and licenses	15	19	14	20
11. there are no special obstacles	13	7	19	12

Source: IET surveys.

The forecasts of changes in demand become more and more optimistic. Expected sales growth rates (after excluding seasonality) exceeded the results of the previous month by 5 points and reached an absolute maximum over 1992-2007. As a consequence the plans for output changes were also revised towards the increase. Planned production growth rates exceeded plans for February by 4 points and reached absolute maximum over last fifteen years. Industry does not intend to slow down.

S. Tsukhlo

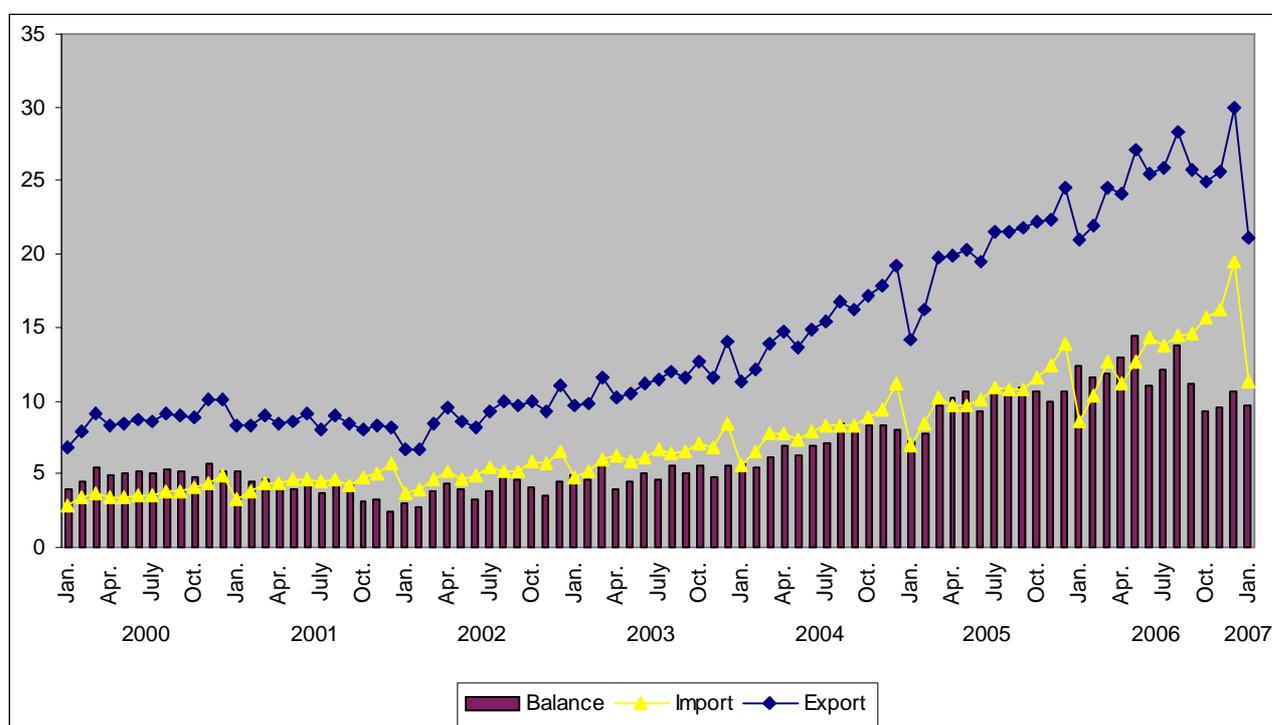
## Foreign Trade

First month of 2007 was characterized by considerable drop in prices for the main Russian export commodities as well as the intensification for the trend of anticipating import growth rates to Russia as compared with Russian export growth rates.

Russian government is changing export policy with regard to woodwork production with the aim to decrease export volumes of non-processed wood.

In January 2007 Russian foreign trade turnover, calculated by the balance-of-payments methodology, increased up to USD 32.4 bln., which is 9.8% higher than the figure of January 2006, which is the lowest in annual terms value of increase since June 2002.

The basis of the trade turnover is formed by the trade with non-CIS countries – USD 27.6 bln., which exceeds the figure of January 2006 by 9.2%. Trade with CIS-countries grew by 13.2% and reached the level of USD 4.8 bln.



Source: Central Bank of the Russian Federation

*Figure 1. Main Indices of the Russian Foreign Trade (as USD bln.)*

In January 2007 Russian export was equal to USD 21 bln., which exceeds the figure of January 2006 only by 0.5%. Besides, January seasonal export recession as compared with December is much deeper this year than last year – export is by 29.9% lower than December 2006 figure, while in 2006 such a recession was 14.4%.

In comparison with the year ago index of the export to non-CIS countries did not change and was equal to USD 18.2 bln. As for CIS countries, goods worth USD 2.9 bln. were exported there, which is by 3.7% more than in January 2006. Export supplies growth slowdown was the continuation of the trend, which outlined in 2006.

Though the situation at the world markets became worse for Russian exporters at the beginning of 2007, it still remains quite favorable.

As compared with the last month, in January 2007 the average price for oil grade Brent went down by 13.2% and was equal to USD 54.8 per barrel, the average price for oil grade Urals went down by 13% to

USD 55 per barrel;. As compared with January 2006 the prices on average were higher by 12.4 and 15.9%, correspondingly.

Average price for oil grade Urals over January-February was equal to USD 51.816 per barrel. Accordingly, the value of export duty for oil will decrease by USD 23.3 per ton and will be equal to USD 156.4 per ton from 1 April 2007. Following oil duties, export duties for oil products will decrease – from USD 133.4 to USD 117.7 per ton of light oil products and from USD 71.8 down to USD 63.4 per ton of dark oil products.

In January 2007 oil products prices were on average lower than a year ago. Petrol premium cost USD 1.6 per gallon, which is by 14% lower than in January 2007.

The price for natural gas was equal to USD 6.9 per BTU, which is by 28.9% lower than a year ago and by 5.9% lower than the figure of December 2006.

As compared with the previous month, in January 2007 prices for non-ferrous metals due to the decrease in industrial demand went down for the most part. At the world market of non-ferrous metals according to the results of London Metal Exchange quotations with the immediate delivery period, the average price per 1 ton of copper was USD 2808.3, which is by 14.7% cheaper than a month ago. The price for aluminum decreased by 0.3% down to USD 2808.3 per ton. Price for nickel increased by 6.4% and was equal to USD 36795.2 per ton. However as compared with the corresponding period of 2006 the prices grew up considerably: by 19.7% for copper, by 18.1% for aluminum and by 152.8% for nickel.

*Table 1*

**Average Monthly World Prices in January of the respective year**

	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Oil (Brent), USD/bbl	23.4	15.3	11.3	25.5	26.0	19.4	28.1	31.3	42.9	62.5	54.8
Natural gas, USD /1 mln BTU	2.486	2.097	1.426	2.431	5.214	2.146	5.048	6.156	6.907	9.725	6.917
Petroleum, USD /gallon	0.685	0.507	0.494	0.739	0.865	0.573	0.852	0.992	1.291	1.849	1.59
Copper, USD/ton	2400	1682	1528.2	1887.9	1849.6	1557.8	1571.3	2441.9	3170	4734	5668.7
Aluminum, USD/ton	1598	1480	1301.4	1695.5	1641.5	1377.9	1291.1	1608.2	1832	2378	2808.3
Nickel, USD/ton	7485	5496	4550.8	8338.1	7091.3	6094.6	7643.9	14855	14505	14555	36795.2

Source: calculated on the basis of London Metal Exchange, International Petroleum Exchange (London) data

According to the Federal Customs Service data, the crude oil export in January 2007 was equal to 19.2 mln. tons, which is by 11.2% higher than the level of supplies in January 2006. The volume of export to non-CIS countries increased by 17.7% and reached the volume of 17.6 mln. tons. Average contract price for crude oil was equal to USD 379.9 per ton in January 2007, which was by 4% lower than the corresponding figure of the previous year. There were 1.6 mln. tons, corresponding to 74.2% to the level of January 2007, exported to CIS countries. The decrease in oil supplies to CIS countries is caused by the decrease of export to Belarus.

As compared with the corresponding period of the previous year, export volumes of crude oil increased by 6.7%, of oil products – by 3.8%, of ferrous metals – by 24.4%, of unprocessed timber – by 16.4%, of refined copper – by 66%, of unprocessed nickel – by 139.9%. There was by 16.6% less of natural gas, by 51.7% of unprocessed aluminum and by 32.2% less machinery and equipment exported than a year ago.

The attention should be paid to the fact that machinery and equipment export decreased considerably. According to the Federal Customs Service data, in January 2007 there was by 32.2% less machinery and equipment sold abroad than in January 2006. At the same time the export of this kind of goods to CIS countries increased by 41.5%, and to non-CIS-countries – decreased by 57.2%.

On the whole, fuel and energy commodities still comprise the most considerable part in export goods structure – 72.4% of the total volume, which is, nevertheless, a bit less than in January 2006. the share of metals and metal goods increased by 13.6%, the share of chemistry industry production did not experience significant changes and was equal to 5.6%, timber, pulp and paper goods increased slightly and was equal to 2.8%, the share of machinery and equipment changed considerably – from 3.7% in January 2006 to 1.6% in January 2007.

In January 2007 in commodity structure of export to CIS-countries, the share of fuel and energy complex production decreased by almost 25% and was equal to 46.6%. the share of machinery and equipment increased up to 16.6%, metals and goods thereof – up to 12.9%, chemistry industry production – up to 9.8%.

In January 2007 import to Russia was equal to USD 11.4 bln., which is by 41.5% lower than the figure of the previous month, but by 32.3% more than the figure of January 2006. Import from non-CIS countries was equal to USD 9.4 bln, exceeding the figure of January 2006 by 32.6%. There were goods worth USD 2 bln. that were imported from CIS countries, which is by 31% more than a year ago.

High Russian import growth rates were assisted by the increase of 13.1% of real disposable population income and ruble appreciation against the main currencies. According to the Central Bank of the Russian Federation data, ruble appreciation to dollar was 14.0%, to euro – 5.8%, to the basket of the main trade partners' currencies – by 6.6%.

The volume of import of the main part of the most important goods in January 2007 increased considerably in comparison with January of the previous year. It was import supplies of foodstuffs and agriculture raw materials that increased considerably. As compared with January 2006 the monetary volume of this goods group increased by 67.4%.

Machinery and equipment supplies increased by 58.4%, passenger car supplies – by almost twofold. There were by 81.1% more ferrous metals, by 121.3% of steel pipes, by 82.3% of clothes, by 325.9% of fresh and frozen meat, by 74.4% of alcoholic and non-alcoholic beverages, by 58.4% of raw sugar imported than a year ago. Medicines import decreased by 31.2%, main reason being the attempt to improve the remedies safety system by substitution of the remedies compulsory certification for conformity declaration, according to which the supplier takes all the responsibility for the quality of medicines.

Similarly to the situation a year ago, the commodity structure of import consists almost by half from machinery and equipment supplies (49.6%). The share of metals and goods thereof increased considerably up to 28.4%, the share of foodstuffs and primary products for their production increased up to 18.6%, the share of chemistry industry production decreased down to 14.1%.

In the structure of import from CIS-countries the share of metals and goods thereof increased considerably up to 28.4%, of machinery, equipment and transport vehicles – up to 25.5%. The share of mineral products was equal to 16.6%, of chemistry industry production – to 12.7%.

The balance of trade was positive and equal to USD 9.7 bln. However due to the fact that the monetary volume of Russian import growth exceeded export growth, trade surplus in January 2007 decreased by 8.5% as compared with December 2006 and by 21.5% as compared with January 2006.

As for geographic structure of Russian foreign trade it is the European Union that still remains the biggest trade partner, whose share in January 2007 is equal to 54.5% of Russian foreign trade turnover, which is, however, by 1.2% lower than last year. Among EU-countries, the most notable growth of trade turnover occurred with Italy and the Netherlands – up to 8.9% and 9.2% of the total Russian trade turnover, correspondingly. The share of the turnover with Asian-Pacific Economic Cooperation countries increased from 15.4% to 17.1%. Among these countries a notable increase in the turnover occurred with Korea, whose share increased from 1.5% to 2.4%. The share of Russian trade turnover with Euro-Asian Economic Community increased from 7.6% to 8.1%, the share of CIS-countries– from 14.6% to 15%, the share of Ukraine and Belarus decreasing at the same time. It was Kazakhstan in this region that experienced the most considerable growth of trade turnover– from 2.1% to 3%.

In February 2007 Russian government made decisions, marking the change in export policy with regard to woodwork production with the aim to decrease export volumes of rough wood.

At present Russia supplies 40% of the unprocessed softwood world market, remaining considerably behind the countries with the most developed forestry by the extent of raw materials processing. At the same time extremely favorable customs regime was in effect over the last years. Export duty rate for roundwood is only 6.5% at present, which is much lower than in Brazil, Canada, the USA and other exporting countries. Over the last 10 years the volume of rough wood export to non-CIS countries tripled, being equal to 47.4 mln. cu. m in 2005. In 2006 roundwood export increased up to 50.4 mln. cu. m. It should be however noted that as a result of the last year the export growth rates went down to 6.3% from 15.8% in 2005. Export growth rates slowdown can be partially accounted for by the increase of export duty specific component from euro 2.5 to euro 4 per cu. m.

Rational integration in the world market requires implementation of a certain strategy in export policy, concerning, in the first place, roundwood. In February 2007 decree of the Government of the Russian Federation No 75 was published. Its main idea is the increase of export customs duties for some kinds of roughwood, excluding small-scale pulp-wood, hard and fine wood in three stages: specific component of export customs duty is established at the level of euro 10 per 1cu. m. from 1July 2007, of euro 15 per 1 cu. m. – from 1 April 2008, of euro 50 per 1 cu. M. – from 1 January 2008. r

Earlier some measures to decrease roughwood export and stimulate domestic wood-processing have already been undertaken. Thus, import duties for the main kinds of high-technological equipment, which is not produced in Russia were zeroed (more than 600 articles). Export duty rates for more than 300 kinds of wood and paper production with high added value – plates, plywood, market cellulose, dominant paper and cardboard production - were abolished. At the same time export duty rates for some kinds of roundwood. In

order to protect domestic market import duty rates for furniture were amended. The exporters were supported by export credits interest rates subsidizing.

The intention of the Russian Government to increase export duty rates for roughwood caused apprehension in Finland. Russian wood comprises 80% of the raw materials supplied to Finland from foreign countries. According to the forecasts of the Finnish experts, the increase of duties for rough wood will lead to the cessation of the wood import from Russia, which threatens not only the loss of the raw materials source but also thousands of workplaces in the timber industry.

Finnish party considers that Russia's resolution to increase export duties for rough wood is contrary to the bilateral agreement on the conditions of Russia's accession to the WTO, which was signed by the EU and Russia in May 2004. This issue should be settled before Russia's accession to the WTO.

*N. Volovik, S. Vlasov*

## **Comments on the RF Draft Federal Law "On the Bank for Development"**

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On 14 February 2007 the RF State Duma adopted, in the first reading, the Draft Law "On the Bank for Development". The text of the draft law, as well as the Explanatory Note thereon, and the Concept of the Draft Law are sufficiently detailed in describing the basic principles and terms of functioning, in Russia, of a Bank for Development, thus making it possible to get a comprehensive idea of the character of the proposed scheme.

In accordance with the submitted documents, the Bank for Development is planned, in fact, as non-banking noncommercial establishment, which is to perform a number of banking operations, whose range is rather limited, in accordance with the tasks set by the RF Government.

From our point of view, the submitted draft federal law is insufficiently worked out in some of its details, and therefore requires considerable elaboration. Otherwise, the efficiency in achieving the goals set for the Bank for Development and the efficiency and transparency of the Bank's activity as such cannot be sufficiently guaranteed.

1. Within the framework of the proposed concept, the Bank for Development is a non-banking establishment, accountable for the most part to the RF Government. The Bank of Russia controls only a very narrow range of technical issues with regard to the Bank for Development's reporting. Thus, from our point of view, the construction suggested in the draft law represents a mixture of two different concepts of establishments operating in the countries around the world – the Bank for Development proper, and state corporations for development. Accordingly, the former, as a rule, are banking establishments accountable to the agencies of bank supervision; and they play the role of a financial institution guaranteeing the achievement of the state goals determined by other state agencies. The latter are noncommercial public organizations operating in close cooperation with the governments and commercial financial institutions.

Thus, the proposed construction have no analogues in world practice, while neither the Concept of the Draft Law nor the Explanatory Note offer any convincing arguments in favor of the adopted decision.

2. The draft law and the attached documents absolutely fail to mention that the RF Bank for Foreign Economic Affairs, which is planned to be reorganized into the Bank for Development, is a state asset manager in charge of the pension savings of RF citizens. This fact should have been mentioned at least once in the Draft Law's section devoted to the reorganization of the RF Bank for Foreign Economic Affairs. Moreover, the draft law directly prohibits for the Bank for Development to handle operations on financial markets (except in the instances specified by the RF Government; however, a government decision is unlikely to be sufficient to resolve the issue of pension savings management, and therefore it is necessary to legislatively consolidate this issue). Accordingly, the adoption of this draft law and the creation of the Bank of Development cannot be effectuated until the issue of pension savings management is resolved at the legislative level (which means establishing a new state asset manager and transferring to it the resources of the Bank for Foreign Economic Affairs).

3. A number of provisions regarding the organization of management of the Bank for Development are open to questions. In particular, it is proposed that the Chairman of the Bank for Development should be appointed by decree of the RF President, which we assume to be unnecessary. This decision can well be taken by the Chairman of the RF Government. Also, the draft law envisages that the amounts of remuneration for the Supervisory Board's members should be established by the Supervisory Board itself, which cannot be a guarantee of a transparency and justice. As in the previous case, it would be advisable to assign this function either to the RF Government or to one of the ministries or agencies of the economic block.

4. In accordance with the draft law, the Bank for Development should not be a professional participant of the securities market, which can create certain impediments to its activity, including operations on international markets.

Bearing in mind the aforesaid comments, we believe that the adoption of this draft law would be premature, and that it is advisable to rework the Draft Law "On the Bank for Development" in accordance with the concept of creating the Bank for Development as a banking institution with a specific bank charter and specific limitations imposed on its operations, which would be accountable to both the RF Government (in the part of its goals and the operations being performed) and the Bank of Russia (in the part of controlling its current activities as well as economic and financial indicators).

*S. Drobyshevsky*

## **The institutional and structural disproportions of the stock market**

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Below, some institutional and structural problems associated with the development of Russia's stock market in 2006 are discussed. Special attention is focused on those long-term disproportions in the market's development which remained important in the period of 2006 - 2007.

The year 2006 saw very considerable growth in the external financing of biggest companies and banks. In 2006 the aggregate volume of the biggest initial public offerings (IPO) (including those by "Rosneft") amounted to no less than \$ 17 billion. Corporate bonds became the driving force of the issues released on the debt market, their placement volume having increased from 260.6 billion roubles in 2005 to 465.3 billion roubles in 2006, or by 1.8 times. The total volume of rouble-denominated bonds in circulation, including federal securities, corporate and regional bonds, increased from 1.5 trillion roubles in 2005 to 2.2 trillion roubles in 2006, or by 1.4 times.

According to the estimations made by analysts from several investment banks, the aggregate volume of the IPOs made by Russian companies may amount in 2007 to \$ 20 - 22 billion, and including those by Sberbank and Vneshtorgbank - to 30 - 40 billion. Approximately 60 Russian companies are planning to make IPOs in the year 2007, but in reality (given the existing level of market preparedness and the general situation on the market) this will be achieved by only 30 companies. Moreover, there also exists a pessimistic forecast: as estimated by Citigroup Global Markets, Russian companies will not be able to exceed in 2007 the level of 2006 (the forecast for the year 2007 is 32 IPOs and \$ 18.4 billion), while after the 2008 presidential election the situation will be rather similar to that of 2005 (in 2005 - \$ 5.2 billion, the forecast for 2008 is 18 IPOs and \$ 4.7 billion). The current dramatic growth in the number of IPOs is therefore directly associated with the desire to insure against the risks of the new phase of the politico - business cycle which will begin after March 2008.

The foreign expansion of quite a few of large private Russian companies (or groups), which was characteristic of 2005 - 2006, can also be explained, in all probability, not only by the logic of corporate development, the consolidation of their positions on new markets and a search for appropriate objects to invest their free funds in, but also by the preparation for a new politico - business cycle in Russia. These considerations can also be applied to some of the biggest state-owned companies, although for other reasons. In late January 2007, Director of the Federal Agency for Federal Property Management V. L. Nazarov announced that one more public offering of a block of shares in "Rosneft", within the limits of 25 % (or approximately \$ 20 billion), was possible, but very shortly this declaration was undermined by his supervisor in the government - RF Minister of Economic Development and Trade G. O. Gref. Nevertheless, such a controversy in approaches, according to available estimates, has demonstrated that the attempts to privatize the greatest possible part of the state-owned block of shares in "Rosneft" before March 2008, with their subsequent legalization in the interests of a very limited circle of subjects, are becoming more intense.

The electoral cycle, according to forecast, is going to directly influence the decrease, in 2007, in the volume of foreign direct investments (where, as noted earlier, it is quite difficult to differentiate between truly foreign and repatriated capitals). Forecasts are unanimous in the general expectation of a slump in this sphere, however the motives pointed to are different. Thus, Standard&Poors explained the forecasted slump by the expected simultaneously weakening rush on the raw materials markets, which used to promote investments in the raw-materials assets of developing countries, and by the nationalization of the energy assets in Russia, Bolivia, Venezuela, and Ecuador. The Russian Union of Entrepreneurs and Industrialists directly links the slump with the future political risks associated with the parliamentary and presidential elections in Russia. Besides, there exists the objective problem of the preparedness of Russian companies. In contrast to the attitude of Russian owners, the political risks which are not directly connected to the electoral cycle remain very significant in the eyes of the most conservative among foreign institutional investors.

At the same time, in recent years the development of the stock market has been characterized by a number of disproportions, which, in effect, represent a chronic phenomenon.

The growth of the share market in 2006 was produced by the very intense growth of the trading activity of non-residents, the population and Russian institutional investors. The decisive role there, just as in 2005, was played by **non-residents**. The attractiveness of the Russian stock market for non-residents was associated not only with the high yields on the investments in shares, but also by such factors as the overall stable macroeconomic situation in this country supported by the high prices of exported raw materials, the liberalization of the market for “Gazprom”'s shares, the strengthening of the rouble / USD exchange rate, the lifting of restrictions formerly imposed by legislation on foreign currency regulation and foreign currency control, and the excessive liquidity on the global markets resulting from low interest rates.

During the first 9 months of 2006 the demand of non-residents for shares in Russian companies increased, in the form of the balance of foreign direct investments (FDI), by \$ 11.1 billion, and in the form of portfolio investments – by \$ 11.5 billion. The specificity of placing investments in the category of FDI is such that there, in fact, belongs the mainstream of investments being made by hedge funds and direct investment funds. For this reason, the FDI in shares of Russian differ little from portfolio investments.

In 2006 the share of non-residents in the total value of purchase and sale transactions in shares on the MICEX became 25.4 %, having exceeded even the share of transactions effectuated by physical persons (22.9 %). The noticeable enhancement of the role of non-residents on the MICEX coincides with the period after the lifting of the restrictions on transactions with shares owned by non-residents, formerly established by legislation on foreign currency control and foreign currency regulation. It should be noted that in actual practice the role of non-residents in the transactions with shares of Russian companies in the territory of Russia is even more prominent. In fact, many big brokers and banks purchase shares on the MICEX in their own name for purposes of their subsequent resale by non-residents through offshore companies. Such resale of shares is formalized as ex-pit transactions, which constitute approximately 20 – 30 % of the turnover of shares on the MICEX. The sale of shares by non-residents is also carried out as ex-pit transactions. Considering this factor, the share of non-residents on the share market is approximately 50 %, in accordance with our estimations.

The problem faced by the Russian stock market in connection with the participation in this market of foreign portfolio investors is that so far it has not become a target for investing on the part of the world's biggest investment and pension funds oriented to foreign retail investors. The funds whose specialty is Russia are usually characterized by a low degree of capitalization and mostly have the status of hedge funds or funds oriented to qualified investors (for example, the Hermitage and the funds managed by J P Morgan Fleming). According to the data published by the Rosstat, offshore zones in 2006 (Luxemburg, Cyprus, the Virgin Islands and the Cayman Islands) accounted for 40 % of the accumulated foreign investments in Russia. According to the information published at EmerginPortfolio.com, the total value of the investments made by portfolio investment funds in Russia as of the beginning of 2006 amounted to approximately \$ 10 billion.

The principal investors in the shares issued by Russian joint-stock companies are foreign investment funds specializing in investments in shares of companies located in the developing European countries, as well as the global funds of developing markets. In this connection, in the sphere of investments in Russia the dominant role is played by the investment funds registered in Luxemburg, which account for approximately 47 % of the assets owned by portfolio investors in Russia, followed by those from the USA (23 %), Ireland (8 %), Austria (7 %) and the Cayman Islands (2 %). Nearly 60 % of the assets is constituted by the funds established in offshore zones (Luxemburg, Ireland, the Cayman Islands and Guernsey).

These foreign investment funds invest in developing markets on a “package” base, making it their goal to diversify their investments between different countries irrespective of their macroeconomic situations. The significance of the factor of developing markets attractiveness is generally higher than that of the specificities of individual developing markets, and the country-based approach usually prevails over the industry-based one<sup>12</sup>.

The prevalence of the country-based strategy of forming their portfolios among the foreign investors operating in Russia has a negative impact on the qualitative structure of the market for the shares in Russian companies, because it creates the phenomenon of synchronous changes of their prices, independently of the indices characterizing the activity of companies proper. This can be seen by the near-1 Beta coefficients of the majority of blue chips, which characterize the degree of deviation of the return on investments in some or

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<sup>12</sup> Brooks R., Del Negro M. The Rise in Co movement across National Stock Markets: Market Integration or IT Bubble. Federal Reserve Bank of Atlanta. – Working Paper 2002-17a, September, 2002.

other securities from the return of the stock indices. The Beta coefficients of most of the issues of shares are approximated to 1, which is indicative of a high correlation between the fluctuations of their prices and the return of the MICEX index. The average Beta coefficient for all issues of shares was 0.92 in 2005 and 0.91 in 2006, thus demonstrating the dominant role of the synchronicity of the movement of the prices of blue chips on Russia's stock market.<sup>13</sup>

The synchronicity of the movement of shares does not only represent an impediment for institutional investors and the population in terms of opportunities for taking advantages of the diversification of portfolios on the domestic market, but also is indicative of the existence of certain efficiency problems associated with the management of the biggest corporations. The portfolio theory usually assesses the efficiency of managers by applying Alpha coefficient, which demonstrates the deviation of a portfolio's actual return from its potential return in conditions of a given return on a basic portfolio (i. e., index) and Beta coefficient of a given portfolio.

During the first 11 months of 2006, the **investments of banks in shares** increased by 65.6 billion roubles, or by \$ 2.4 billion, which is very modest figure by comparison with those characterizing the growth of capitalization and liquidity on the stock market. At the same time, the gap between the level of the development of the stock market and the banking system's potential was becoming greater.

In 2006, the share of capitalization in GDP increased to 92.7 %, as compared to 61.5 % in the preceding year. In the same year, Russia became one of the world's leaders in the attraction of FDI. Against this background, the share of domestic credit in GDP, which in 2005 went down from 25.9 % to 20.6 % of GDP, in 2006 remained nearly at the same level as in the preceding year. The gap between the indices of capitalization and those of domestic credit is indicative of the existence of serious disproportions between the level of development of the banking system and the growth of Russian companies.

The shortage of domestic credit resources urged banks and nonfinancial companies to actively attract **borrowings on the external market**. In 2006 the external debt of nonfinancial companies and commercial banks amounted to \$ 135.4 billion and \$ 78.5 billion, respectively. In one year, the debt of nonfinancial companies increased by 8.4 %, that of banks – by 56.7 %, that is, the growth of banks' external debt was far ahead of that of the external borrowings of nonfinancial organizations. In 2007 this trend, in all probability, will persist - in 2007 only "Rosneft" has decided that it is going to attract credits in the sum in excess of \$ 22 billion (within the framework of accumulating resources for purchasing the assets of "Yukos").

The borrowing activity of banks was much higher than that of nonfinancial companies. The year 2006 saw significant prevalence of the share of foreign liabilities of banks over the share of the corresponding assets, which was the consequence of the strategy of banks aimed at an accelerated formation of their liabilities denominated in foreign currencies and their reinvestment in rouble-denominated assets. The risks of such a policy for banks are that, in an event of a noticeable fall of the rouble's exchange rate, a fall in the return on rouble-denominated assets, or a growing cost of foreign currency – denominated borrowings, banks may be faced with the problem of liquidity. A lack of balance between the foreign currency – denominated assets and liabilities of banks was one of the main causes of the collapse of the biggest Russian banks in August 1998 in the situation of the rouble's rapid depreciation. In 2006 there existed a similar lack of balance between the assets and liabilities of banks, which was much greater than on the eve of the 1998 crisis. In 1997 it constituted 5.0 % of the value of assets (or liabilities) banks, while in 2006 it became as high as 7.7 %. This is indicative of growing liquidity risks faced by banks and the vulnerability of their financial status in an event of any significant changes in the external factors of the foreign currency and credit markets.

One traditional problem is represented by the low level of **the population's savings invested in securities**. The population's share in the stock exchange transactions on the MICEX, in the 2006 prices, amounted to approximately 20 %. The population is one of the main driving forces of the trade via the Internet, and the citizens are active in using the opportunities of marginal crediting for increasing yields and the volume of transactions on the stock market. According to the MICEX, the number of physical persons operating on the market at the end of 2006 was 250,000, or by 2.5 times higher than their number at the year's beginning.

However, the statistical data concerning the population's investments in securities within the first 11 months of 2006 have demonstrated that the population's contribution to the growth of the Russian stock market in 2006 was rather moderate. The share of the population's incomes invested in securities in 2006 amounted to 0.6 %, which is by 3 times less than the level of 1998 – the pre-crisis year. According to the

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<sup>13</sup> For the sake of fairness, it should be added that some analysts, for example A. Vernikov from "Aton – Line", have noted that in 2006 there appeared a trend of a gradual deterioration in the synchronicity of the circulation of shares, due to the appearance of new generators of market growth – companied dealing in energy carriers энергетических компаний and banks (see comments in Quote.ru of 29 January 2007).

data published by the Rosstat, the growth of the population's net investments in securities in 2006 was as high as 87.3 billion roubles, or \$ 3.2 billion, which is nearly by one-third higher than that registered last year. The population's savings in securities in 2006 are higher than the growth of the assets of banks invested in shares, but against the annual growth of capitalization in the amount of \$ 426 billion and the growth in liquidity on the stock-exchange share market in the amount of \$ 397 billion they appear to be rather modest. As for the total value of securities held by the population in 2006, it achieved the level of \$ 20 billion.

It should also be noted that, according to the preliminary data of the year 2006, two negative trends have emerged: the population's inclination in 2006 to invest their savings in financial assets - from 11.7 % of their incomes in 2005 to 8.0 % in 2006, and a dramatic growth of the population's debt against bank credits, which in 2006 became as high as 5.3 % of the population's incomes - nearly equal to the sum of the population's rouble-denominated bank deposits.

The rapid growth of the stock market and the attraction of resources through the placement of corporate bonds and IPO should, in an ideal situation, be conducive to growth of investments and economic boom. However, for this connection to become operative, the investments attracted by companies on the stock market must be real investments, that is, be aimed at creating new capacities, fixed assets and production stocks. Nevertheless, despite the very active growth in IPO and placements of corporate bonds, **the activity on the stock market has not resulted, so far, in real capital growth.**

As already mentioned earlier, in 2006 the companies from Russia attracted approximately \$ 17 billion within the framework of IPO, and another \$ 17 billion – through placing rouble-denominated bonds. At the same time, according to the Rosstat, of the \$ 17 billion received from the placement of shares only \$ 2.5 billion, or 14.7 % the total funds attracted in this way, was invested in fixed assets. Even more paradoxical is the statistics on the use of the \$ 17 billion yielded by the placement of corporate bonds. Only \$ 60 billion out of the aforesaid sum, or 0.4 %, was spent on the growth of fixed assets. Some allowances may be made for errors in the official statistical data, but on the whole this can hardly make any difference in terms of the main conclusion that the resources generated by issuing shares and bonds are not invested in fixed assets and thus have no impact on economic growth.

In all probability, the main bulk of these resources is spent on the refinancing of debt and the acquisition of assets from their effective owners. On the contemporary Russian stock market we can now see the same processes as were characteristic of the US market in the late 1980s, known was the financing of LBO (leverage-buy-out) transactions through the issue of junk bonds and IPOs. The transactions mainly represented large-scale borrowings on the stockom market by applying the lever of crediting for purposes of buying-up companies and their assets. The main risk associated with such transactions is the low performance of the companies being thus purchased, which may prove insufficient for the settling of debts incurred for purposes of such a purchase. In USA the junk bonds market ended in 1989 in a spectacular collapse of the corporate borrowers.

*A. Abramov, A. Radygin*

## **On the provision with pharmaceuticals of certain categories of citizens with the right to state social support**

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The program of additional provision of pharmaceuticals (hereinafter – the APP program) to certain categories of citizens was launched in 2005 due to the adoption of Law of the Russian Federation No 122 - FZ. In 2005 the APP program was implemented nearly without any mishaps, which provided grounds for the belief that in 2006 the dynamic of the indices pertaining to the APP programs, that is, the average cost of a prescription issued by a physician, the average monthly number of issued prescriptions, and the number of persons placed within the established categories of citizens, would be developing as before. However, this forecast proved to be unrealistic, and in 2006 the APP program was faced with some serious problems, the most important among which was the dramatically increased need in the financial backing of the pharmaceuticals delivered on preferential terms (free of charge or at a reduced price), coupled with the budget constraints established and approved in the budget of the federal system of mandatory medical insurance.

Resulting from the crisis situation that had emerged in the sphere of the provision of pharmaceuticals on preferential terms in the Russian Federation, some proposals were prepared by various related agencies of executive authority (including the RF Ministry for Economic Development and Trade) and submitted to the RF Ministry of Public Health Care and Social Development, which supervises the implementation of the APP program.

It should be noted that much has already been said about the risks associated with the APP program, including in the publications issued by the Institute for the Economy in Transition. Below we are going to attempt to determine the factors influencing the APP program's implementation and the measures capable of relatively reconciling the interests of all the subjects involved in the APP program.

### **The problems posed by the withdrawal from the APP program.**

The withdrawal from the APP program, in 2006, of 7.5 million citizens to whom Law No122-FZ can be applied has resulted in the diminishment of the amount of resources initially earmarked for covering the cost of the medications provided for those citizens who remained within the program. When those citizens who were relatively less in need of pharmaceuticals withdrew from the APP program, the solidarity principle of the distribution of funding was upset. The initially established per capita provision standard was calculated on the basis of the total contingent of privileged categories of citizens, and thereby its relatively small size was preserved (in 2006 – 424 roubles.) After those not in need of pharmaceuticals had been excluded from the program, and the money earmarked for them had been withdrawn, this standard estimate – 424 roubles per capita – was no longer sufficient for covering the needs of one citizen from the privileged category. The estimated needs of those citizens who remained in the program, as demonstrated by the results of 2006, turned out to be substantially higher.

Among the potential measures designed to relieve the crisis currently faced by the APP program and being now actively discussed, the imposition of restrictions on the withdrawal from it has not been suggested. No such proposal has been put forth by the RF Ministry of Public Health Care and Social Development, either, the reason for which is probably the political implications with which this problem is fraught.

In our opinion, if the inertia scenario of the situation's development is realized, the negative selection will continue. Therefore, it would be feasible, as one of the available alternatives, to coordinate the choice of a citizen as to whether he or she is going to stay within the APP system or not with the budget cycle – for example, by shifting the timeline for such a choice from the autumn to the spring of the year preceding the implementation of the APP program. Also, another option is possible – *the reduction of the amount of money compensation for those who has decided to leave the APP program* by comparison with the average per capita standard established for the whole preferential contingent.

### **The problems associated with the expansion of the range of persons to whom Law No 122-FZ of the Russian Federation applies.**

One more important problem is represented by the control over the process of recognizing a citizen as disabled. During the year 2005, the number of citizens targeted by Law FZ-122 increased from 14.2 million to 16.4 million. According to the data published by the Ministry of Public Health Care and Social Development, as of 1 January 2007 the number of persons with a "privileged" status was 17, 027, 220. This growth can largely be explained by the expansion of the range of persons granted the status of disability. The substantiation for disability in many instances appears dubious and must be confirmed by a more rigorous medical expert's estimation. The RF Ministry of Public Health Care and Social Development, being well aware of this risk, has begun to work at improving the performance of the bureaus for medico – social expertise, but the positive results achieved so far are insufficient for stabilizing the numbers of persons recognized as disabled.

### **The list of pharmaceuticals prescribed under the APP program.**

During 2006, substantial cuts were made in the list of pharmaceuticals covered by the APP program – from 1,740 trade names and 496 international non-patented names as of 31 March 2006 to 1386 trade names as of the end of 2006. According to the RF Ministry of Public Health Care and Social Development, from the beginning of 2007, 550 trade names of pharmaceuticals have been supplied to regions.

In our opinion, the APP program's cost can be brought down by *making more precise the list of pharmaceuticals, with its simultaneous inventory*, and by replacing the expensive items by their cheaper analogues, as well as by establishing an ultimate timeline for making changes to it (with no subsequent revisions during one year).

### **The optimization of medical care standards.**

Among the proposals being put forth by the RF Ministry of Public Health Care and Social Development and aimed at improving the infrastructure for providing the population with pharmaceuticals, there is a proposal for *the optimization of the medical care standards applied in the treatments of certain diseases, based*

*on medical proof and cost-effectiveness of pharmaceuticals.* This measure, indeed, has long been needed not only in terms of the financial and economic estimation of the already developed medical care standards, but also in connection with the medical care standards and tables of supplies to hospitals and outpatient clinics presently being developed. The financial feasibility study of the developed medical care standards, and first of all for those diseases in the treatment of which the most expensive pharmaceuticals are applied, would make it possible to optimize the list of pharmaceuticals to be used under the APP program.

### **Covering the cost of pharmaceuticals applied under the APP program**

In accordance with the approved plan of measures for optimizing the provision of necessary pharmaceuticals to the population, at present the RF Ministry of Public Health Care and Social Development is dealing with the problems created by the overpricing of pharmaceuticals being supplied within the APP program's framework, by carrying out experts' estimations of the invoices prepared by pharmaceutical organizations for the pharmaceuticals supplied in 2006 and submitted for payment to the territorial funds of mandatory medical insurance. As estimated by the RF Ministry of Public Health Care and Social Development, a thorough experts' estimation of the prescriptions issued in 2006 will result in up to 20 % of prescriptions being rejected.

In our opinion, in order to improve the control over the cost of the APP program, it will be necessary to establish *the mechanism of basic prices*, where emphasis is to be placed on the price of a less expensive pharmaceutical with a similar pharmacological effect, which is to be taken as a basic price. In this connection, two options are possible. The first one will be *for a citizen to cover the difference between the basic price and the more expensive pharmaceutical*. In this case, the system's solidarity will become lower, but the rationality of a citizen's behavior in the choice of a more expensive pharmaceutical will be higher. The second option will be *to establish a certain price bracket above the basic price within which a physician will be able to issue a prescription, and above the upper margin of that price bracket the prescription of a pharmaceutical must be executed by a special board*.

### **Insurance companies within the APP system.**

Insurance companies, contrary to the initial plans, have failed to become fully fledged participants in the APP system. For the year 2007, the RF Ministry of Public Health Care and Social Development has extended its policy of preventing the participation of insurance companies in the APP program, having submitted to the Government of the Russian Federation a draft decree of the Government of the Russian Federation "On making amendments to Item 1 of Decree of the Government of the Russian Federation of 29 December 2004, No 864". At the same time, both the Ministry of Public Health Care and Social Development and the insurers also have a general understanding of the potential of insurance companies for becoming informed buyers of pharmaceuticals for the needs of certain categories of citizens, but for such cooperation to be realized the insurers will need clearly determined and transparent rules.

It is noteworthy that the transfer of the functions of buyers of pharmaceuticals for privileged categories of citizens to insurance companies, with the implementation of a system for distributing the risks associated with the deviation of actual costs from the planned targets between an insurer and an outpatient clinic, on the one hand, and between an insurer and a territorial fund for mandatory medical insurance, on the other, will be possible only in the event of implementing the whole set of measures determined, in particular, in our materials. Only by increasing the responsibility of outpatient clinics for the procedure of prescribing pharmaceuticals and creating for them appropriate incentives for taking into account the financial aspect with the help of insurance companies will it become possible to decrease, on a large scale, the cost of pharmaceuticals being prescribed, and thus to provide an instrument for controlling the growth of the APP program's cost in the federal budget and the budgets of subjects of the Russian Federation.

*M. Gladkov*

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## **Introduction of a two-stage system of higher professional education**

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This review outlines the main provisions of a two-stage system of higher professional education adopted by the Russian government, contains a forecast assessment of to what extent this change will make it possible to improve the quality of education and the efficiency of the use of budget funds, and also identifies possible risks linked to the transition to the new system.

At a government session on 9 March, the Russian Ministry of Science and Education presented draft law "On amendments to several legislative acts of the Russian Federation (in terms of setting up levels of higher

professional education)". The draft law envisages the establishment in Russia of two levels of higher education: a bachelor's degree at the first level and a master's degree or professional training at the second level. The Russian system of higher education has been set the task to join the Bologna process by 2010. This task implies that by that time the list of professions that require one-stage training (professional qualification) and the list of professions that require two-stage training (both bachelor's and master's degree) will be defined.

At the moment Federal Law of 22 August 1996 "On higher and postgraduate professional education" envisages that main curricula in higher professional education can be implemented continuously and along the following steps: a bachelor's degree (at least four years of studying the main curricula); professional qualification (at least five years of studying the main curricula, with the exception of cases covered by the relevant state education standards); a master's degree (at least six years of studying the main curricula).

The draft law views studies for a bachelor's or master's degree or for a professional qualification as independent levels of higher education with separate state education standards and independent examinations on the basis of which a bachelor's or a master's degree or a professional qualification is awarded. The licensing, certification and state accreditation of higher educational establishments under a bachelor's, a master's or a professional qualification programmes are also proposed to be separated.

Admission to higher education establishments to study for a professional qualification, a list of which is set by the Russian government, or for a bachelor's degree will be carried out on the basis of applications from individuals who have completed secondary education or vocational training, on a competitive basis on the strength of the single state examination. Competition for admission to the second level of professional higher education is provided for in Article 43 of the Russian Constitution, under which everyone has the right – on a competitive basis – to receive free-of-charge higher education in a state or municipal education establishment and at work. The introduction of competition at the second stage of higher professional education will make it possible to enrol individuals who are best suited and prepared for mastering the curricula at this level. This is particularly relevant for creating flexible, customized education routes, for example entering the second level after gaining some professional experience or choosing a new area of studies for one's second stage of professional higher education.

The bill sets the required duration of studies for a bachelor's degree – from three to four years, depending on the subject; for a master's degree following a bachelor's degree – two years; for a professional qualification – at least five years. Postgraduate studies are open only to those who have a master's degree or a professional qualification. For some subjects and professions (for example, medicine) another duration of studies may be stipulated. A list of subjects (professions) for which the state education standard may set a different duration of studies to obtain a bachelor's or a master's degree or a professional qualification will be approved by the government of the Russian Federation.

At the moment the trend for a two-stage higher education is led by Moscow State University (offering a bachelor's degree in 28 subjects) and St Petersburg State University.

The bill is proposed to come into force on 1 September 2007. Since the adoption of this draft law may complicate the implementation of regulations which set qualification requirements for officials in certain positions or engaged in certain activities, it is proposed that simultaneously amendments to some legislative acts will be made to clarify the qualification requirements that some categories of officials need to meet.

It is expected that the adoption of this draft law will help to remove a sharp structural mismatch between the demand for and supply of university-educated workforce that exists on the Russian labour market. According to the Russian Science and Education Ministry, at the moment only 15-20 per cent of Russian universities train graduates who meet the requirements of the labour market. In the opinion of the Russian science and education minister, Andrey Fursenko, the two-level system will make it possible to spend budget funds more efficiently and to involve employers in forecasting future educational needs as well as to considerably expand their participation in financing human resources training, especially on the second level.

One of the main arguments in favour of adopting the two-level bachelor's-master's system is the need for Russian higher education to integrate into the world education space and meet international education standards.

At the same time it appears that the proposed model for moving to a two-stage system of higher professional education contains certain problems and risks the more substantial of which are the following:

1. The problem of content and of differences between the curricula and study plans under a bachelor's and a master's programmes; justification of requirements and criteria for the division between two levels. There is a risk that the move to the new system will become an imitation and a formal reduction of the duration of studies from five to four years. The experience of the above mentioned universities, which are already working under the new system, shows that the transition takes several years; therefore the mandatory introduction of the two stages of higher education for all universities from the next academic year is unlikely to mark a

real change in training. If the draft law merely provides the opportunity to move to the new system, it is not clear what its point is: this opportunity is already provided in the current legislation. That is why a thorough study and development of new curricula (together with teaching methodologies) for the bachelor's and master's levels are required.

2. Limited access to master's degrees, increase in the provision of paid-for education services. The transition to the two-stage system of higher education poses the question of the need for a better-justified regulation of budget-funded places on master's courses. The existing practice shows that the transition to what is in effect paid-for master's degrees becomes a crucial factor that limits access to higher education for certain categories of students. Some university vice chancellors predict that the bachelor's stage will retain its competitive basis, while the master's state will largely become paid-for. The most capable and talented students will get a quota for free education of about 30 per cent. Studies for a master's degree will provide students with research and analytical skills required to become university professors, do research in the academic or commercial sector.

3. Uncertainty over the status of graduates with bachelor's degrees in the eyes of prospective employers. Future employers are uncertain in their assessment of the two-stage system of higher education. The labour market does not yet consider graduates with bachelor's degrees as full-fledged experts. At the same time polls conducted among employers show that when recruiting an individual, they are considering a whole set of factors, primarily their relevant professional training: employers are interested not so much in formal qualifications as in skills and work experience.

4. Cuts in budget funding for universities. Some university vice chancellors are concerned that the transition to a two-stage system may lead to cuts in the amount of budget funds their universities receive because the duration of studies for a bachelor's degree is four years as compared with the five years of current professional training.

Thus, one has to admit that for the Russian system of higher education the transition to the two-stage system and integration with the Bologna process presents not just the formal task of changing the duration of studies at different levels but the problem of filling curricula with new content in accordance with employers' requirements and the need to enable Russian graduates to compete on the modern labour market, both domestic and international.

*I. Rozhdestvenskaya*

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## **New trends in Russia's migration policy**

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In 2006-2007 Russia adopted a set of laws and regulations aimed to change the situation with regulating migration flows, to make international migration manageable and predictable. The main changes referred to the administrative registration of migrants and their employment in Russia. However, a number of problems remain, in particular as regards the economic justification of some decisions in migration policy – the introduction of quotas for foreign workforce and the ban on foreigners' to work in the retail sector.

The second half of 2006 and especially early 2007 marked a period of an unprecedented rise in attention paid by the Russia legislative and executive authorities to the problem of international migration to the country. That was manifest in the adoption of a number of regulations that introduced a drastic change to rules governing foreign nationals' residence and registration in Russia. Significant changes have been introduced to regulations governing foreign nationals' work in Russia. Let us consider the innovations brought by these laws and regulations, their expected results and possible bottlenecks.

The first laws and subsequent regulations for international migration were adopted in post-Soviet Russia in the early 1990s and were defined by new trends in international migration. The new laws and other provisions were largely about regulating flows of forced migrants from former Soviet republics; ensuring the new rights and freedoms of former Soviet citizens in terms of their place of residence; setting rules for entering and leaving Russia given more open borders and the creation of the institute of citizenship of the new independent states.

In the mid-1990s there came a certain turning point in the nature of migration processes: the flows of forced migrants had been gradually replaced by flows of labour migrants, which necessitated the adoption of special regulations governing the status of foreign workers and rules for recruiting foreign workforce in Russia. The relevant legislative process developed not only at the federal level: many regions used their right for legislative initiative to adopt their own laws and regulations, which often ran counter to federal regulations.

By the late 1990s it became clear that a new legislative field was needed in which foreign nationals could legally arrive, study and work in Russia. For several years work continued on a set of new federal norms

which culminated in 2002 in the adoption of a law on the legal status of foreign nations and in 2003, of a law on Russian citizenship.

So why just several years after all that did a drastic revision of the recently adopted laws and the development of some new regulations become necessary? A rather tough approach to regulating the status of foreign nationals' in Russia, especially labour migrants, resulted in violations of the laws on a massive scale. The large scale of illegal labour migration in Russia in the early 2000s<sup>14</sup> was largely provoked by the considerable difficulties foreign national encountered when obtaining registration and work permits and the inefficiency of the existing mechanism for controlling employers' activities. The procedure for employers to obtain permission to recruit foreign workforce was also very complicated.

What is the gist of the main changes in Russian migration laws, which many experts believe to be to a certain extent revolutionary? On the whole, the new regulations remove part of excessive obstacles, which were of little value in terms of managing the migration situation and by default discouraged a considerable section of migrants (and employers) from abiding by the law. The liberalization covered, among other things, the procedure of registering foreigners who arrive in Russia on short stays and the procedure of obtaining work permits for citizens of countries, which have a visa-free regime with Russia. Excessive administrative procedures that applied when Russian employers took on these workers were scrapped. Together with simplifying the legalization of foreign nationals' stay and employment in Russia, tougher administrative punishments for violating the new norms<sup>15</sup> were introduced. Changes have also been made to quotas for foreign workforce and to regulations for employing migrants in different sectors.

The new rules for the administrative registration of short-term migrants differ from the old ones in that foreigners visiting Russia no longer have to spend endless hours in the local passport and visa departments and be accompanied by all grown-up residents in the address at which they were planning to get their registration. Instead, a representative of the receiving side (for example, a Russian resident or a representative of the foreign national's prospective employer) needs to fill in a special form and post it to the local branch of the Federal Migration Service. At the post office the sender is given a stamped slip, which later serves as proof of the foreigner's legal stay in Russia<sup>16</sup>. Another feature of the new registration requirements envisaged by the law on migration registration is the possibility to get registered not at one's residential address – as required by the previous law<sup>17</sup> - but at a legal entity address, for example that of the employer. This considerably simplifies the registration procedure, however does not remove the problem of providing foreign employees with decent living conditions.

The new regulation governing the procedure for obtaining a work permit in Russia contains a clearer explanation of differences in the rights and obligations of foreigners coming from countries which have a visa regime with Russia and those that don't. Citizens of those countries which have a visa-free agreement with Russia can be issued with a work permit directly at the Federal Migration Service's local branches and without the employer's involvement, as used to be the case which complicated the work permit procedure by adding several more stages to it. For their part, employers of nationals from countries, which have a visa-free regime with Russia, do not need to obtain work permits for these employees. Old rules for employees and employers are retained only for migrants who cannot enter Russia without a visa.

Judging from pronouncements by senior officials of the Federal Migration Service and from media reports, the liberalization of legislation has brought about a sharp increase in the number of migrants who wish to make their stay and work in Russia legal. However, the structure that was meant to service the new regulations, has turned out to be not ready, which has resulted in long queues (at post offices and divisions of the Migration Service) and an immediate reaction from intermediaries who – for a rather high fee – are offering

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<sup>14</sup> Experts, who adhere to a balanced approach to estimating the number of illegal migrants in Russia, agree on an average annual figure of 4-5 million foreign nationals, as opposed to the persistently quoted in the media amount of 15 million. The latter figure seems excessive. Given the specific gender and age structure of labour migrants and even more specific structure of their employment in different sectors of Russian economy, the proponents of the 15-million figure must admit that in such sectors as retail trade, construction and several others, the number of illegal migrants (predominantly, men) equals the total number of employed Russian nationals, hence their contribution to total output produced.

<sup>15</sup> See Federal Law No 189-FZ of 5 November 2006 on amendments to the Russian Code of Administrative Violations (as regards tougher punishments for violating the procedure of employing foreign nationals and individuals without citizenship). This article does not consider that aspect of the law.

<sup>16</sup> Russian Government Regulation No 9 of 15 January 2007 "On procedure for migration registration in the Russian Federation of foreign nationals and individuals without citizenship".

<sup>17</sup> the same requirement applies to Russian citizens who wish to obtain a temporary registration at a location different from their permanent address.

to post notifications of migration registration and to obtain work permits. It is worth noting that by now there has come a certain change in the authorities' attitude to this problem. The work of post offices in terms of coping with the new functions has been streamlined; regions which accept labour migrants (namely, Moscow) are planning to build basic mobile hotels to accommodate foreign labourers; the creation of a network of state-licensed agencies which would assist in migrants' registration is being considered and so on. Thus the year 2007 may become a period of radical change in the migration situation in Russia, a period when a large number of labour migrants will be legalized, when their legal and economic status will be clarified.

However, not all regulations adopted recently can be interpreted in an unequivocally positive light.

An understandable debate has been stirred by a government regulation that banned in 2007 labour migrants from working as vendors at Russian markets, one of the justifications for which was the notion that Russian citizens (allegedly) can and want to engage in trade<sup>18</sup>. Research shows (and it is accepted by the majority of experts) that migrants occupy specific niches in the labour market, without entering into competition with Russian workforce<sup>19</sup>. The ban on migrants<sup>20</sup> to work at markets does not resolve the problem of the criminalization of retail trade; rather it only increases its shadow-economy component. In addition, this policy may well result in empty market stalls, which in some regions will definitely lead to negative consequences for the regional economy and will turn out to be to the extreme disadvantage of the majority of the population. It is perfectly clear that the majority of problems in market trade are linked not to hired vendors who were manning market stalls across Russia, but to the activities of the senior levels in ethnic diaspora communities closely linked to the criminal world. As a rule, these people have long obtained Russian citizenship and registration in major Russian cities.

A few words need to be said regarding new regulations on quotas on foreign workforce. This system, as a whole, has posed and continues to pose numerous questions. Until November 2006 there was no issue of quotas for jobs for nationals from countries with visa-free regime with Russia: quotas referred to invitations for individuals who came to Russia on a work visa. In the first years following the introduction of quotas on invitations for labour migrants from visa-regime countries, they were not fully used up. In November 2006 it was decided<sup>21</sup> to introduce a quota on work permits for nationals of countries which have a visa-free regime with Russia and set it at 6 million work permits. In foreign countries, whose experience the Russian authors of the law must have used, quotas are introduced if 1) it is necessary to contain the inflow of immigrants and 2) there are efficient mechanisms to ensure that containment. Russia at the moment has a need not to limit the inflow of immigrants but to increase the legal migration component. At the same time the mechanisms for exercising this need and controlling migrants' stay and work in the country do not work very well. The point of creating the institute of quotas was questioned from the very beginning. The figure of over 6 million workers, which has no equivalent anywhere else in the world, indirectly proves that the introduction of quotas on labour migrants in Russia – at least at this stage – is pointless and, in any event, does not have clear and economically justified grounds. The demand for seasonal, temporary and long-term workers has not been calculated, which only adds to the uncertainty over the point of the introduced quotas.

Thus, alongside regulations which make migration policy procedures more logical and convenient for migrants and the state, in recent months there have been adopted regulations that do not have sufficient justification, which makes their efficiency questionable.

*O. Chudinovskikh*

## **Issues considered at Russian government sessions in March 2007**

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In March the government of the Russian Federation considered the following issues: draft key areas of tax policy for 2008-2010; means of improving the administration of the value-added tax; draft key areas of customs policy for 2008-2010; draft law on establishing a register of municipal regulations; draft three-year budget for 2008-2010; draft key areas of debt policy for 2008-2010; results of implementing the programme

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<sup>18</sup> See Russian Government Regulation No 683 of 15 November 2006 "On setting for 2007 the permissible share of foreign employees employed by retail businesses in the Russian Federation".

<sup>19</sup> See, for example, E. Tjurjukanova "Forced labour in modern Russia: Uncontrolled migration and human trafficking." International Labour Organization, Geneva, 2006, pp 89, 94.

<sup>20</sup> in effect amounting to a ban on profession

<sup>21</sup> Russian Government Regulation No 682 of 15 November 2006 "On setting for 2007 a quota for work permits for foreign nationals arriving in the Russian Federation visa-free"; for nationals of other countries there another government regulation, No 665 of 11 November 2006 "On setting for 2007 a quota for issuing invitations for foreign nationals to enter Russia to work in retail trade".

of Russia's state internal and external borrowing in 2006, and draft programmes of state internal and external borrowing for 2008-2010.

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The Russian government session on 2 March discussed a draft of key areas of tax policy for 2008-2010 . Under this draft the main areas for developing medium-term tax policy are: control over transfer pricing for taxation purposes; taxation of dividends paid to Russian nationals; regulation of taxation of controlled foreign companies; issues of defining tax residence of legal entities; introduction of the institute of consolidated tax accounts when calculating profit tax; improvement of the value-added tax; profit tax on securities transactions; income tax on securities transactions and others.

The session also discussed the Finance Ministry's report on improving VAT administration. The report noted a drop in VAT revenues in the budget. The relevant federal agencies were instructed to develop a plan for improving VAT administration, including measures to increase VAT revenues in 2007 by – among other things – reducing arrears, and measures to improve controls over recovering VAT for transactions taxable at the 0-per-cent rate and others.

At the same session the government listened to reports from the economic development and trade minister and the head of the Federal Tax Service and approved a draft of main areas of tax policy for 2008-2010 they had developed together with the other relevant federal bodies.

The government session on 15 March discussed the implementation of the president's budget address to the Federal Assembly on budget policy for 2008-2010. The government instructed heads of federal executive bodies to carry out their activities and draw up the federal budget for 2008 and up to 2010 on the basis of key tasks set in the president's budget address, namely: to provide funding for adopted decisions on the implementation of large-scale programmes and projects of national significance; to improve the efficiency and effectiveness of the use of budget funds; to use combined principles of forming and carrying out state capital investments and others.

At the same session the government discussed draft federal law "On amendments to several legislative acts linked to the establishment and maintenance of a register of municipal legal acts". The draft law is aimed at governing the powers of state authorities in constituent entities of the Russian Federation as regards the establishment and maintenance of the municipal register and of the authorized federal body of executive power as regards the maintenance of a federal register of municipal legal acts. The government approved the draft law.

The government session on 22 March listened to several reports from the finance minister.

The Russian finance minister's report on the outcomes of implementing the programme of state internal and external borrowings of the Russian Federation in 2006 and on draft programmes of state internal and external borrowings of the Russian Federation for 2008-2010. The session largely approved the draft programmes of state internal and external borrowings of the Russian Federation for 2008-2010. In addition, the Finance Ministry, the Economic Development and Trade Ministry and the Federal Financial Markets Service together with the Bank of Russia were instructed to ensure monitoring of external borrowings in the corporate sector in order to use its outcomes in assessing the Russian Federation's debt stability. Progress in the above work is to be reported to the government by 20 May 2007.

The Russian finance minister's report "On key characteristics of the draft federal budget for 2008 and up to 2010 and the allocation of federal budget revenues during that period along the ministerial structure and sections of the functional classification of expenditures of Russian Federation budgets". The key characteristics of the federal budget for 2008 and up to 2010 were adopted as a basis for preparing a draft three-year federal budget, including the allocation of expenditures in the 2008-2010 federal budget alongside the ministerial structure and sections of functional classification of expenditures of Russian Federation budgets.

The government session on 29 March discussed draft federal law "On invalidating Federal Law 'On financial-industrial groups'". The draft law had been developed by the Economic Development and Trade Ministry to fulfil a ruling of the government commission on administrative reform to end excessive state regulation that had been approved by the Russian Federation government and to recognize that Federal Law "On financial-industrial groups" had become void.

At the same session the government discussed a draft government regulation on a procedure for hearing disputes that arise between bodies that regulate tariffs and surcharges for goods and services in the utilities sector and public utility companies that had been drawn up by the Federal Service on Tariffs in accordance with Federal Law "On basic principles of regulating tariffs in the utilities sector".

Under the above draft, the Federal Service on Tariffs is the federal executive body authorized to consider disputes arising between executive bodies of power in constituent parts of the Russian Federation that regulate tariffs for goods and services of public utility companies, local authorities that regulate tariffs and sur-

charges by public utility companies and public utility companies themselves as regards set tariffs and surcharges in compliance with the procedure proposed in the draft. The draft sets the time frame and procedure for considering a statement of disagreements. It also outlines grounds for refusing to consider a statement of disagreements or suspending the deadline for considering the dispute.

*M. Goldin*

## **A review of economic legislation for March 2007.**

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In March, the following alterations were introduced in current legislation: amendments to Article 217 of the RF Tax Code in the part concerning the exemption of the grants allocated by Russian organizations to support science & education and culture & art from the personal income tax; the law on municipal service was adopted; changes were introduced in the list of foreign and international organizations whose grants should not be taken into account for purposes of taxation as part of the incomes of Russian organizations; and the data to be applied for calculating the tax on the extraction of mineral resources in regard to oil, for February 2007, were published.

### **I. FEDERAL LAWS of the Russian Federation**

1. "ON THE INTRODUCTION OF ALTERATIONS IN ARTICLE 217 OF PART TWO OF THE TAX CODE OF THE RUSSIAN FEDERATION" of 23 March 2007, No 38 – FZ .

The Law enters into force from 1 January 2008, but no earlier than one month after the date of its official publication.

In accordance with the introduced alterations, the taxpayers will be exempted from taxation with regard to the sums received by them in the form of grants (or gratis aid) allocated to support science & education and culture & art in the Russian Federation, including the Russian entered in the list authorized by the RF Government. At present, the sums in the form of grants received from international and foreign organizations are not subject to exemption from the personal income tax.

2. "ON MUNICIPAL SERVICE IN THE RUSSIAN FEDERATION" of 2 March 2007, No 25 - FZ

The Law enters into force from 1 June 2007.

The Law is aimed at improving the institution of municipal service in the Russian Federation. Municipal service is understood as the vocational activity of citizens of the Russian Federation, and in the instances specified by the law, also of citizens of other states, pursued on a permanent basis in the form of municipal service jobs held by way of concluding a labor agreement (or contract).

The Law has regulated the relations dealing with the taking, holding and terminating of a job, and also with the definition of the legal status of municipal employees. The right to enter municipal service is granted to persons who have reached the age of 18, have a working knowledge of the official language of the Russian Federation, and meet the corresponding qualifying requirements established for holding municipal service jobs. A citizen should not be granted a job in municipal service after he or she has reached the age of 65, the limiting age established for holding municipal service jobs (previously, the age limit was 60 years). The qualifying requirements regarding the level of vocational education, the length of being employed in municipal service or the length of practicing one's profession, and the professional knowledge and skills, should be established by municipal legal acts on the basis of the standard qualifying requirements established by a law of a RF subject in accordance with the classification of municipal service jobs.

The Law has determined the procedure for creating the jobs, for their classification and for the conditions for their inclusion in the Register of municipal service jobs in a subject of the Russian Federation, and has also determined the major qualifying requirements for holding these jobs.

The Law has consolidated the legal status of a municipal employee: his or her rights and responsibilities, the limitations and prohibitions dealing with municipal service, and the procedure for the submission, by the employees, of the data on their incomes and property.

Special chapters are devoted to: the remuneration of municipal employees and the guarantees granted to them; the procedure for estimating the length of work in municipal service; the incentives for and the disciplinary responsibility of municipal employees; and the organization of personnel management in a municipal formation.

The Law does not define the status of the persons who hold municipal jobs without being municipal employees, that is, deputies and members of elected bodies of local self - government, and elected officials of local self – government bodies, members of the electoral commissions of municipal formations functioning on a permanent basis and being juridical persons with the right of decisive voice.

From 1 June 2007 onward, the Federal Law of 8 January 2007, No 8 – FZ, “On the Fundamental Principles of Municipal Service in the Russian Federation” (with all the alterations included) should be deemed to be null and void.

## **II. DECREES OF THE GOVERNMENT of the Russian Federation**

1. “ON THE INTRODUCTION OF ALTERATIONS IN THE LIST OF FOREIGN AND INTERNATIONAL ORGANIZATIONS WHOSE GRANTS ARE NOT TO BE TAKEN INTO ACCOUNT FOR PURPOSES OF TAXATION AS PART OF THE INCOMES OF THE RUSSIAN ORGANIZATIONS – RECIPIENTS OF THE GRANTS AUTHORIZED BY DECREE OF THE GOVERNMENT OF THE RUSSIAN FEDERATION OF 24 DECEMBER 2002, No 923” OF 15 MARCH 2007, No 159

For purposes of applying Subitem 14 of Item 1 of Article 251 of the RF Tax Code, the list of the foreign and international organizations whose grants should not be taken into account for purposes of taxation as part of the incomes of Russian organizations – recipients of the grants is extended by the additional inclusion of nine organization, while one organization from the number of those on the list is excluded from it.

## **III. ORDERS, LETTERS**

1. Order of the RF Ministry of Justice “ON THE APPROVAL OF THE DECISION – MAKING PROCEDURE CONCERNING STATE REGISTRATION OF THE EMBLEMS OF NONCOMMERCIAL ORGANIZATIONS AND THE SYMBOLS OF SOCIAL ASSOCIATIONS” of 22.02. 2007, No 39

The document regulates the activity of the RF Federal Registration Service with regard to decision - making concerning State registration of the emblems of noncommercial organizations and other symbols of social associations acceptable for public use. Relegated to the symbols of a social association are the emblem, the flag, the pennant, and other symbols, while the emblem is relegated to the symbols of other noncommercial organizations<sup>22</sup>. The symbols of a noncommercial organization, including a social association, which include images and descriptions, should be approved by the authorized control agency in accordance with the constituent documents of a given noncommercial organization. The consideration of the appeal and the preparation of a corresponding decision by the RF Federal Registration Service should be completed within thirty working days from the day on which the necessary documents were submitted.

2. Letter of the RF Federal Tax Service “ON THE DATA NECESSARY FOR CALCULATING THE TAX ON THE EXTRACTION OF MINERAL RESOURCES, IN REGARD TO OIL, FOR FEBRUARY 2007” of 16 March 2007, No ChD-6-21/197@

The data used for calculating the tax on the extraction of mineral resources, in regard to oil, for February 2007 were published as guidance, to be applied in actual practice:

- the average level of the prices of “Urals” – 53.57 USD / barrel;
- the average USD - RRB exchange rate for all the days of the tax period – 26.3354;
- the value of price coefficient – 4.5133.

*I. Tolmacheva*

## **Summary of taxation regulations adopted in February – March 2007**

1. Russian Federal Tax Service Letter No GV-6-05/172@ of 9 March 2007 and Russian Finance Ministry Letter No 03-04-07-02/4 of 14 February 2007 clarify issues of how to prepare forms for calculating advance payments on the single social tax and mandatory pension insurance payments for accounting periods in 2007 as well as issues of submitting single social tax declarations by individual businessmen and lawyers for the year 2006. Since the Federal Tax Service believed it unnecessary to devise a new form, in 2007 – just as in 2006 – calculations submitted to tax authorities should be based on forms approved by Russian Finance Ministry Order No 48n of 24 March 2005. As for individual businessmen and lawyers submitting single social tax declarations for 2006, they should use Russian Tax and Levies Ministry Order No BG-3-05/649 of 13 November 2002.

2. Russian Finance Ministry Letter No 03-11-02/62 of 2 March 2007 sets the K1 deflator coefficient for applying Chapter 26.3 on the single tax for imputed earnings for certain activities. The tax basis (imputed earnings) is calculated as a product of the basic yield on a certain type of business activity and the value of the physical factor characterizing this activity and the deflator coefficient.

<sup>22</sup> Envisaged by Article 24 of Federal Law “On Social Associations” of 19 May 1995, No 82 – FZ, and by Article – of Federal Law “On Noncommercial Organizations” of 12 January 1996, No 7 – FZ.

The deflator coefficient is calculated as a product of annual coefficients for a series of consecutive years. In 2006 it was set at 1.132. Russian Economic Development and Trade Ministry Order No 359 of 3 November 2006 sets the value of this coefficient for 2007 at 1.096. Thus, when the single tax on imputed earnings is calculated, starting on 1 January 2007 the value of the K1 coefficient should be 1.241 (i.e.  $1.132 \times 1.096$ ).

3. Russian Federal Tax Service Order No MM-3-13/90@ of 27 February 2007 introduces changes to the format of submitting tax declarations, accounting and other reports that are used to calculate and pay taxes and levies electronically (version 3.00), as approved by Russian Taxes and Levies Ministry Order No BG-3-13/705@ of 22 December 2003.

Russian Federal Tax Service Letter No GI-6-04/135@ of 21 February 2007 explains the procedure for tax agents (organizations and their autonomous divisions) to submit information on individuals' incomes.

It is explained that the information is submitted to the tax authority either 1) at the location where the organisation's head office is registered with tax authorities – for the whole organisation, including its autonomous divisions, or 2) separately for the head office and its structural units.

5. Russian Finance Ministry, Federal Treasury and Central Bank Letters No 03-04-08-01/7; No 42-7.1-15/5.2-69 RF; No 20-T of 20 February 2007 clarify issues of how the simplified procedure for individuals to declare their income is applied.

Applications for individuals' transfers of declaration payments are not sent by credit organizations to the relevant regional branches of the Federal Treasury. Instead they are kept by the credit organizations until 1 January 2012. When a credit organization receives from an individual a payment document, an application for the transfer of the declaration payment, they themselves compile a document for the payment of the relevant amount to the account of the relevant regional branch of the Federal Treasury in compliance with regulations for registering information in the sections of payment documents for the transfer of taxes, levies and other payments to the Russian Federation budget system. There is no fee for transferring declaration payments.

6. Russian Federal Tax Service Letter No GB-6-05/214@ of 19 March 2007 and Russian Finance Ministry Letter No 03-04-07-02/3 of 30 January 2007 clarify the issue of recognizing that – for the purposes of calculating the single social tax – the definition of an agricultural producer provided in Federal Law No 193-FZ of 8 December 1995 "On agricultural cooperation" and the definition of an organization engaged in agricultural production provided in Federal Law No 167-FZ of 15 January 2001 "On mandatory pension insurance in the Russian Federation" are identical.

*L. Anisimova*

A review of budget legislation for March 2007

In March 2007, the RF President delivered, to the RF Federal Assembly and the RF Government, the Budget Message "On Budgetary Policy in the Years 2008 – 2010". Apart from this, the following changes took place in budget legislation: the Law "On the Execution of the Budget of the Social Insurance Fund of the Russian Federation for the Year 2005" and the Law "On the Budget of the Mandatory Medical Insurance Federal Fund for the Year 2007" were adopted. Also adopted were the Decree of the RF Government "On the Measures Aimed at the Implementation of the Federal Law "On the Federal Budget for the Year 2007" and a number of other legal acts of the RF Government.

The RF President's Budget Message to the Federal Assembly, of 9 March 2007, "On Budgetary Policy in the Years 2008 – 2010"

The Budget Message specifies the principal directions and aims of budgetary policy in 2008 – 2010. The Message analyzes the major results of budgetary policy in the years 2000 – 2006, and in particular, the creation of an efficient system for managing public finances, the reforming of interbudgetary relations, the adequate balancing of budget assets and liabilities, etc. .

Also, the Message formulates the principles of budgeting strategy for the years 2008 – 2010 and for a longer term. The Federal Budget should become an efficient instrument of macroeconomic regulation. It is planned to ensure the long – term balancing of the budget and to reduce the rate of inflation to 3 – 4% per annum. It is also planned to increase the period of budgetary planning in the Russian national economy and to approve the federal budget for a three – year period as a base for switching over to long – term financial planning.

Also defined as major tasks are the achievement of an adequate execution of spending obligations, the analysis of the efficiency of all budget expenditures, the transition to modern principles of making state capital investments, etc.

Stated as major priorities are the allocation of funds to the implementation of high – priority national projects; the financing of measures designed to develop the agroindustrial complex; the execution of payments

at the expense of parent (or holding) capital, etc. Also, the Message outlines certain measures designed to improve interbudgetary relations.

## **Federal legislation**

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The Federal Law, of 28 February 2007, “On the Execution of the Budget of the Social Insurance Fund of the Russian Federation for the Year 2005”

The Law approves the report on executing the Social Insurance Fund’s budget for the year 2005 in the amount of 186,692,034.8 thousand roubles on the revenue side, and in the amount of 165,311,675.8 thousand roubles on the expenditure side, with revenue exceeding expenditure by 21,380,359.0 thousand roubles with regard to the sources of internal financing of the deficit of the Fund’s budget for the year 2005, and also with regard to the structure of the budget’s expenditure by items, subitems, target items and the types of expenditures specified in the functional classification of expenditures of budgets of the Russian Federation.

Federal Law of 13 March 2007, No 35 – FZ, “On the Introduction of Alterations in the Federal Law “On the Budget of the Mandatory Medical Insurance Federal Fund for the Year 2007”. The Law enters into force as of the day of its official publication.

The Law introduces alterations in Article 8 of Federal Law of 29 December 2006, No 243 – FZ, “On the Budget of the Mandatory Medical Insurance Federal Fund for the Year 2007”. The alterations are caused by the necessity to extend the time for completing the settlements with the mandatory medical insurance territorial funds with regard to the pharmaceuticals actually supplied to individual categories of citizens in the year 2006, and also by the necessity to determine the additional sources for the funding to be allocated in order to achieve these ends.

The alterations introduced by this Federal Law extend to the legal relations which have arisen since 1 January 2007.

### **Legal acts of the RF Government**

The Decree of the RF Government, of 19 February 2007, “On the procedure for the allocation, in the Year 2007, by the Mandatory Medical Insurance Federal Fund to the mandatory medical insurance territorial funds, of the resources to finance the implementation of the territorial programs of mandatory medical insurance within the basic program of mandatory medical insurance”

In particular, the approved Procedure establishes that the Mandatory Medical Insurance Federal Fund should allocate, to the budgets of territorial funds, subsidies and resources from the federal budget.

The Decree specifies that the use of the afore-said resources should be purpose – oriented – the subsidies should be allocated to the implementation of the territorial programs of mandatory medical insurance, while the federal budget’s resources – to the provision of state social aid to individual categories of citizens, in the form of supplying them with pharmaceuticals.

It is established that the jurisdiction of this document extends to the legal relations which have emerged since 1 January 2007.

Decree of the RF Government of 23 February 2007, No 126, “On the Measures Aimed at the Implementation of the Federal Law “On the Federal Budget for the Year 2007”.

The Decree establishes the procedure for executing the federal budget for the year 2007. It is pointed out that the execution of the federal budget should be effectuated in accordance with the consolidated revenue and expenditure of the 2007 federal budget and should follow the procedure established by the RF Ministry of Finance.

Also, the Decree determines the procedure for introducing alterations in the consolidated budget revenue and expenditure in the year 2007, and the procedure for approving the limits of budget obligations.

Apart from this, the Decree gives a number of instructions on the execution of the 2007 federal budget to the federal agencies of state authority – the administrators of the federal budget’s revenues, and to the federal agencies of state authority – the administrators of the sources of internal and external financing of the federal budget’s deficit. Also, it establishes the procedure for granting and spending the subventions and subsidies to be allocated from the federal budget to the budgets of subjects of the Russian Federation for various purposes envisaged by Federal Law of 19 December 2006, No 238 – FZ, “On the Federal Budget for the Year 2007”.

Decree of the RF Government of 03 March 2007, No 137, “On the approval of the procedure for granting the subsidies, from the Federal Fund for Co-Financing Social Expenditures, designed to partially compen-

sate the budgets of subjects of the Russian Federation for the expenditures on granting rent and utilities subsidies to citizens”.

The approved Regulation determines the terms and procedure for granting the subsidies, from the Federal Fund for Co-Financing Social Expenditures, designed to partially compensate the budgets of subjects of the Russian Federation for the expenditures on granting the rent and utilities subsidies to citizens, and on calculating the size of these subsidies.

In this connection, the previously published decrees of the RF Government which contain similar norms are to be deemed to be null and void.

### **Letters of the RF Ministry of Finance**

Letter of the RF Ministry of Finance, of 08 February 2007, No 02-14-07/274, “On the Procedure for the Conduct of Revaluation”

The Letter informs on the recommended procedure for conducting the revaluation of fixed and intangible assets by budgeted enterprises, and for the reflection of its results in budgetary accounting and reporting.

In particular, it is announced that the revaluation of the objects of fixed assets and intangible assets as of 1 January 2007 should be carried out within the first six month of the year 2007.

In order to carry out the revaluation, a commission should be set up, which will include representatives of the economic departments of a corresponding enterprise and will be chaired by the head of the enterprise or by one of his or her deputies. The results of the revaluation should be recorded in an arbitrarily formulated statement signed by the members of the afore – said commission.

The Letter explains the use of three categories of the additional downward adjustment coefficients approved for revaluating individual categories of non-financial assets.

Also, the document specifies the procedure for revaluating those fixed and intangible assets which have not been revalued in 2003 prices.

For purposes of guaranteeing the accuracy of estimations and making it possible to efficiently carry out the checking of the estimations performed, the Letter recommends the report forms to be applied for the revaluation of non-financial assets and for the revaluation of buildings and structures, and also the form of a consolidated report on the revaluation of non-financial assets and on the calculated depreciation of assets as of 1 January 2007.

*M. Goldin*