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The review provides a detailed analysis of main trends in Russia's economy in 2009. The paper contains five big sections that highlight single aspects of Russia's economic development: the socio-political context; the monetary and credit and financial spheres; the real sector; social sphere; institutional challenges. The paper employs a huge mass of statistical data that forms the basis of original computation and numerous charts.

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In memoriam of Yegor Gaidar



Yegor Gaidar, founder and director of the Institute for the Economy in Transition, passed away on 16 December 2009.

His death is an irreplaceable loss for the Institute, just as it is for Russia. Yegor Gaidar is usually referred to as 'former Prime Minister', and the market reforms of the first half of the 1990s as 'the Gaidar reforms'. However, he was never even a Prime Minister – his official post was that of 'Acting Chairman of the Government of the Russian Federation', and he actually remained in office for only six months — from June through December 1992; for seven months before that, and then for another four months in 1993-94 he was Deputy Chairman of the RF Government. However, this was enough for a whole era in Russia's history to be inextricably associated with the name of Yegor Gaidar. The power of his intellect, his honesty, integrity and true courage made him a moral leader of Russian reforms of the late 20th century.

He effectively became head of the government precisely when the country was on the brink of an economic and political disaster, both the economic and the administrative systems of the government having by then become dysfunctional. Gaidar managed to lay foundations for the new market-oriented institutions and, moreover, to prevent the familiar revolution scenario when the collapse of the former regime is followed by a period of universal chaos, unrest and bloodshed.

His instinct of a brilliant economist was augmented by political astuteness based on a profound knowledge of history. Unlike an overwhelming majority of his contemporaries, his deep insight into historical perspectives was combined with sufficient moral courage enabling him to put forth his visionary initiatives despite resistance and a general lack of understanding. This is what makes Yegor Gaidar an epoch-making figure.

While heading the Institute for the Economy of Transition, Yegor Gaidar set up a school of economists capable of bringing theoretical research to the level of economic policy advice and of assessing the political consequences of economic decisions with due regard for the specificity of economic laws in conditions of systemic social transformation. Due to his intellectual honesty and moral integrity combined with fearlessness in political decision-making, Yegor Gaidar was recognized as top authority even by his opponents, and so became one of the indisputable champions of Russia's civil society.

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Crisis and Russia[1]

"Economic Policy" journal has already published my articles on the impact of cyclic nature of global economic growth on the Russian economy and policy[2]. Making analysis of an ongoing economic crisis is the task dangerous to professional reputation. Nevertheless, the impact of the crisis on the life of the country is too serious to leave the analysis of current economic situation to historians of the future.

Institute for Economy in Transition has prepared and published two books on the impact of processes of global economic slowdown in Russia[3]. The World Bank took a similar decision and in November 2009 presented a book on the impact of the crisis on the economies of emerging markets. It was originally designed as a book about twenty years of transition, but the severity of problems caused by the crisis led the authors to revise priorities[4].

The global economic crisis, especially as deep as the current one is a dynamic process. The economic situation is changing, it is not easy to predict it. Let me once again address the issue, how the events in the world economy affect Russia.

For the majority of Experts the economic crisis was a complete surprise, they failed to predict it. This is not a result of the lack of effort or low expertise of economists. It is rather a natural result of fundamental changes in the global economy that emerged at the turn of XVIII-XIX centuries, characterized as modern economic growth by Simon Kuznets. Now the global economy is changing rapidly (and it is often unpredictable). Acceleration of growth of per capita GDP and related changes in social indicators are followed by new challenges. One of them is the impact of cyclical economic development of individual countries - leaders of economic growth on the situation in the global economy in general. The other one is transformation (primarily - globalization) of the world financial system, which determines the nature of the crises of recent time.

The Bretton Woods system, formed in 1944, proved to be unstable. It implied a high level of responsibility of the country, which has the world's dominant reserve currency, i.e., the USA, for the quality of its fiscal policy. Against the background of the expansion of social obligations, the war in Vietnam, weakening of monetary policy, the country failed to maintain the level of confidence in the dollar, comparable to the confidence in gold before the First World War.

Since early seventies, after the refusal of the US authorities to exchange dollars for gold at a fixed price, a new monetary regime was actually set up in the world. Although formally the Bretton Woods system was not abolished, its basic characteristics have been changed. Now it is based on floating rates of the world leading currencies and on the open channels of capital

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[1] This is the last article of Yegor Gaidar, Director of the Institute for Economy in Transition. He wrote it shortly before his death. The article was published in the journal "Economic Policy" (No. 6, 2009). It was expected that a revised, completed with the annual statistics material will be used as an introduction to the annual report "Russian Economy in 2009". The Editorial Board does not consider itself authorized to make changes, so the text is published in its original wording.

[2] *E. Gaidar.* "Dizzy with success"// Economic policy. August 2008. No. 3. PP. 5-19; E. Gaidar "The global economic crisis: implications for the Russian policy"/ Economic policy. August 2009, No. 4. PP. 37-46.

[3] Financial crisis in Russia and in the world/ Ed. By E. Gaidar. M.: Prospect, 2009; World financial crisis: Historical parallels and the ways out/Ed. by E. Gaidar, V. Mau. M.: Alpina Publishers, 2009.

[4] *Mitra P., Selowsky M., Zalduendo J.* Turmoil at Twenty: Recession, Recovery, and Reform in Central and Eastern Europe and the Former Soviet Union. Washington: The World Bank, 2010.

cross flow. This organization of the financial world has arisen recently, its arrangement is unclear. The number of indicators available for understanding how it works, is limited.

The nature of the slowdown periods in economic growth in the leading countries with fastest economic growth in the first decades after the World War II was understandable in general. The events in America in many ways defined the economic situation of all countries in the world, because the US role in the global economy at that time was dominanting (see *Fig.* 1).



Source: A. Maddison. Historical Statistics of the World Economy: 1-2006 AD, March 2009 (http://www.ggdc.net/maddison/).

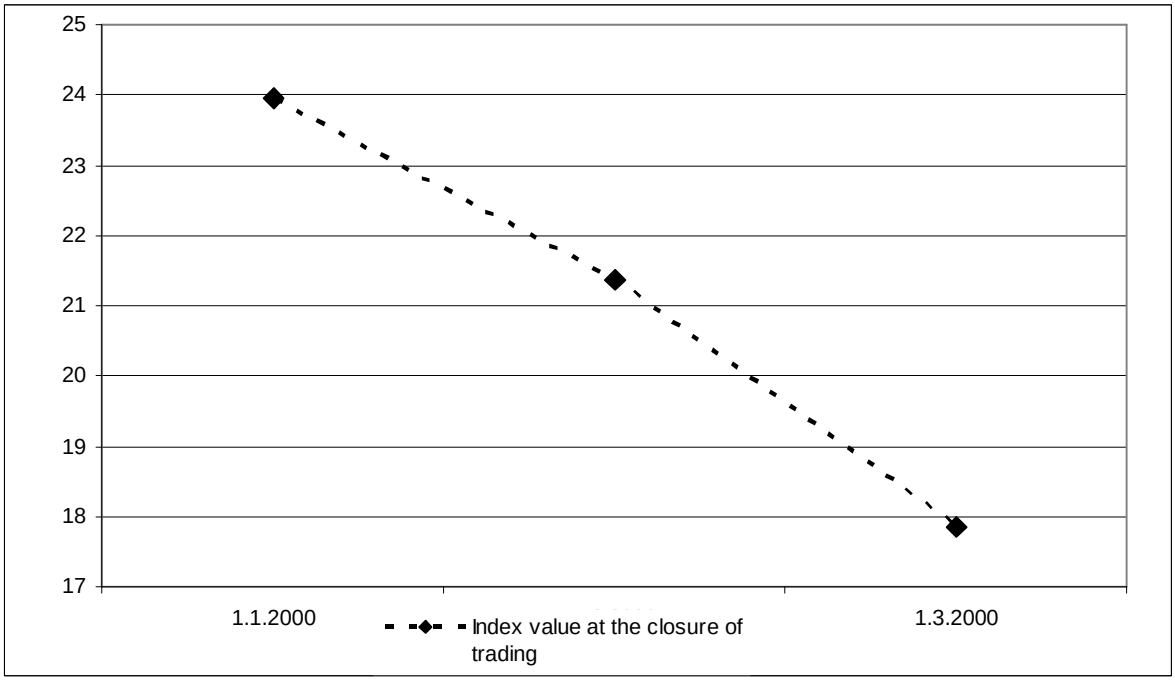
Fig. 1. The Share of the US Economy in the World GDP in 1950, 1960, 1970, 1980, 1990 (in %).

A major role in the development of the economic situation in the world were playing by the expansion of the US government obligations, weakening of monetary policy, growing inflation rates, followed by anti-inflationary measures, higher unemployment level, and then the new abatement of fiscal policy.

After the opening of capital markets in many countries and globalization of the world economy it became more difficult to predict changes in market conditions, including crises. Qualified experts who worked in the 1990-s in the US Treasury, the International Monetary Fund, until the last moment did not foresee neither the Mexican crisis in 1994, nor the crisis of 1997-1998, which began in the Southeast Asia, further spread to the CIS and Latin America countries[1].

[1] *DeLong J.B., Eichengreen B.* Between Meltdown and Moral Hazard: The International Monetary and Financial Policies of Clinton Administration. University of California at Berkeley and NBER, July 2001; *Crafts N.* East Asian Growth Before and After the Crisis. IMF Staff Paper. Vol. 46. № 2, June 1999*; Berg, A.* The Asia Crisis: Causes, Policy Responses and Outcomes. IMF Working Paper, 1999; *Kochhar K., Loungani P., Stone M.R.* The East Asian Crisis: Macroeconomic Developments and Policy Lessons. IMF Working Paper 99/28. August 1998; *Balino T.J.T., Ubide A.* The Korean Financial Crisis of 1997 – A Strategy Financial Sector Reform. IMF Working Paper 99/28. March 1999. Of course, this did not mean that none of the experts paid attention to the problems accumulated in the Southeast Asian (See, for example: P.Krugman. The Myth of Asia's

In the late 1990-s - early 2000-s there were published works expressing concern of the rapid growth of stock prices of high-tech companies in the US[1]. But only few people could imagine that the collapse of the "soap bubble" (see *Fig. 2*) will lead to a recession in the United States and the general slowdown in the global economic growth.



Source: www.nasdaq.com.

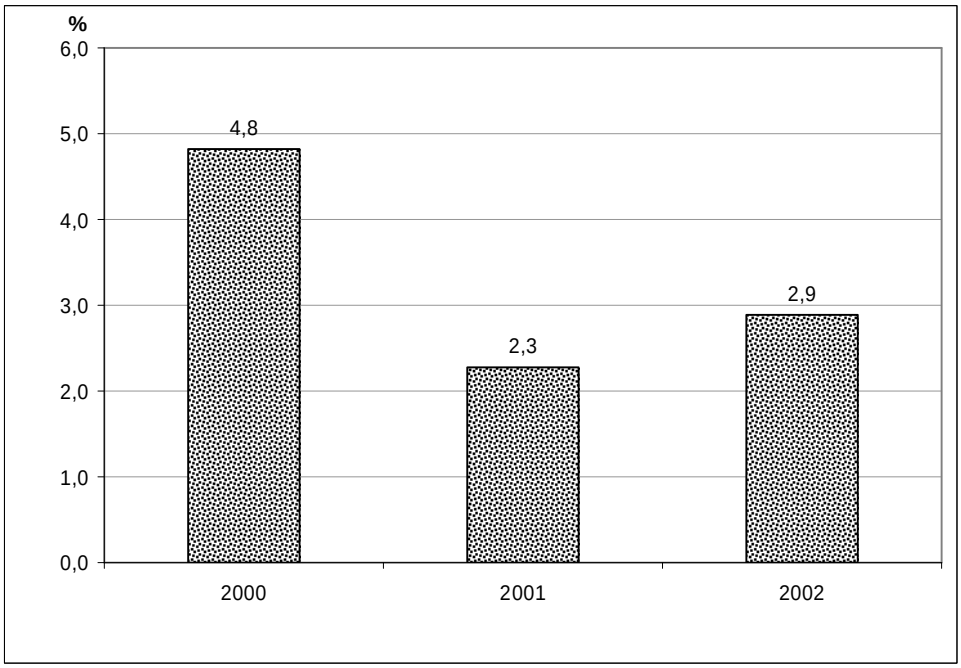
Fig. 2. NASDAQ-100, 1 Index Dynamics, January 1, 2000 - March 1, 2000

The attack against the US economy caused by the collapse of the market of high-tech stocks, was aggravated by the economic consequences of the terrorist attacks of September 11, 2001.

It is virtually impossible to predict the combination of these events. Meanwhile, the slow-down in the US economy growth has seriously affected the situation in the world (see *Fig. 3*).

Miracle // Foreign Affairs. Nov. / Dec. 1994. Vol. 73. P. 62-78.) However, the markets, and most of the expert community did not believe in the probability of a deep crisis of the Southeast Asia.

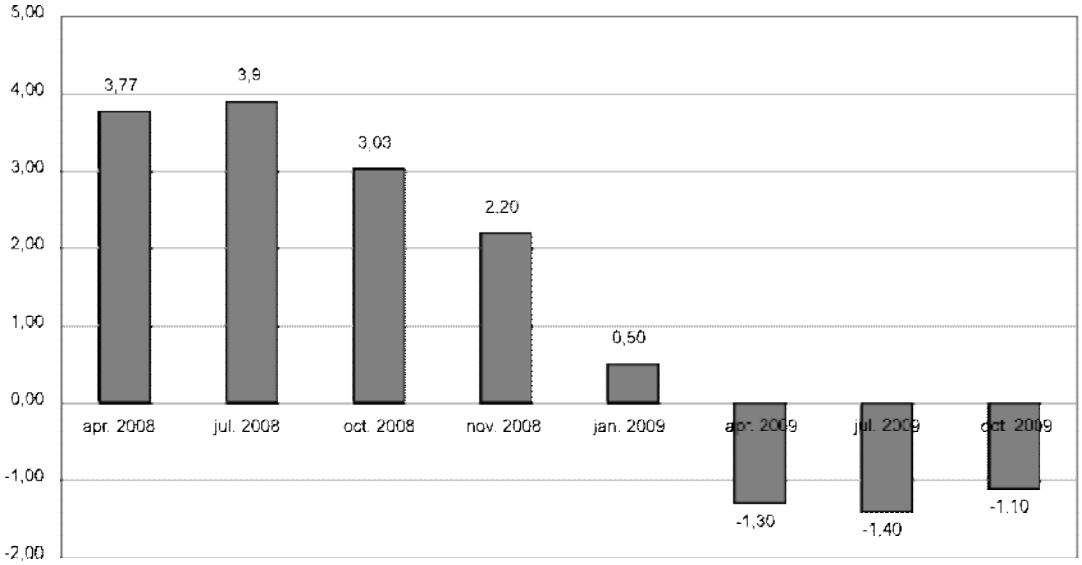
[1] Warren Buffett: 'I told you so'. BBC News world edition. Tuesday, 13 March, 2001. http://news.bbc.co.uk/2/hi/business/1217716.stm; IMF world economic Outlook (WEO). Recessions and recoveries. April 2002. https://www.imf.org/external/pubs/ft/weo/2002/01/index.htm



Source: IMF World Economic Outlook, October 2009 (http://www.imf.org/external/pubs/ft/weo/2009/02/ weo-data/download.aspx).

Fig. 3. Growth Rate of the World GDP in 2000-2002 (in % Versus Preceding Year)

The crisis of 2008-2009 was a surprise to the leading international financial institutions as well (see Fig. 4).

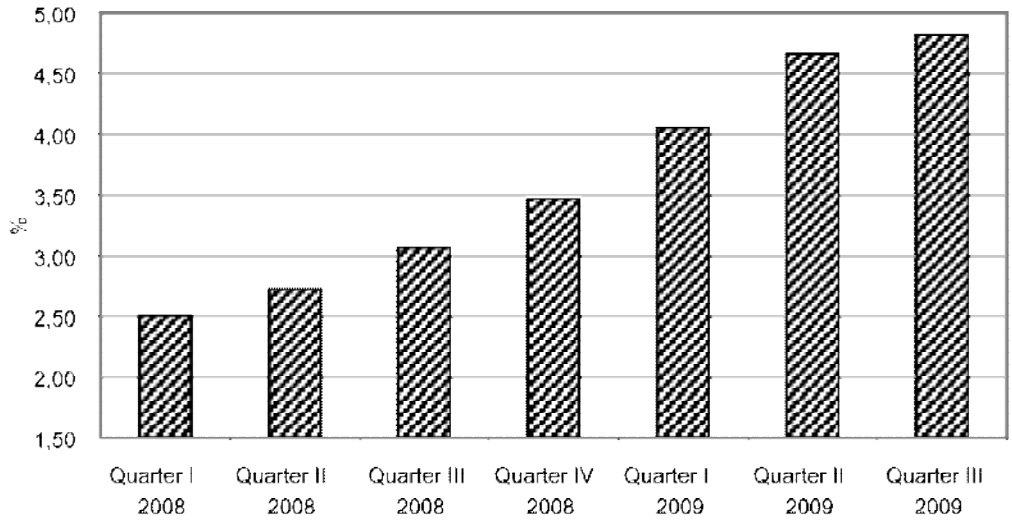


Note. The horizontal axis - the dates when the forecasts were made.
Source: IMF, World Economic Outlook for several months of 2008–2009 (www.imf.org).

Fig. 4. Adjustment of IMF Forecasts of Global Economic Growth in 2009 (in % Versus Preceding Year)

In late 2007 - early 2008 there was a widespread opinion that there will be no recession in America, but if it happens, it will provide no major impact on what is happening and the global economy will continue to grow[1]. Back in the late summer of 2008, many people in Russia had the same opinion[2].

These hopes proved to be illusive. In autumn 2008, when the bank "Lemon Brothers" turned bankrupt, and the US National Bureau of Economic Research announced that the US economy since late 2007 is in a recession[3], there came a common understanding that we are probably facing the deepest crisis of the world economy since the Great Depression (see *Fig. 5*)[4].



* Adjusted with regard to seasonal factors.
** Quarterly data are estimated as the arithmetic average based on available monthly indicators.
Source: Federal Reserve Bank of St-Louis (http://research.stlouisfed.org/fred2/series/UNEMPLOY/ download-data?cid=12).

Fig. 5. The Number of Unemployed in the US *, Quarter I of 2008 - Quarter III of 2009 ** (% of Total Population)

[1] *Chandra S.* U.S. September Retail Sales Rise More Than Forecast. http://www.bloomberg.com/apps/news?pid=20601087&sid=ajcgcopCXqkA&refer=home

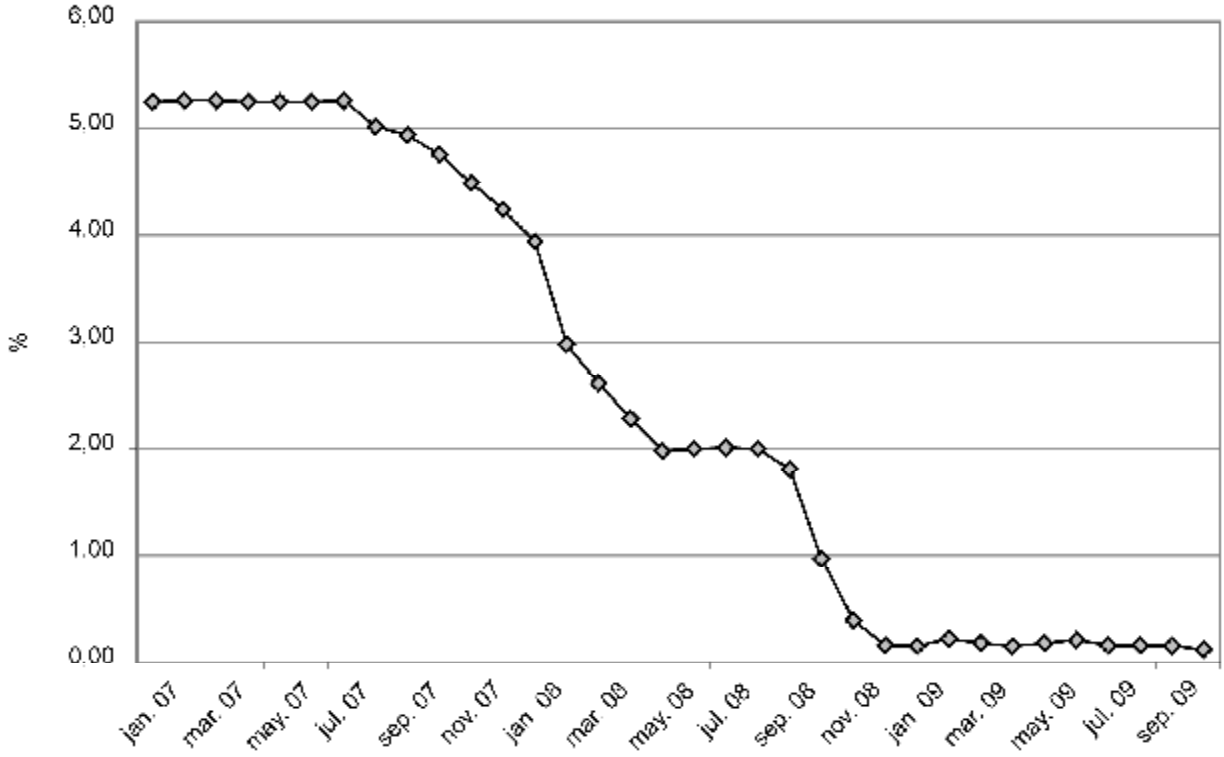
[2] "First of all, it looks that the mortgage crisis in the US is coming to an end. Its peak was in February of this year, and over the past four months the situation is gradually improving. In addition, there was no recession in the US and very likely, it will not happen in 2008. When Gaidar started to speak of recession in January 2008, its likelihood was estimated by futures market at 80 percent. Then I did not dare to express a disagreement with Gaidar's forecast and suggested that the recession probably will not happen. Over the past 6 months, the recession did not come". See: As a liberal to a non-liberal. Interview of A. Illarionov to L. Telen. 01.08.2008. http://www.izbrannoe.ru/43508.html

[3] November 28, 2008. Committee on the dates of the business cycles of the National Bureau of Economic Research, the most authoritative body dealing with the chronology of the beginning and end of a recession in the US, decided that the peak of economic activity in the United States was reached in December 2007. Since then, the domestic economy of the country is in recession. See: Determination of the December 2007 Peak in Economic Activity. Version of December 11, 2008. http://www.nber.org/cycles.html.

[4] *Stanton E.* U.S. Stocks Post Steepest Yearly Decline Since Great Depression http://www.bloomberg.com/apps/news?pid=20601087&sid=a5RkfQG30k1k; *Kueffner S.* Andean Region Must Integrate to Face World Crisis, Leaders Say. http://www.bloomberg.com/apps/news?pid=20601086&sid=aV1G7GCvfwew&refer=latin_america

In January 2009, the famous American economist N. Roubini, who was one of the first to speak about the likelihood of a deep economic crisis, was writing that the United States were certainly facing a dramatic recession, happened within the past decades and there was a high probability of deep downfall in production, which will last at least until the end 2009, and that even in 2010 the economic recovery may be extremely weak, one per cent or close to it. Later, those predictions have become even more pessimistic[1]. N. Roubini spoke about the likelihood that the recession will last until the end of 2010[2].

The reaction of the US monetary authorities to those events was prompt and energetic[3]. The base interest rate was sharply reduced. However, the ways of monetary policy mitigation in the crisis situation are limited. By January 2009 they were exhausted (see *Fig. 6*).



Source: Federal Reserve, Federal Reserve Statistical Release (http://www.federalreserve.gov/releases/h15/data.htm).

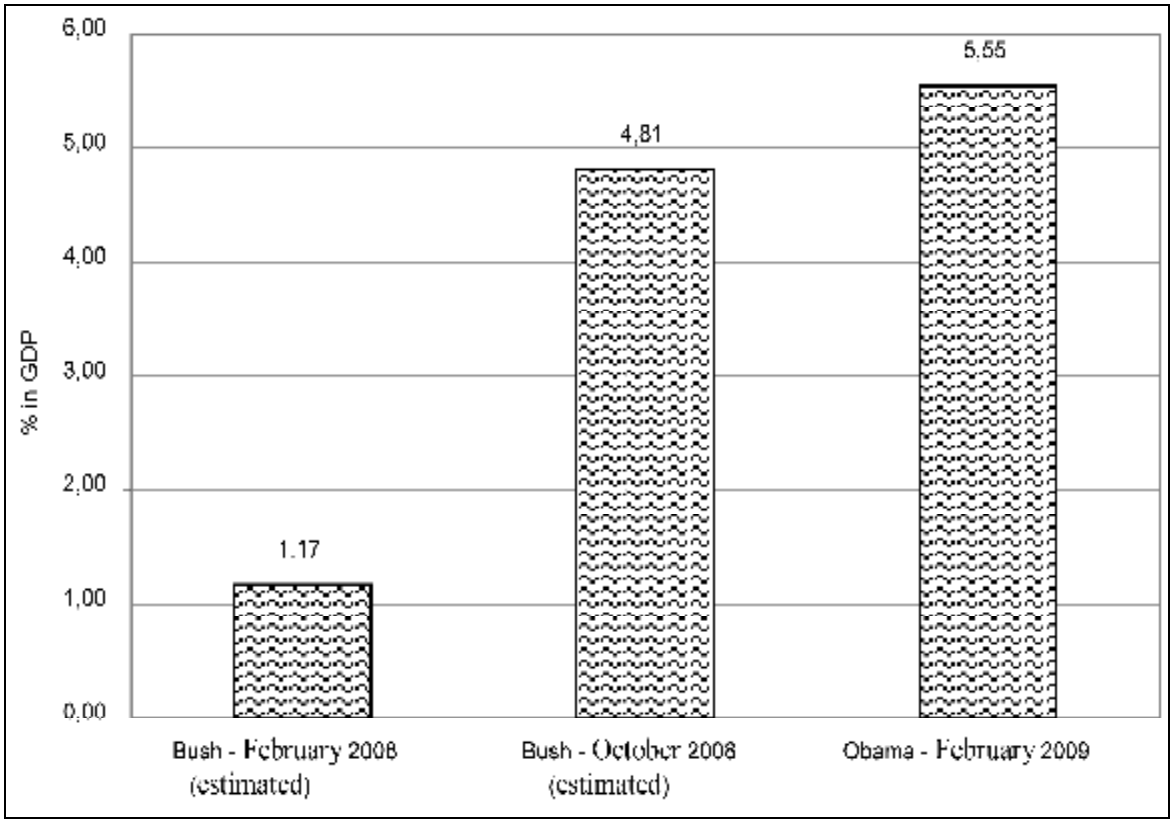
Fig. 6. The Base Interest Rate of the US Federal Funds, January 2007 - October 2009 (%)

[1] Roubini Says Worst Still Is Ahead of Us: Year in Review. http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aUy55wEBqrB8 Last Updated: January 1, 2009.

[2] *Thomas Ch.* Roubini Says Recession May Continue Until End of 2010 (Update1) http://www.bloomberg.com/apps/news?pid=newsarchive&sid=ayVsI_55G8.0 Last Updated: March 6, 2009.

[3] Perhaps it happened under the impact of the fact that Ben Bernanke, Federal Reserve Chairman was an Expert during the Great Depression. In 1979, Bernanke received his Ph.D. from the Massachusetts Institute of Technology. During post-graduate course, Bernanke studied monetary economy. His thesis was «Long-term Commitments, Dynamic Optimization and the Business Cycle»). The most famous of his works was devoted to the Great Depression. *Bernanke Ben S.* Essays on the great depression. Princeton: Princeton univ. press, 2000.

This made the US authorities increasingly using fiscal incentives to increase aggregate demand (see *Fig. 7*).

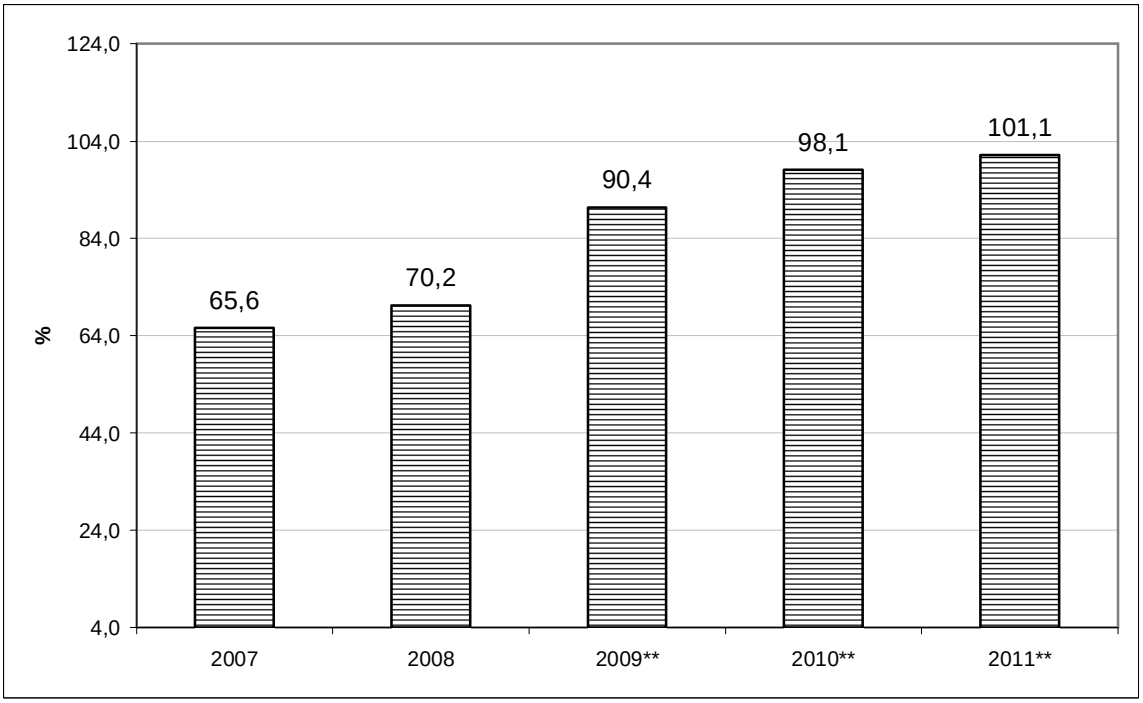


* Given the lack of data on the volume of GDP in terms of one month, February 2008 corresponds to the GDP in the I quarter of 2008, October 2008 and 2009 - GDP in III quarter, respectively.

Note. The package of budget and financial incentives proposed by Bush Administration in February 2008 amounted to 168 billion dollars in October, its volume was increased in October to 700 billion dollars by the administration of Barack Obama and in February 2009 - up to 787 billion dollars http://www.rian.ru:80/us_news/20081124/155800218.html; http://top.rbc.ru/economics/14/02/2009/280613.shtml

Fig. 7. The Package of Budget and Financial Incentives Proposed by Bush Administration in 2008 and the Administration of Barack Obama in 2009 (in % of GDP*).

However, the possibilities for maneuver in fiscal policy are limited. This is confirmed by the rapid growth of the public debt ratio to GDP in the US (see *Fig. 8*).



* Gross federal debt.
** Estimates.
Source: Federal Office of Management and Budget: Budget of the US Government Fiscal Year 2010, Updated Summary Tables (http://www.whitehouse.gov/omb/budget/fy2010/assets/summary.pdf).

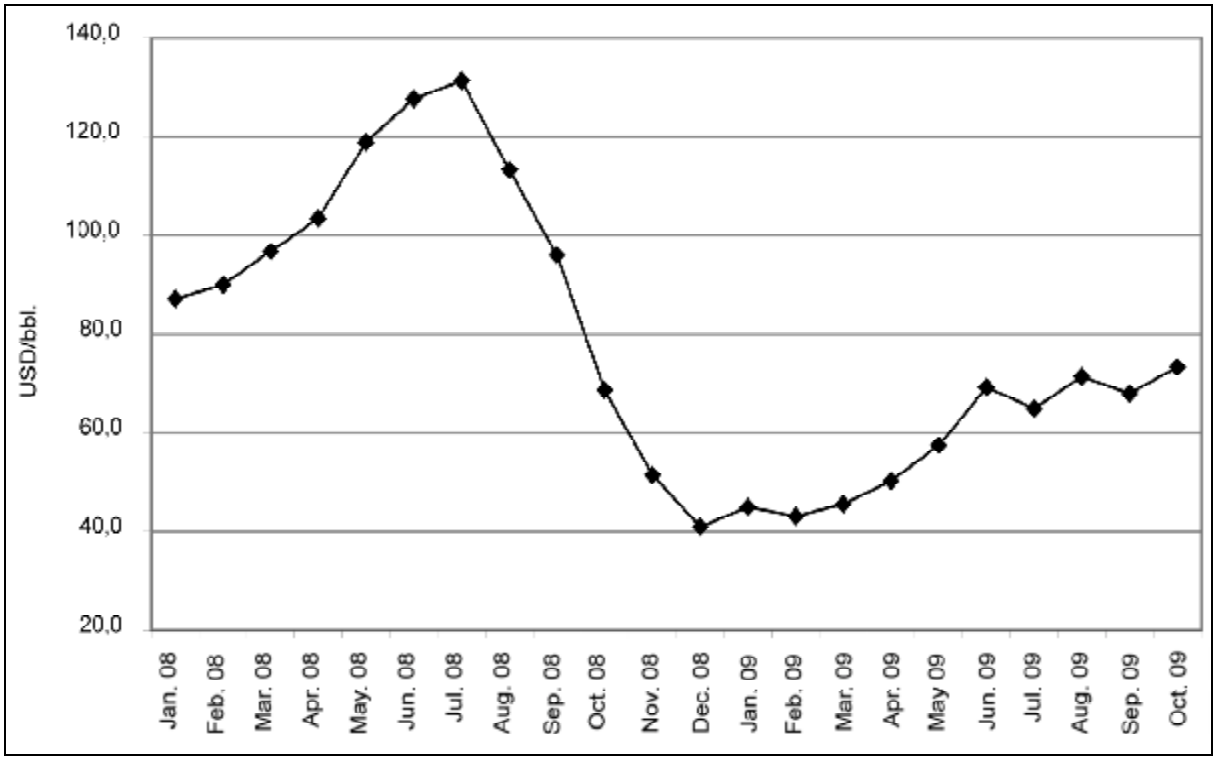
Fig. 8. * US Government Debt in 2007-2011 (in % of GDP at the End of the Year).

Russia has faced the challenges posed by the global economic crisis under peculiar circumstances. In the late 1980-s - many of the 1990-s our country was experiencing severe consequences of bankruptcy and collapse of the Soviet economy. Only in the late 1990-s, when the basic institutions of private and market economy were established, when the participants of the economic process have adapted to them, the national economy started to grow. Interrupted for a short time by the 1998 crisis, this growth generally continued for 10 years. There was a financial stability, the budget was executed with surplus. A major problem has become a high growth rate of foreign currency and gold reserves, which has complicated the anti-inflationary policy for monetary authorities. At this background, it was easy to understand the aggressive atmosphere of optimism, clearly observed in the official documents of the early-mid 2000-s[1].

[1] "Over the decade we should at least double the gross domestic product. Doubling of GDP is a systemic and of course a major challenge. It will require a thorough analysis and refinement of existing approaches to economic policy. ... I am convinced that Russia already has all the conditions for the identification and implementation of such objectives, there is a real opportunity to accomplish large-scale construction of a modern and strong economy, and as a result, to form the state competitive in all senses of the word". See: Message from the President of Russia V. V. Putin to the RF Federal Assembly on May 16, 2003.
http://archive.kremlin.ru/text/appears/2003/05/44623.shtml; concept of long-term socio-economic development of the Russian Federation of October 31, 2007 http://www.economy.gov.ru/wps/wcm/myconnect/economylib/mert/welcome/legislation/documentsofministry/doc1193835322297

However, some lessons from the collapse of the Soviet economy were learned. In late 2003, it was decided to establish the Stabilization Fund, later transformed in the Reserve Fund and the National Welfare Fund. Fiscal policy has remained conservative. The budget was split into two parts, one of which was independent on oil and gas market, another part of the budget was formed from oil and gas revenues. There was established an upper limit of subsidies provided to the national budget from oil and gas revenues[1].

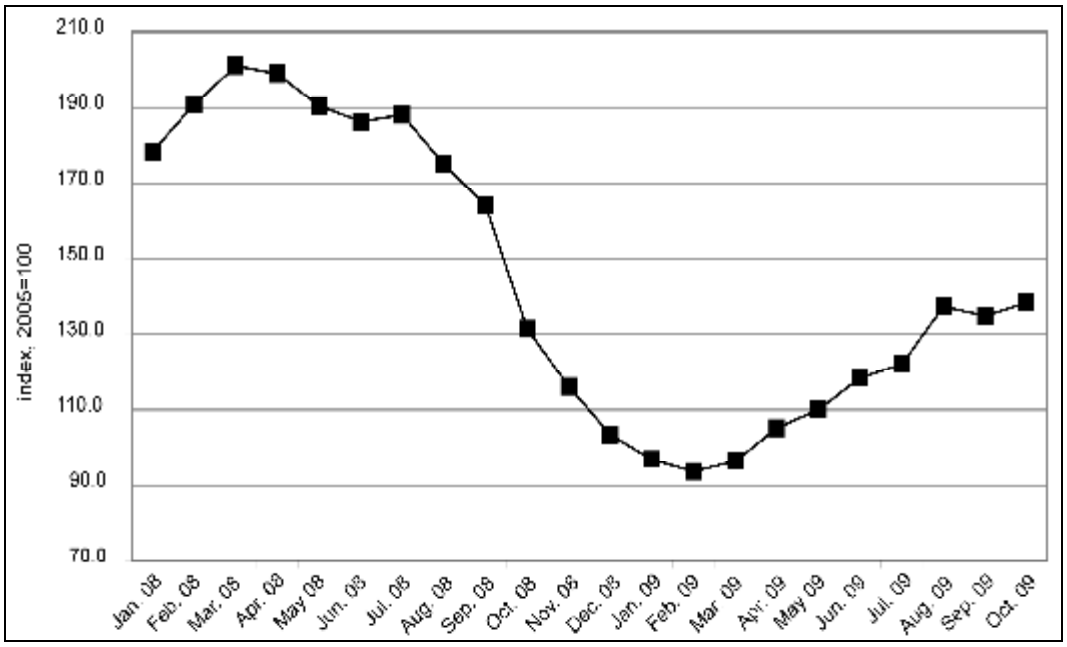
A slowdown in global economic growth has provided an impact on the Russian economy by two main trends. This is, firstly, the reduced demand for primary commodities that form the basis of the export potential of Russia, and the consequent decline in their prices (see *Fig. 9, 10*).



Source: IMF.

Fig. 9. The Actual Price of Crude Oil Brent, January 2008 - October 2009 (USD per barrel)

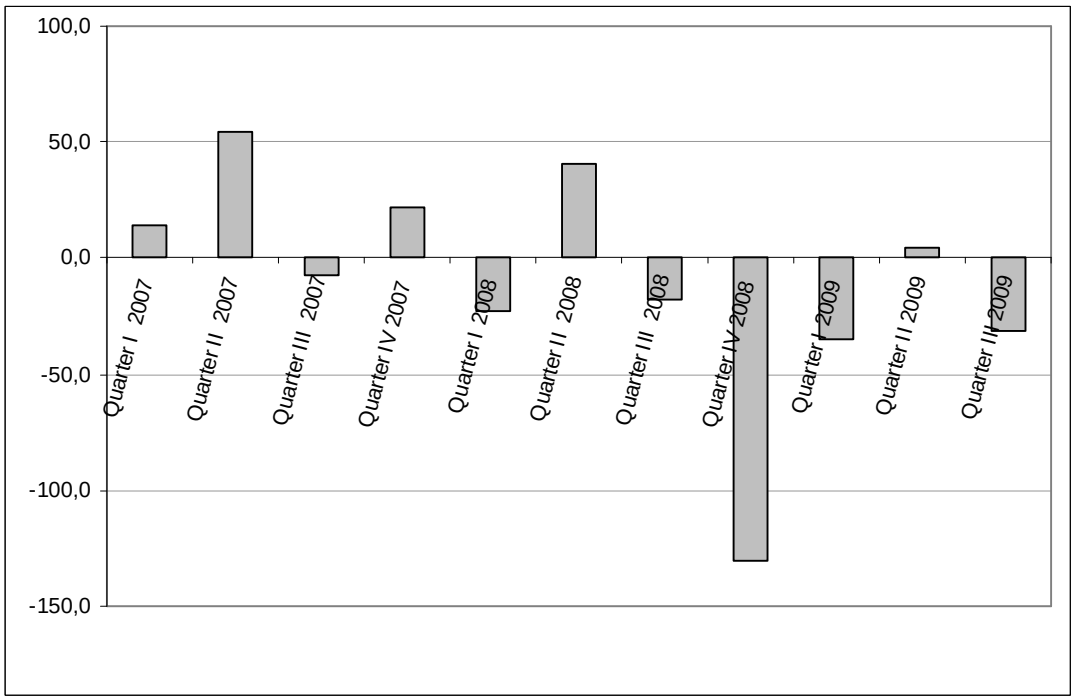
[1] See: The main activities of the Government of the Russian Federation for the period until 2012. Russian Federation Government Decree No. 1663-r dated of November 17, 2008. On the concept of the long-term socio-economic development of Russia for the period until 2020. Decree of the Russian Federation Government No. 1662-r dated of November 17, 2008.



Source: IMF.

Fig. 10. Price Index of the World Metals Market, January 2008 - October 2009 (2005 = 100)

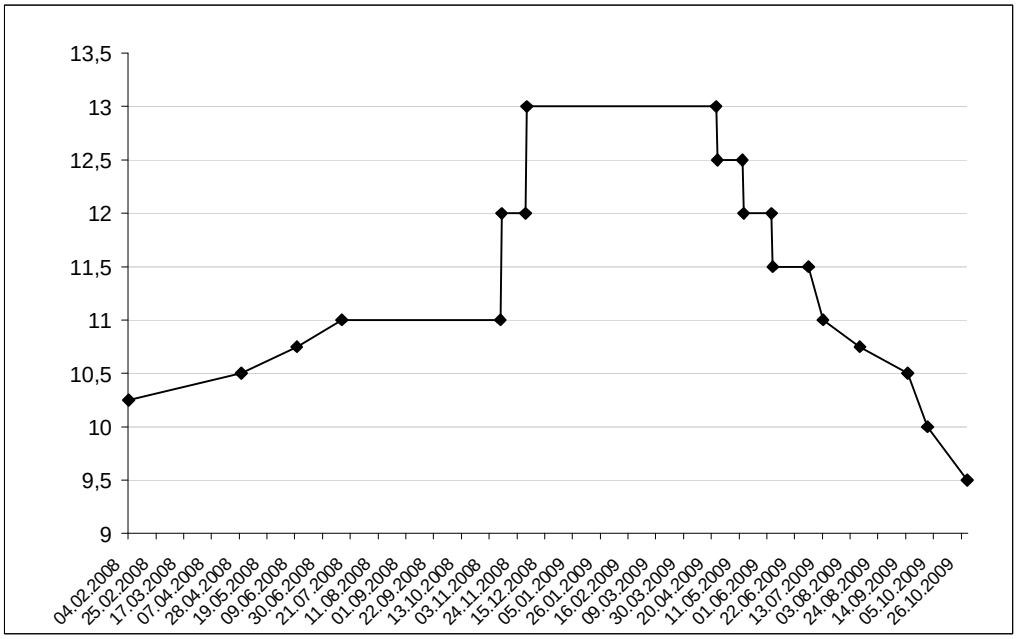
Secondly, the change of direction of capital flows (see *Fig. 11*).



Source: RF Central Bank.

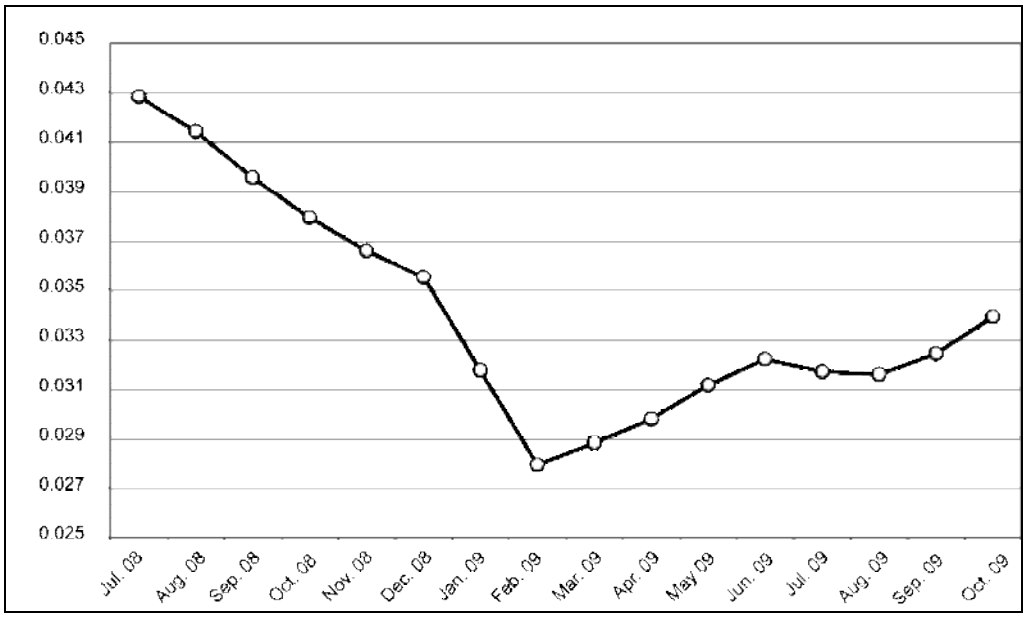
Fig. 11. The Amount of Capital Inflow / Outflow to/from the RF, Quarter I of 2007 - Quarter III of 2009 (USD bn).

The reaction of Russian authorities to the crisis was late by 6-9 months. It was reasonable, but asymmetric in relation to the economic policies of the countries with reserve currencies: raising interest rates, rather than reduction thereof, lowering the exchange rate of national currency against the US dollar (see *Fig. 12, 13*).



Source: RF Central Bank (www.cbr.ru).

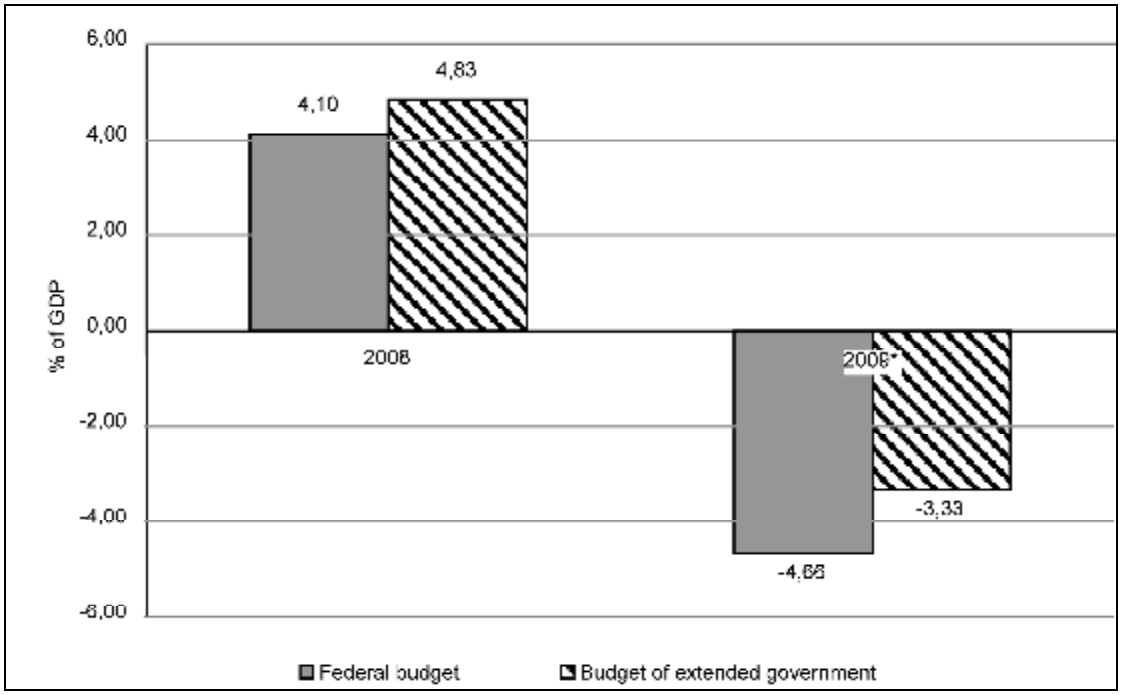
Fig. 12. Refinancing Rate of the RF Central Bank, January 2008 - October 2009 (%)



Source: RF Central Bank.

Fig. 13. Nominal Exchange Rate of Ruble Against US Dollar (USD for Rb), July 2008 - October 2009 (Average for the Period)

It is easy to understand the reasons for the asymmetric reaction of interest policy in Russia to the crisis in comparison with the events happening in the world's largest economies, primarily in the United States and European Union. Ruble is not a global reserve currency, so the possibility of weakening monetary policy in Russia was limited. In the situation of capital outflow from emerging markets and continued high inflation, the most important tasks were to preserve foreign currency and gold reserves and to curb inflationary processes. Against the background of the changed market, the situation with the budget has drastically deteriorated (see *Fig. 14*).



* Nine months of 2009.
Source: Russian Treasury, Russian Statistical Service.

Fig. 14. Deficit (-) / Surplus (+) of the Federal Budget and the Budget of Extended Government of Russia, 2008–2009 (in % of GDP)

The impact was provided also by a downfall of taxes for minerals production and export duties, most closely related to the commodity markets situation, and the unwillingness of the authorities to implement measures aimed at restraint of budget expenses beyond the financial capacity of the state in the radically changed conditions.

However, the refusal from actively discussed at the highest level measures of rates reduction or changes in the structure of taxes, less dependent on oil prices[1] (VAT, income tax of indi-

[1] "First, as recently mentioned by the President: as soon as possible it is needed to adopt a law defining the period of transition to a unified reduced rate of VAT. In parallel, further analysis of the feasibility and other steps could be made. Namely - the replacement of VAT by sales tax. Based on the fact that complete resolving of VAT refund or, in fact, stealing the VAT from the budget, which affect our taxpayers and tax authorities and which are not completely resolved even by the most advanced European Union countries". From the shorthand report of the First Deputy Prime Minister Dmitry Medvedev report at the V-th Krasnoyarsk Economic Forum on February 15, 2007. http://krsk.kp.ru/daily/24049/103037/; «At the meeting of President with the leadership

viduals), allowed to avoid the budget collapse. With changes in the external economic environment those taxes served as a basis of the budget stability (see *Table. 1*).

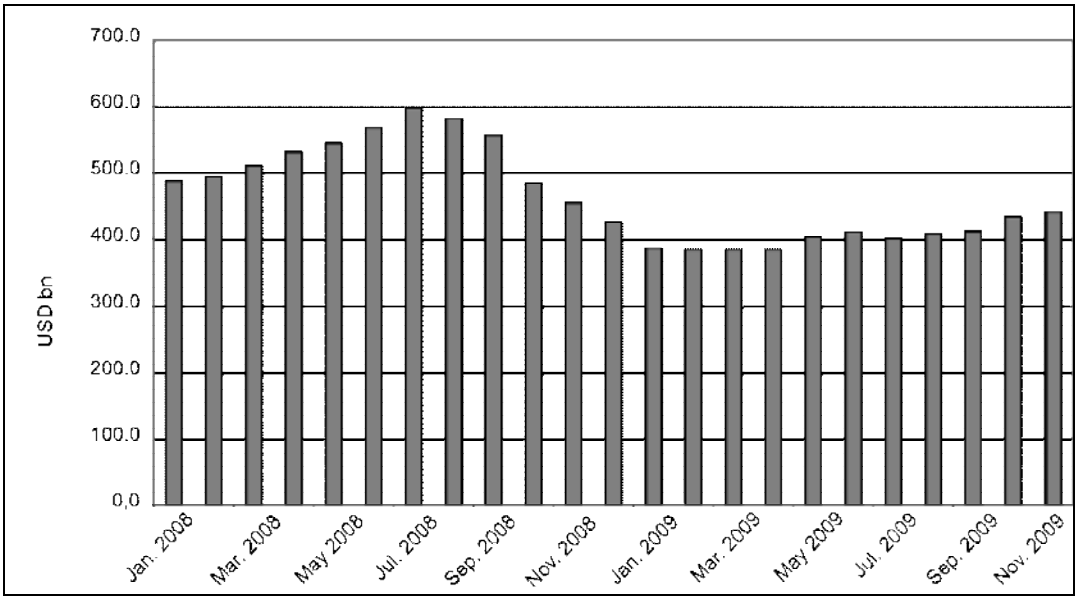
Table 1

Tax revenues of the RF budget system within January-October 2008 and 2009. (in % of GDP)

	January-October 2008	January-October 2009
Corporate income tax	6.56	3.29
Personal income tax	3.87	4.13
VAT	5.30	5.29
Royalty	4.49	2.56
Export customs duty	6.65	4.07

Source: Russian Treasury.

As a result of taken measures, in the first place of interest rate increase, there was no substantial devaluation of the ruble against the basket of major reserve currencies, and since mid-January 2009 it was possible to stop the decrease of foreign currency reserves (see *Fig. 15*).

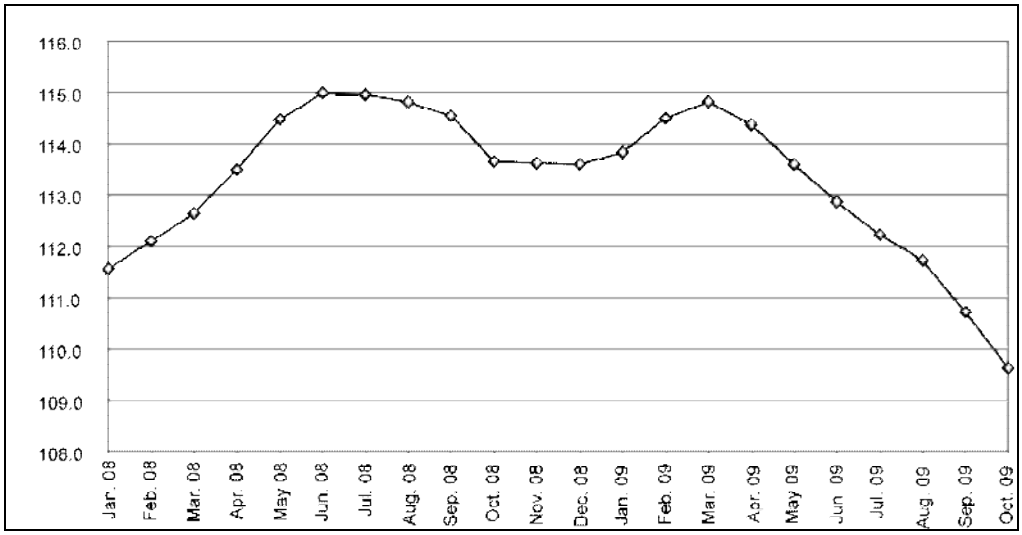


* As of November 13, 2009.
Source: RF Central Bank.

Fig. 15. RF International Reserves, January 2008 - November * 2009 (Billion Dollars)

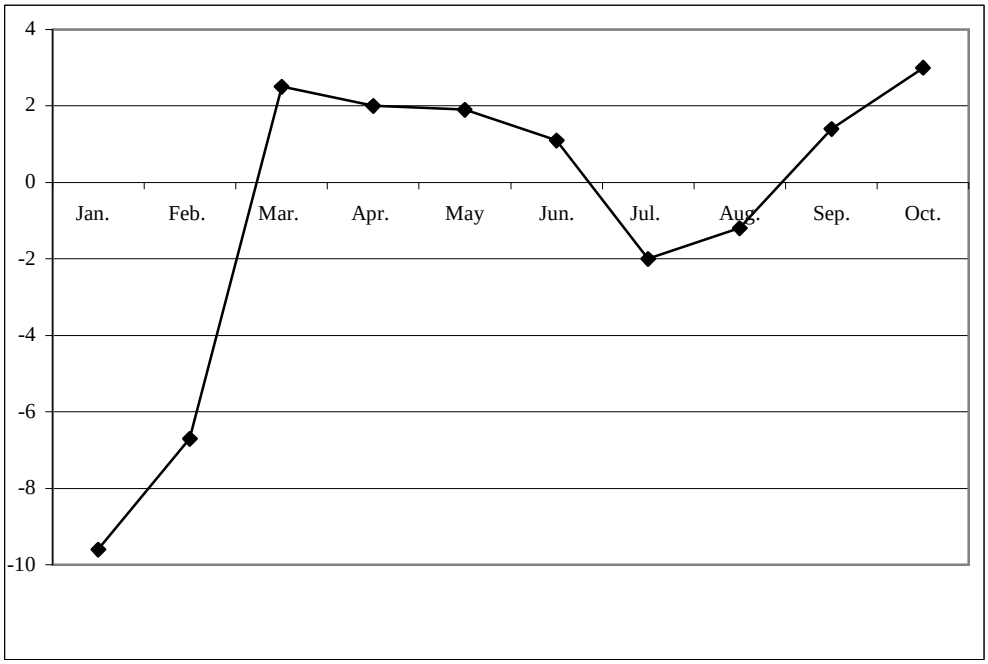
of the State Duma Speaker Gryzlov and President Vladimir Putin have exchanged views on the preferred rate of VAT. Gryzlov proposed to reduce the VAT rate as a primary measure of the future Cabinet of Ministers: "The rate should be uniform and not exceed the current beneficial VAT rate, that is, 10%. We should be really prepared to reduce VAT rate to 10%", said the Speaker. See: Putin proposed a "very cautious" approach to the VAT reduction. March 11, 2008. http://www.newsru.com/finance/11mar2008/nds.html; «Head of Expert Department of the President Arkady Dvorkovich believes that the VAT rate may changed from 18% to 12-13%. See:A. Dvorkovich: VAT rate can be reduced to 12-13% from February 8, 2008. http://www.newsru.com/finance/08feb2008/dvorkovitch.html; Dvorkovich A.: Reduction of VAT should be considered as an investment project. http://kp.by/daily/24124.4/345319/

Another consequence of the changing fiscal and monetary policy were the reduced inflation, stabilization of the national currency (see *Fig. 13*) and prevention of banking sector panics (see *Fig. 16, 17, 18*).



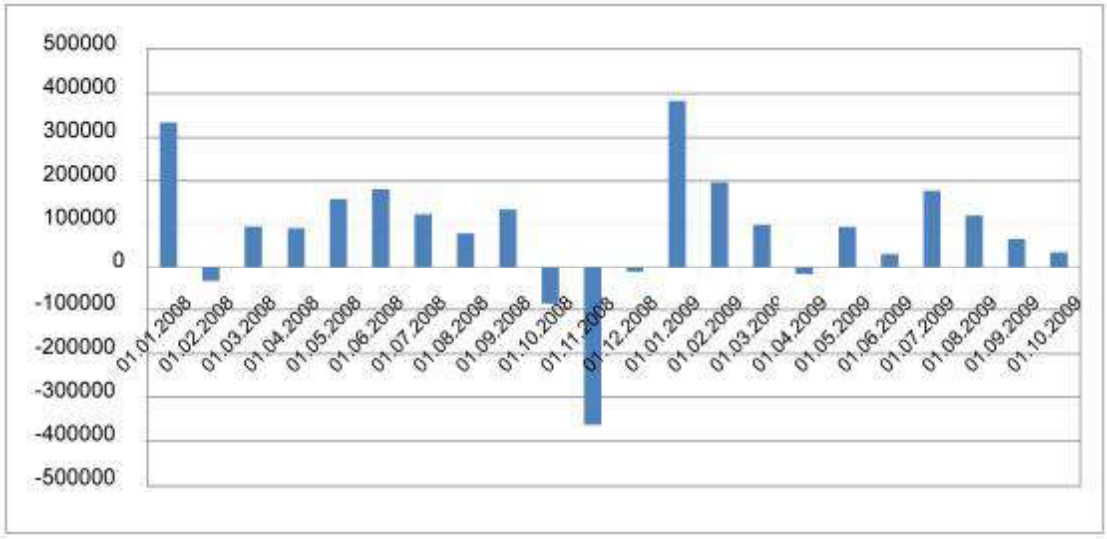
Source: Russian Statistical Service.

Fig. 16. Inflation in Russia, January 2008 - October 2009 (in % Versus the Relevant Period of Preceding Year)



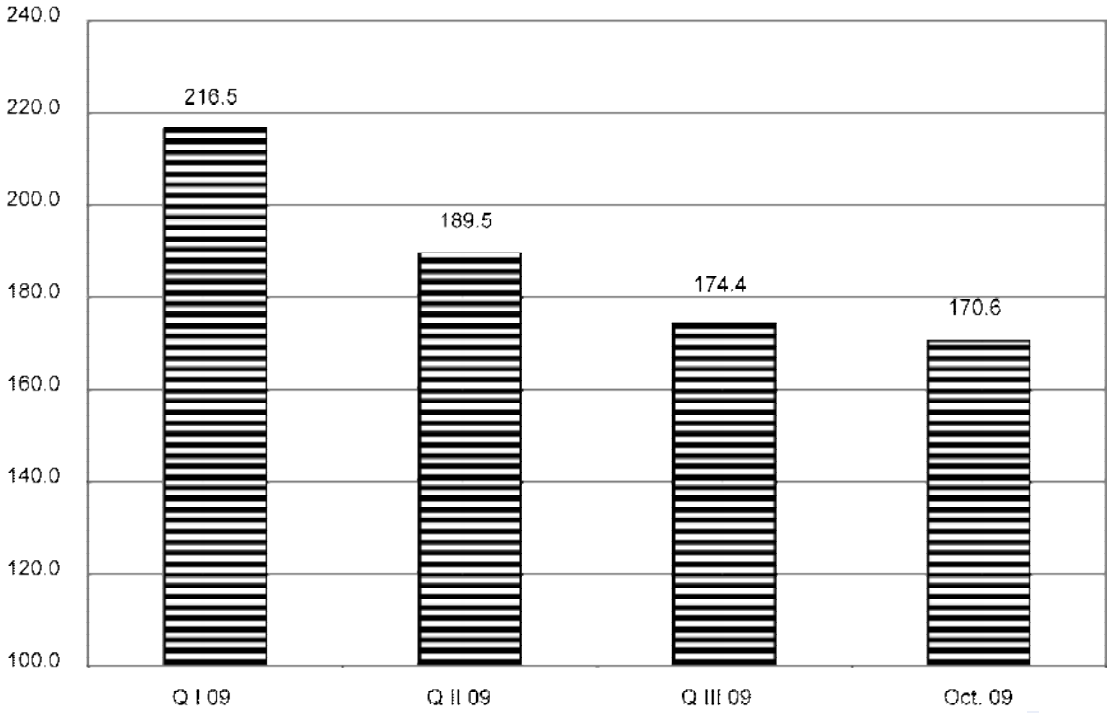
Source: RF Central Bank (www.cbr.ru).

Fig. 17. Index of Nominal Effective Exchange Rate of Ruble Against Foreign Currencies in January-October 2009 (in % of Growth Versus the Preceding Period) .



Source: estimates based on RF Central Bank data.

Fig. 18. Growth of Population's Deposits in the RF Banks, January 2008 - October 2009 (Million Rubles on the 1st Day of Each Month)



Source: estimated as the arithmetic mean based on monthly data of the Ministry of Finance of Russia.

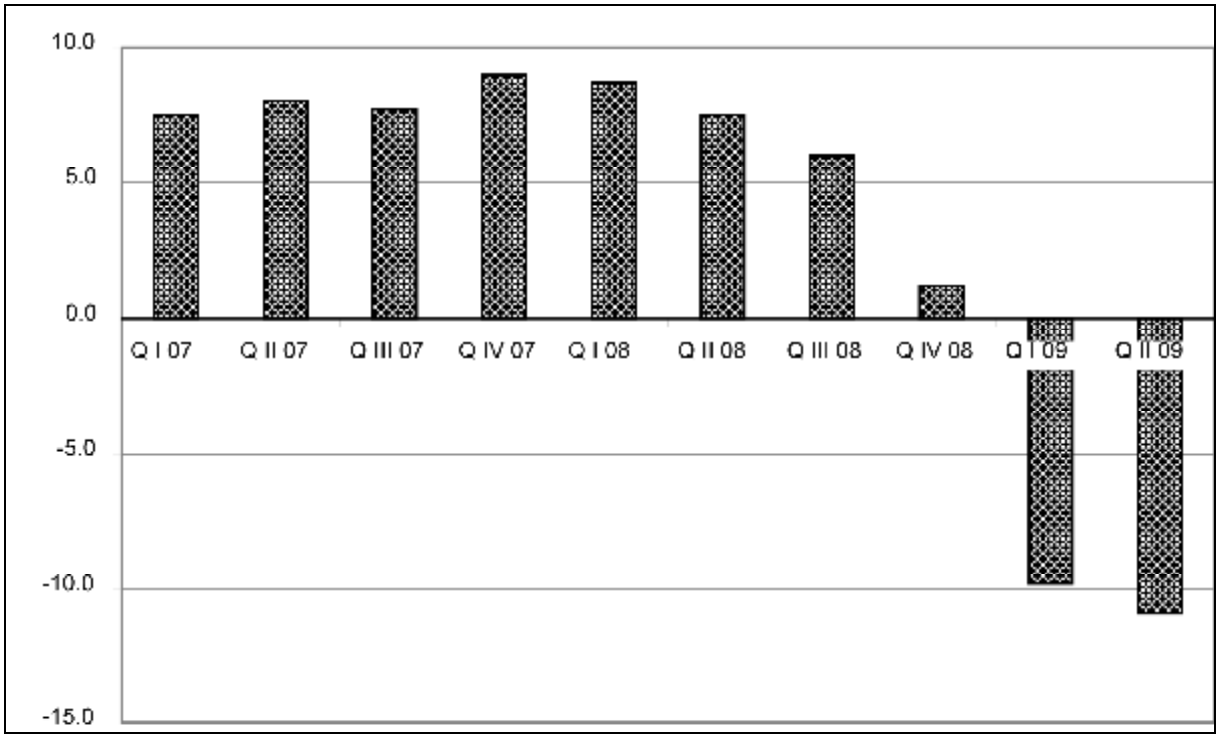
Fig. 19. Aggregate Reserve Fund and National Welfare Fund of Russia, Quarter I ,2009 - October 2009 (Dillion Dollars - at the End of Period)

Meanwhile, Russia has managed to avoid the development of the crisis under catastrophic scenario similar to what happened and is happening in Latvia or Ukraine[1].

The fee for the preservation of financial stability was significant. Developments in 2008-2009 have outwardly demonstrated how timely it was to establish the Stabilization Fund (see *Fig. 19*).

Until recently the Funds ensured the Russian budget adaptation to the conditions of sharply decreased revenue from mineral extraction tax, corporate profit tax and export duties.

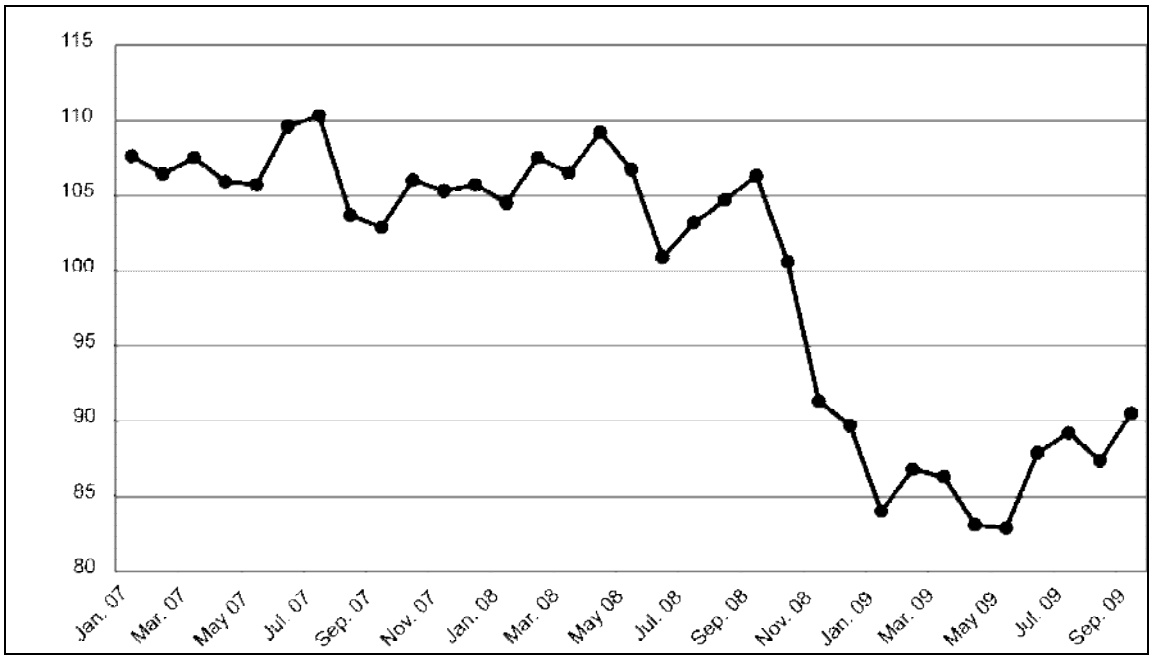
The damage inflicted by the crisis to the real sector of the Russian economy has been severe (see *Fig. 20, 21, 22*).



Source: Russian Statistical Service.

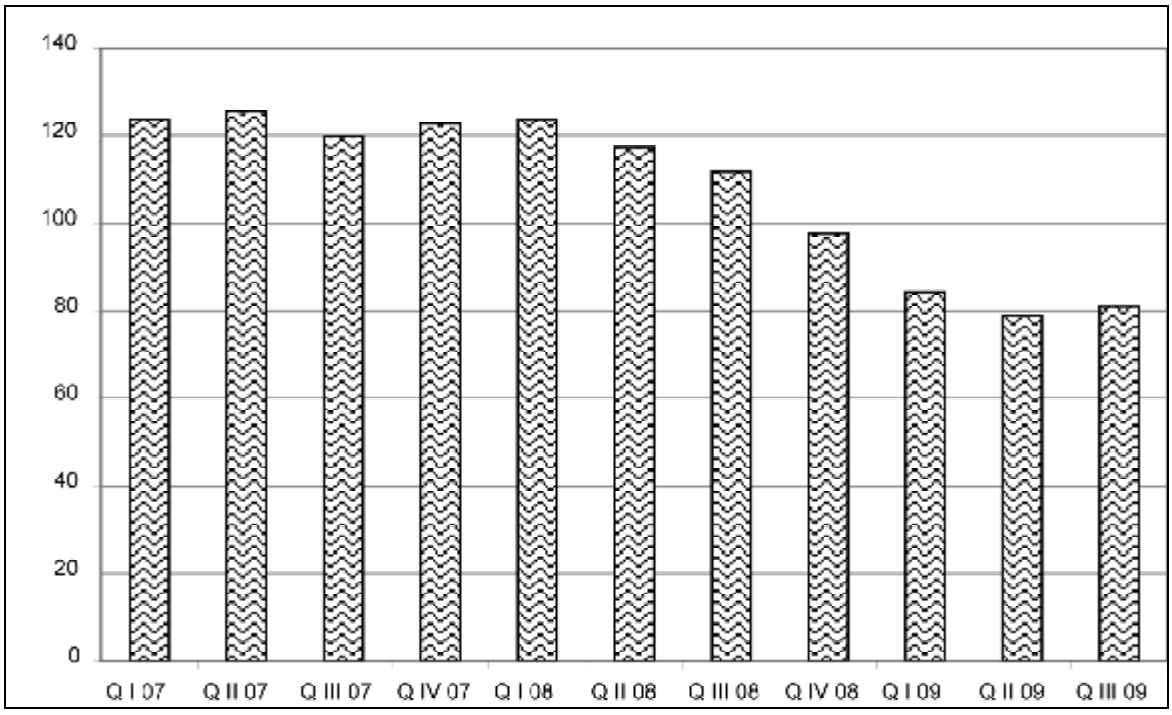
Fig. 20. Growth of Real GDP of Russia, Quarter I, 2007 – Quarter II, 2009 (in % Against the Relevant Period of Preceding Year)

[1] In Latvia, in the I-st quarter of 2009, real GDP has declined by 18%. By the end of June, the number of registered unemployed rose to 11.5% compared with 7% in late 2008. In Ukraine, according to IMF estimates, the GDP in 2009 will decrease by 14%. The total financial liabilities of Ukraine for 2009 make approximately 41 billion dollars. With the optimistic forecast, the overall ability to mobilize financial resources to fund the liabilities do not exceed USD 31 billion. See:Republic of Latvia: First Review and Financing Assurances Review Under the Stand By Arrangement, Requests for Waivers of Nonobservance of Performance Criteria, and Rephasing of Purchases Under the Arrangement. http://www.imf.org/external/pubs/ft/scr/2009/cr09297.pdf; Ukraine: Second Review Under the Stand-By Arrangement and Request for Modification of Performance Criteria – Staff Report; Press Release on the Executive Board Discussion. http://www.imf.org/external/pubs/ft/scr/2009/cr09270.pdf



Source: Russian Statistical Service.

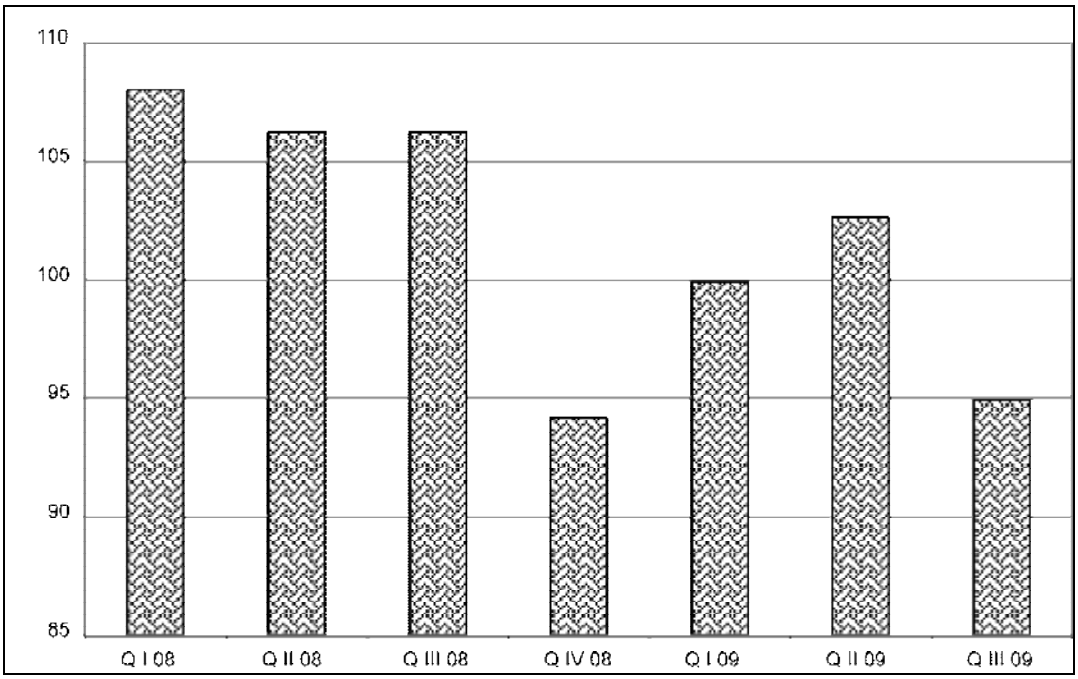
Fig. 21. Index of the RF Industrial Production, January 2007 - September 2009
(In % Versus the Relevant Period of Preceding Year)



Source: Russian Statistical Service.

Fig. 22. Investment n the RF Fixed Capital, Quarter I, 2007 – Quarter III, 2009
(In % Versus the Relevant Period of Preceding Year)

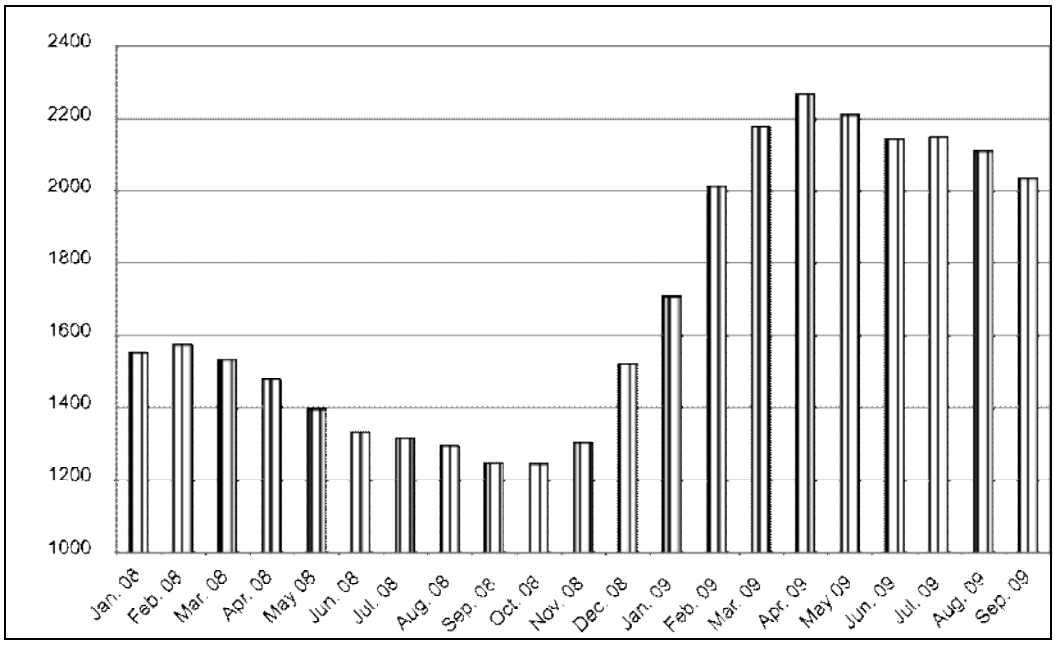
Naturally, this could not affect the income of the population (see *Fig. 23*).



Source: Russian Statistical Service.

Fig. 23. Real Disposable Monetary Income of the RF Population, Quarter I, 2008 - Quarter III, 2009 (in % Versus the Relevant Period of Preceding Year)

And the labor market situation (See *Fig. 24*).



Source: Russian Statistical Service.

Fig. 24. The Number of Officially Registered Unemployed in Russia, January 2008 - September 2009 (at the End of the Month, Thousands of People.)

Against the background of falling real incomes, growing unemployment, public reaction to the challenges associated with the crisis was peaceful according to international standards. The number of persons who participated in strikes was minimal.

It is too early to speak of the reasons for such a calm reaction to changes in the economic situation and how stable it is. One can only express a hypothesis. The society, which experienced a deep social and economic crisis due to the collapse of the Soviet Union, can understand what is happening better than the citizens of those countries which have been stable and prosperous for decades. However, one should have no illusions. Such peaceful situation during the crisis is not eternal. As demonstrated by the experience of the Soviet Union, with a sharp deterioration in economic conditions it is difficult to keep up peaceful situation, even with well-organized public relations. Sooner or later, if nothing is changed, people can go out to the streets with the words, repeating those that were heard in the popular film "Assa": "We are waiting for changes!". The only question is whether these changes are going to be orderly, gradual and non-violent, or we will be faced with the threat of a new revolution. The second scenario must be avoided. Russia has enough experience of the two revolutions that we have overcome in the past century.

Now the depth of the crisis, which began in autumn of 2007 is doubtless. Like in 1998 and in 2001, it had a greater impact on Russia than on the totality of all (other) CIS countries[1].

For the development of economic policy of our country it is important to have an answer to the question: how long will the crisis last? What impact will it provide on the medium-term prospects for economic growth, the financial situation in the world?

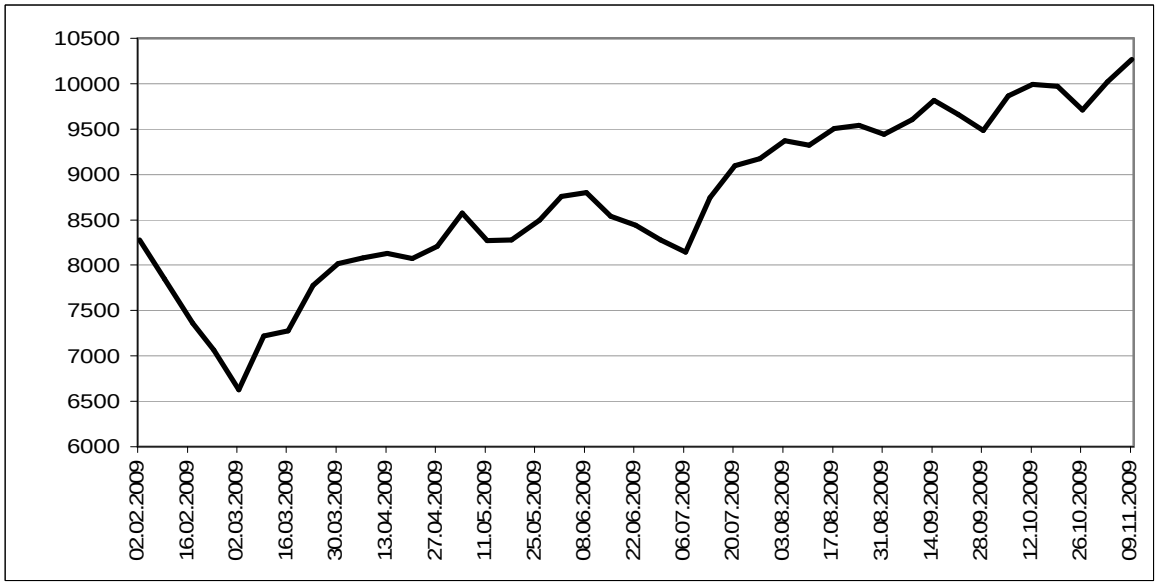
There are Experts who believe that the peak of the crisis over, that measures taken in the United States, Europe, China on an unprecedented scale over the last decade to inspire aggregate demand, allowed to overcome the decline in production, have created conditions to restore economic growth[2].

Perhaps this hypothesis is correct. After the adoption in the US a package of anti-crisis measures, the situation in the stock and commodity markets began to improve gradually (see *Fig. 25, 26*).[3]

[1] *E.T. Gaidar, A.B. Chubais.* Economic notes. M.: ROSSPEN, 2008. P. 62.

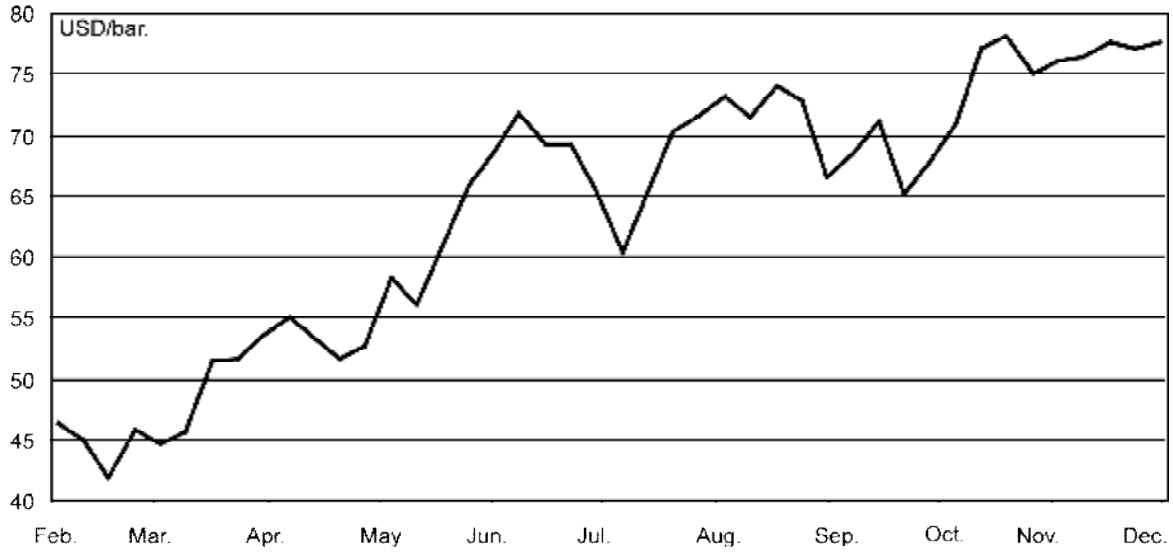
[2] "Economic has activity started to straighten in the United States and other countries. Herewith, the prospects of a returning to the growth in the short term are quite good". Bernanke, B. http://globalist.org.ua/?p=22189; «Apparently, the recession in the US is over." *B.Bernanke*. Recession likely over in US, says Bernanke. 15.09.09. http://www.ft.com/cms/s/0/91439968-a224-11de-9caa-00144feabdc0.html; V. Kudinov, A.Ulyukayev: "The bottom of the crisis is passed, the rate of the Central Bank continues to decline. Vedomosti. November 25, 2009 http://www.vedomosti.ru/tnews/news/2009/11/25/434; *A.Illarionov*, The recession is over. What does it mean? April 30, 2009. http://www.iea.ru/econom_rost.php?id=29

[3] A package of anti-crisis measures was adopted on February 14, 2009. See: http://top.rbc.ru/economics/14/02/2009/280613.shtml



* Index Dow Jones Industrial Average.
Source: Yahoo! Finance (http://finance.yahoo.com/).

*Fig. 25.*Dynamics of the US Stock Market *, February-November 2009 (Points)



Source: www.finam.ru

Fig. 26. Dynamics of Prices for Crude Oil Brent, February-December 2009, Weekly (USD per Barrel)

If you believe that the bottom of the crisis is overcome, then the priorities of economic policies in the countries dependent on commodity markets, can be changed: budget policy can be mitigated, a large-scale package of measures can be approved to stimulate demand and to finance infrastructure projects. For Russia the issues under discussion are the decisions involving the expenditure of tens and hundreds of USD billions. It is easy to understand: when such monetary funds are involved, such proposals provoke serious interests.

The adoption of those decisions would allow temporarily to improve the dynamics of GDP. However, it is dangerous to take such decisions before there are signs of sustainable improvement in the leading economies in the world. Experts are arguing, if a recession will take place in the shape of letters U, W, L, i.e., whether the period of the downfall will be short, and it will be replaced by rapid recovery of growth, two-humped, accompanied by two waves of crisis or the crisis, not followed by economic growth recovery. All participants in this dispute have their own arguments, but these are unproven hypotheses[1].

The fact that the crisis might have a second wave, attributable to the first half of 2010, is widely discussed in the expert community[2]. It is unclear how deep the problems in the banking system of the European Union[3]. The largest corporations are going to face substantial payments on fixed-income securities in 2010[4]. Would it be possible to implement them in view of the tension in the market of credit resources will be seen with time.

China has made vigorous efforts to boost the demand. If at the end of 2007 the Chinese leadership chose the fight against inflation as a top priority and was ready to solve this problem at the expense of a slowdown in economic growth[5] in 2008, now the Chinese economic policy has changed. Priority is in maintaining economic growth and fighting against unemployment[6] (see *Fig. 27*).

[1] See, for instance: *Jefferson R., Woodifield P.* Edinburgh Money Managers Forecast 'Volatile' Recovery (Update3) http://www.bloomberg.com/apps/news?pid=newsarchive&sid=a8rCYuC1OdwA; *Authers J.* The Short View. Published: June 2 2009 The Financial Times Limited 2009. www.ft.com/shortview; *Wilson J.* 'Robust' business for Deutsche Bank. Published: May 26 2009. The Financial Times Limited 2009; *Hume N.* On London: Rally's end leaves investors at a crossroads. Published: May 15 2009. The Financial Times Limited 2009; *Giles Ch.* Darling gambles on growth. Published: April 23 2009. http://www.ft.com/cms/s/0/f0846a1a-2fa1-11de-a8f6-00144feabdc0.html

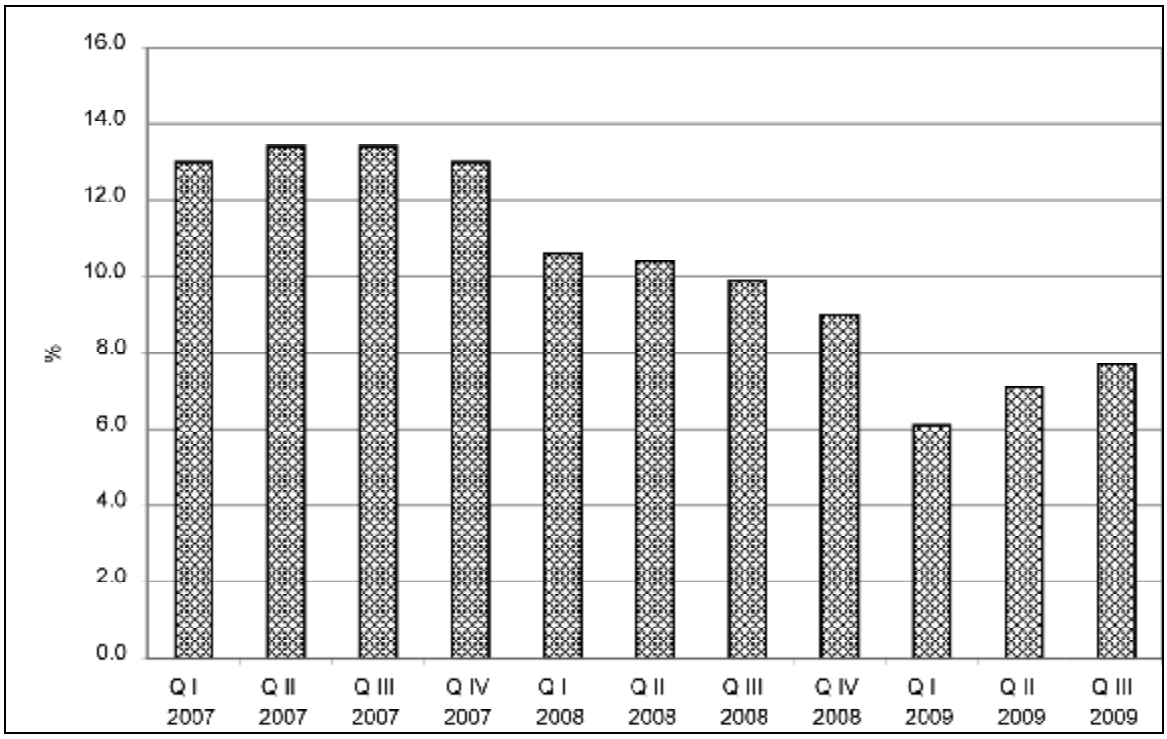
[2] *Goodman W.* Pimco Says World Economic Crisis Faces 'Second Wave' (Update4) http://www.bloomberg.com/apps/news?pid=20601087&sid=anA4PQ48RFhI; *Logutenkova E.* Ackermann Says Bad Loans Are 'Next Wave' of Crisis (Update2) http://www.bloomberg.com/apps/news?pid=20601206&sid=aUKAk1bKBVl8

[3] *Bender Y.* European banks cut access to external fund providers. Published: September 6 2009. http://www.ft.com/cms/s/0/76abe988-9979-11de-ab8c-00144feabdc0.html?SID=google

[4] См., например: Official site of Erste Bank http://www.erstebank.ua; Kommersant. No. 42 (4097). March 11, 2009 г. www.kommersant.ru.

[5] *Cao B.* Yuan to Rise Versus Major Currencies, Researcher Says (Update2) http://www.bloomberg.ru/apps/news?pid=20601087&sid=aQYRO9fjayFk&refer=home

[6] Is the party over in China? Massive unemployment looms. http://www.worldtribune.com/worldtribune/WTARC/2008/ea_china_02_15.asp; *Lawrence D.* China Pledges Faster Labor Mediation as Employment Turns `Grim'. http://www.bloomberg.com/apps/news?pid=20601089&sid=afK0sP5rT6IY&refer=china; *Hamlin K., Yanping L.* China Rate Cut Highlights Concern Over Slowdown, Jobs (Update1). http://www.bloomberg.com/apps/news?pid=20601087&sid=aQrG9UlthDHo; *Adam S.* Yuan 'Straitjacket' Risks Inflating China Bubbles (Update2). http://www.bloomberg.com/apps/news?pid=20601109&sid=awHX2QPENKgQ



Note. Data for Quarter II–IV of 2007–2008. National Bureau of Statistics of China publishes only in terms of accumulated GDP growth.
Source: National Bureau of Statistics of China (http://www.stats.gov.cn).

Fig. 27. GDP Growth Rates in China, Quarter I, 2007 – Quarter III, 2009.
(In % Versus the Relevant Period of Preceding Year)

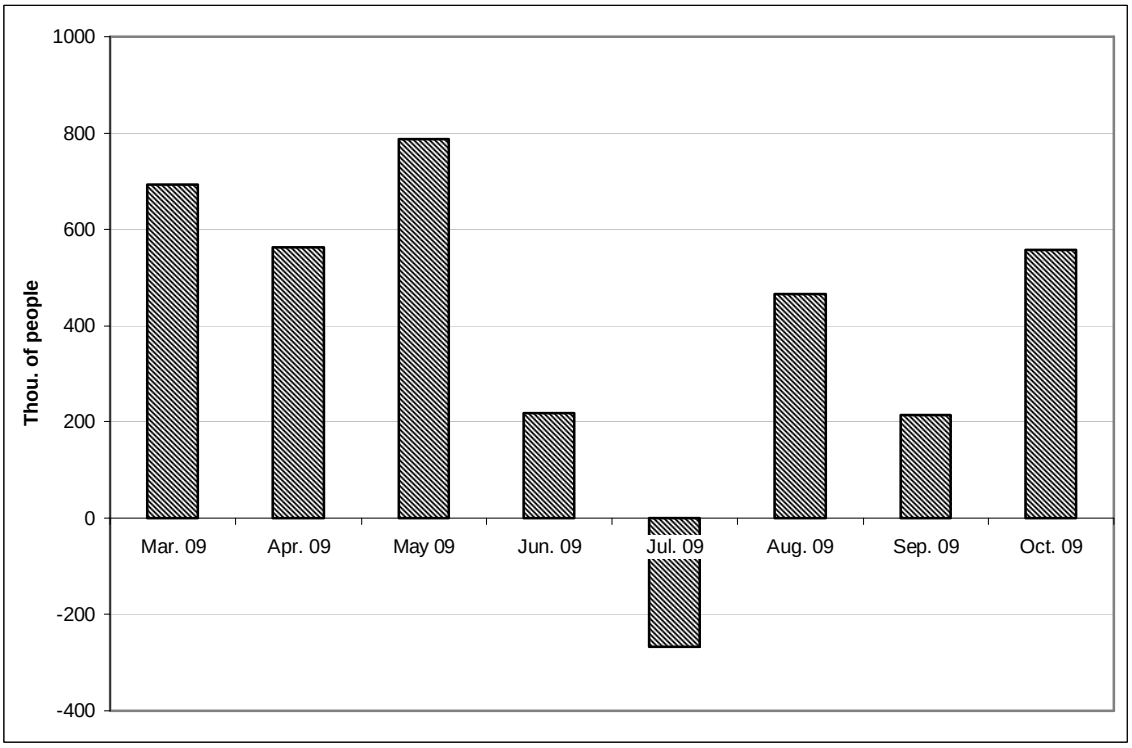
The Chinese authorities have chosen the same macroeconomic policy, which was used by the US administration to combat the recession in 2001. It is difficult to predict, whether such policy will result in a crisis of a "soap bubble"[1].

The scale of financial and banking system problems of other emerging markets is difficult to be assessed as well. By the time this article was submitted for editing, it was impossible to accurately assess the extent to which the risk of default of Dubai guaranteed government bonds

[1] *Shamim A.* Yuan 'Straitjacket' Risks Inflating China Bubbles (Update2). http://www.bloomberg.com/apps/news?pid=20601109&sid=awHX2QPENKgQ&pos=10; *Anderlini J, Tucker S.* CIC head warns of asset price bubble. http://www.ft.com/cms/s/0/47ac3d54-c39a-11de-a290-00144feab49a.html; *Tasker P.* China is heading for a Japan-style bubble. http://www.ft.com/cms/s/0/78e2eae4-c7af-11de-8ba8-00144feab49a.html; Chinese sovereign wealth unit planning $11.7bn bond issue. http://www.ftchinese.com/story/001029668/en; *Xie A.* Insight: Is China due a reality check? http://www.ft.com/cms/s/0/1ed429aa-b99f-11de-a747-00144feab49a.html; *Brown K.* Asia warned over emerging asset bubbles. http://www.ft.com/cms/s/0/236ef0c2-c9ac-11de-a071-00144feabdc0.html; *Dyer G.* Top China banker calls for urgent shift in Beijing's monetary policy. http://www.ft.com/cms/s/0/b4217eba-bea2-11de-b4ab-00144feab49a.html; *Authers J.* Short View: China's bubble. http://www.ft.com/cms/s/0/ba76495c-f05a-11dc-ba7c-0000779fd2ac.html; *Dyer G.* Top China banker urges shift in policy. http://www.ftchinese.com/index.php/ft/story/001029313/en; China's role in the global recovery http://www.ft.com/cms/s/0/2df3ea66-9716-11de-83c5-00144feabdc0,s01=1.html; *Pesek W.* China Risks Bubbles With 'Bernie Madoff Data'. http://www.bloomberg.com/apps/news?pid=20601039&sid=ab99AWGFCBsU; China Must Avert Loan-Fueled Bubbles, World Bank Says (Update1). http://www.bloomberg.com/ apps/news?pid=20601080&sid=aRi.90ENYi.s

with fixed income could affect other markets under the scenario of 1997-1998 in South-East Asia[1]. Moreover, Dubai is not the only important point of the stability for the financial systems of emerging markets, which may face difficulties in meeting their financial obligations.

Economic statistics of the United States in recent months is controversial. It does not give grounds for confidence that the world's largest economy is on the path of sustainable recovery (*Fig. 28*).



Source: Federal Reserve Bank of St-Louis (http://research.stlouisfed.org/fred2/series/UNEMPLOY/download-data?cid=12).

Fig. 28. Growth / Decrease in the Number of Unemployed (Data Adjusted for Seasonal Factor), USA, March-October 2009 (Thousand of People. As of the Beginning of the Month)

In the recent work of the World Bank devoted to the crisis, the authors defend the thesis that even in case of recovery of global economic growth in 2010, in the medium term, the growth will be slower than in the years preceding the current crisis[2].

All the above-said may seem too pessimistic. However, the experience of our country shows that the risks of such developments should be taken into consideration.

Mitigation of monetary and fiscal policy obviously would be popular. It will be easier, when and if there appear clear indications of the world economy recovery, there will be sustained growth in demand for major export commodities of Russia. However, it is a mistake to take such decisions in the situation of continuing uncertainty.

[1] http://www.ft.com Last updated: November 30 2009.

[2] *Mitra P., Selowsky M., Zalduyendo J.* Turmoil at Twenty: Recession, Recovery, and Reform in Central and Eastern Europe and the Former Soviet Union. Washington: World Bank, 2010.

The obvious short-term priorities are anti-crisis measures. However, the current economic crisis has once again highlighted the vulnerability of the domestic economy, the extent of its dependence on factors beyond our control. This brings to the agenda the issue of diversification of the economy as a top priority (to avoid focusing only on investing public funds in large-scale projects that do not always give reasonable feedback, especially rare in the country with highly corrupted public authorities). There are discussions on the need to diversify the economy for two decades. This problem was posed as early as in the first national program for economic reforms extension (in summer 1992). But nothing is changed till now. Perhaps the current crisis will force our government, the national elite, all the people finally to take active measures?

Commodity prices vary in a wide range, it is difficult to predict, much less to manage them. Of course, there will always be found volunteers to invest in oil and gas in the country where it is difficult to speak of the guarantee of private property or an independent and fair judicial system. When the issues in question are high-tech industries, the situation is different. In this case the guarantees of property rights, effective judicial system, fair government authorities are necessary conditions for both domestic and international capital to be invested in them. It is easy to declare this. To create such conditions is more difficult. But this is a task that has to be resolved, if we want a long-term sustainable economic development in Russia.

The crisis is a period of turbulence, uncertainty. Given these conditions, making decisions on the key issues of economic policy, one can make mistakes and get a reverse result. The crisis is like a storm. In the time of sailing fleet, during the storm the ships would pull down the sails and hove-to. This is useful to remember when making decisions today. But the history of the last two centuries shows, that crises, even such deep ones as the Great Depression or the current crisis, sooner or later come to an end. Already today one should think how to ensure the competitiveness of the domestic economy after the crisis.

After the crisis the world will be more tough than in the early 2000-s. Russian companies will have to compete with those corporations that will survive, and thus will be able to restructure production, to focus it on the most efficient facilities and activities, to reduce the number of employees, to increase productivity, quality and competitiveness of their products. If we don't do the same in Russia, it will be not easy to compete in this market. Hence, one can make two conclusions for the long-term economic policy in Russia

First. At least not to impede the Russian companies to operate in the same way as the corporations, which survived during the crisis, let them to get prepared for competition in the tough post-crisis environment, and to adapt social policy to solve that task.

Second. Make a top priority the creation in Russia a competitive sector of the innovation economy.

Skeptics may say that this objective could never be achieved in Russia neither under the czarist regime, nor under the communists, nor after the collapse of the Soviet Union (the military-industrial complex is the only exception to the rule). But this does not mean that it is unresolvable at all. Neither Finland, nor South Korea or Taiwan in the 50-s of the XX century could not be included in the list of countries with the innovation economy. Over the past 60 years there has been accumulated a rich international experience in policies to support the

innovation economy. Many of these programs have been successful[1]. This experience should not be copied literally. Program for the support of innovation economy were specific, adapted to the domestic specifics. For Russia, this experience suggests that the essential conditions for the success of this policy are the amendments to the legislation (tax system, budget legislation, regulations on patent rights, facilitation of foreign trade activities for everyone, who is involved in the innovation economy)[2].

These measures should be complemented by an effective infrastructure for innovation support. I am referring to the active government policy aimed at creation of business incubators focused on the innovation economy, venture capital funds, promotion of the banks incentives to invest in the targeted innovation loans.

Innovation economy is by nature largely different from the standard one. There is a great risk of failure. But in case of success, the results can exceed the expectations by orders, rather than by times. That is why the government economic policy in this area cannot be standard. It requires innovative solutions. The extent to which Russia will be able in the next decade to move in this direction and long-term prospects of our country, largely depends on the situation, in which Russia will come to the next global world crisis.

[1] See, for instance: National Innovation System. A Comparative Analysis. R. R. Nelson (ed.) New York Oxford: Oxford University Press, 1993.

[2] For Russia, this is something that belongs to the commodity group 84-90 (by foreign economic activity - classification ol goods).

Section 1. The socio-political context

1.1. The economic policy of 2009: between crisis and modernization

1.1.1. The main outcome of the crisis year: institutional stability

The previous year began with catastrophic expectations of an unprecedently devastating economic crisis that would involve a financial collapse, a fall of oil prices below 30 USD per barrel, an uncontrollable devaluation of the ruble, a profound drop in production, mass unemployment and social instability. However, nothing of this kind actually happened. Moreover, there even emerged some new positive trends, including a considerable reduction in the rate of inflation.

The results of the past year are very important from the point of view of the functioning of economic-political institutions. This was the second major crisis to be passed through by post-communist Russia's political system based on the 1993 Constitution. In both cases the system demonstrated sufficient stability and flexibility, as well as its ability to respond to a crisis without causing any major political shocks. And one can even notice some progress in this respect. In 1998, Russia's political institutions were unable to undertake adequate and timely actions in order prevent a dramatically unfolding crisis, and the government launched an active anti-crisis policy only when the country was already on the brink of a financial catastrophe – or perhaps had even plunged into it. This time, however, the political system managed to sufficiently quickly adapt itself to the radical change in the market situation and to adeptly switch over to the mode of anti-crisis management.

One could point to a lot of problems and flaws in the Russian anti-crisis policy of 2009, and to offer – in retrospect - some alternative policies. However, it should be acknowledged that the authorities managed to brace up to the challenge and did not lose control over the situation, although at the outset of it there had been apprehensions that the weakness of Russia's institutions and the immaturity of the political class could bring about some grave economic, social and political consequences.

The most important result of Russia's current ordeal is that the country, most likely, will now ascend to a new level of trust that will be built between the main subjects of its economic life. The government has proven that it can rapidly take and implement important decisions (at least in an extraordinary situation). The Central Bank has shown that it can indeed be a creditor of last resort capable of rapidly finding new instruments for resolving problems – whenever they might emerge. The social institutions have proven their capacity to function in crisis conditions and to neutralize the mounting tensions on the labor market. Finally, it has been proven in actual practice that the authorities were absolutely right in their decision to embark on a course toward accumulating reserves that could be used for alleviating a major crisis, which was especially important in view of the particular vulnerability of the Russian economy to sharp fluctuations of external markets.

The global crisis has again emphasized the necessity for our country to undergo a full-scale technological, economic and social modernization. The Russian economy has turned out to be very unstable in terms of its production indices (the fall in the country's GDP and industrial output was one of the deepest in the world) and the situation on its stock market. However, as instability also poses serious threats to long-term development, this country needs to obtain

some instruments capable of ensuring stability of development. This goal can be achieved with the help of modernization and diversification, and it is not by chance that these two issues were the focal point of the political discourse that was started last year on the initiative of the President and the Government. Both issues were promptly put on the strategic agenda of Russia's state authorities.

1.1.2. The specific features of the anti-crisis policy of 2009: Russia against the background of other countries[1]

In contrast to the situation of 1998, Russia's anti-crisis policy in 2009 had to respond to global challenges, while taking into account both the anti-crisis measures that were being implemented by the leading countries of the world and the specific features of this country's own development in the previous years. The global character of the crisis does not mean that it unfolds along the same lines in every country hit by it, and that there indeed exist some universal recipes for successfully curbing its proliferation. Moreover, the results of last year have indicated that the following two factors are of especial importance for the anti-crisis policy of any country: the particularities of the economic situation as it existed before the crisis, and the specific features of the crisis as it was unfolding in a given country. Accordingly, two large groups of countries can be singled out, which can be further subdivided into several subgroups.

The first group consists of the countries which prior to the crisis had strong macroeconomies – that is, low inflation and a moderate budget deficit. For them, the key problem was to prevent a deflation shock and the development of the crisis under the scenario typical of 1930s. As an anti-crisis measure, these countries could apply a stabilizing soft monetary and fiscal policy. This group comprises the USA, Japan, China, and many European countries (Germany, France, the UK).

As far as the specific features of the anti-crisis policy are concerned, this group of countries can be sub-divided into two sub-groups:

– the relatively small countries that were pushed into crisis by the effects of global processes, but then soon started to recover. At the peak of the crisis these countries were pursuing a stabilizing soft fiscal policy, but by now they have gradually begun to abandon such methods. Among the members of this sub-group are Israel and Argentina, where interest rates already started to go up last year.

– the world's biggest countries whose economies started to rebound in the second half-year of 2009, mainly due to measures that involved government support of the economy. The abandonment of these measures is considered to be dangerous both from the national and international points of view. The only measures to be abandoned there after the acute phase of crisis is over will be the extraordinary steps taken by the government in order to ensure liquidity.

The second group is represented by the countries which before the crisis had been characterized by either macro-economic problems or by an unstable foundation for economic growth. For these countries, the main danger was that of falling into a stagflation trap similar to the 1970s crisis. They were forced to focus on the implementation of stabilization programs such as those usually recommended by the IMF, including a reduction of budget expenditure and an increase of interest rates for the purpose of stabilizing their national currencies. Many

[1] This section is based on the materials prepared in co-authorship with K. Iudaeva.

of these countries encountered serious problems in the banking sector, and so had to carry out nationalization and recapitalization of the banks.

Three sub-groups of countries can be singled out here:

– the countries with very serious problems that emerged prior to the crisis and still remain unresolved. At the present time, these countries are forced to pursue rigid macro-economic policies. Among the countries that were in an 'overheated' state even before the crisis, there are the Baltic States, Island and Ireland, Ukraine, and some others;

– the countries which were faced with some macro-economic disbalances at the beginning of the crisis, but managed to localize these phenomena and then pursue a less rigid policy (in particular, a softer monetary policy). These countries include Russia, Hungary and some other East European countries that have been less severely hit by the crisis. After the acute phase of the crisis was over, both Russia and Hungary began to pursue the policy of cutting interest rates;

– the countries where the impact produced by the first wave of the crisis was relatively weak, but the situation became aggravated later because of the authorities' reluctance to pursue a responsible economic policy. These countries, most probably, will switch over to a policy based on the standard stabilization package recommended by the IMF. This is especially true in the case of Greece.

The measures of the 2009 anti-crisis policy can be divided into four categories[1]:

– resistance to the banking crisis, i.e. the prevention of the banks' collapse by taking extraordinary liquidity provision;

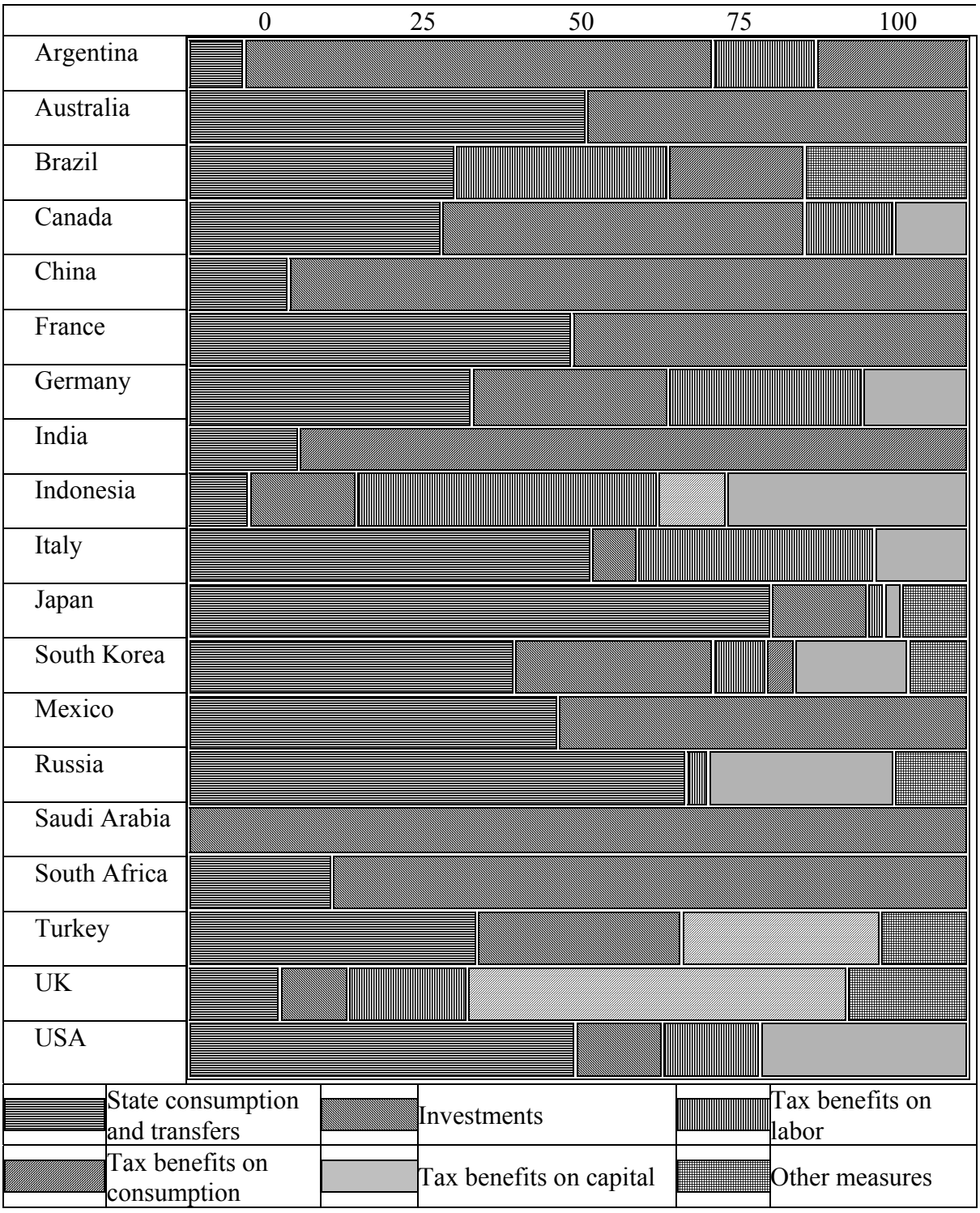
– the measures of monetary policy, including a switch-over from the anti-inflation policy to a quantitative easing policy aimed at sustaining economic growth and broadening the access to credit resources. In this connection, it is important to adequately understand whether it was stagflation or deflation that posed the main danger to a given country;

– government support to the real sector of the economy (stimulation of demand), i.e. to those branches of the economy that are oriented towards domestic demand and are crucial for securing domestic employment;

– government support to the population; here, the key role is played by the employment policy and the easing of social tensions.

The actual combination of the measures that were actually applied differed from country to country, because the authorities had to take into account the specific features of how the problems brought about by the global crisis were manifesting themselves (see *Figure 1*).

[1] For more details on the system of anti-crisis measures, see: Mau V. *Drama 2008 goda: ot ekonomicheskogo chuda k economicheskomu krizisu* [The Drama of 2008: From Economic Miracle to Economic Crisis] // *Voprosy Economiki* [Issues of Economics]. 2009. No 2.



Source: IMF.

Fig. 1. The composition of anti-crisis programs in 2009.

1.1.3. The outlines of Russia's anti-crisis policy

The specificity of Russia's anti-crisis policy in 2009 was determined by the following factors.

First, the level of inflation by the beginning of the crisis had been high (Russia was the only member of the G-20 where inflation topped 10 %). As the crisis triggered a rapid fall in production, the country was on the verge of falling into the stagflation trap, which means that, from the macro-economic point of view, the character of the crisis in Russia turned out to be substantially different from that observed in the majority of the world's countries, where deflation was the main danger. Therefore, the RF Central Bank had, first of all, to increase the real interest rate so as it could become a positive value, and only then to begin reducing it in proportion to decline in inflation.

Secondly, the effectiveness of budgetary stimuli was undermined by the high level of monopolism in the Russian economy. The experience of the pre-crisis years clearly indicated that any expansion of budget demand would result in a rise of prices, and not in a rise of supply. Thus, the role of the classical budget stimuli (first of all, investments into infrastructure and construction) could not be prominent. It was more likely that a certain stimulus to the economy could be given by a cut in taxation. So, in the end of 2008, a number of taxes were reduced.

Thirdly, the effectiveness of budget-support measures was further undermined by the weakness of politico-legal institutions (especially those concerned with law enforcement) [1].

Fourthly, the current global crisis vividly demonstrated the structural vulnerability of the Russian economy and its one-sidedness and inefficiency (although, in fact, this has always been evident). The current crisis is not only cyclic but also structural. For Russia, the issue of modernization has become even more urgent in crisis conditions, and so anti-crisis and modernization measures should be taken in conjunction and supplement one another.

The role of social policy

So, this explains why such a prominent role, among all the anti-crisis measures that were actually implemented in Russia, belonged to *social assistance to the population* (an increase of pensions, the creation of the institution of public works organized at the place of principal employment) and support to individual enterprises (in this second instance, this support, as well as the reasons for its allocation and the forms it took also had a social tinge – see *Table 1*).

The Russian anti-crisis budget turned out to be one of the most socially oriented in the world. Apart from political reasons, there were some economic reasons for such a budget to emerge. The demand generated by social assistance is mostly confined to the poor strata of the population, and is primarily focused on the domestically-produced commodities (which have become relatively cheap because of the devaluation of the ruble) that are turned out by the more competitive sectors of the economy. Such expansion of demand can serve as a better stimulus for the economy than a budget-funded demand for infrastructure objects or housing construction.

[1] For more details concerning the quality of Russia's politico-legal institutions, see Freinkman L., Dashkeev V. *Rossiia v 2007: riski zamedleniia ekonomicheskogo rosta na fone sokraniiaiushcheisia institutsional'noi stagnatsii* [Russia in 2007: The Risks of Slackening Economic Growth Against the Background of Continuing Institutional Stagnation] // Voprosy Ekonomiki [Issues of Economics]. 2008. No 4.

Table 1

Russia's anti-crisis budget

	2009 Plan	2009 Actual
Total, billion rubles	2,244.00	2,412.00
Sectoral measures	1,625.80	1,734.90
Assistance to population	593.7	652.6
Contributions to anti-crisis fund of Eurasian Economic Community	24.5	24.5

Source: RF Ministry of Economic Development and Trade.

The crisis has exacerbated the problems posed by the existence of mono-functional (or single-enterprise) towns. The government was aware of the serious (primarily socio-political) threat associated with such entities; but at the same time, it also saw the emergence of some new opportunities for their restructuring based on a real (and pin-pointed) modernization policy. As there could be no universal solutions in this sphere, it was decided to work out some individual programs for the development and transformation of single-enterprise towns that would involve a variety of measures – from their diversification to (in exceptional cases) their complete liquidation.

Support for the real sector of the economy

The government began to provide *support for a number of businesses* that had been placed on the list of 'system-forming' enterprises. The major instrument of providing such support was state credit guarantees. It had taken a lot of time for this mechanism to be developed, and so it began functioning only in mid-2009. On the one hand, it thus became possible to stabilize the social situation, but on the other, restructuring and innovation were being hampered by such measures because, in fact, many system-forming enterprises were (and still are) 'system-forming' bankrupts, and so rescuing them could not be of any help in terms of solving the problems of modernization.

Unlike many other countries, in Russia the owners and managers of the companies that had been saved by the State were not replaced and suffered minimum personal losses. This fact has an adverse socio-psychological effect, as it clearly demonstrated that big enterprises could indeed blackmail the government.

Growth stimulation was also carried out by means of interbudgetary transfers.

Macroeconomic stimulation, in its classical form, has never been practiced in Russia as yet. The anti-crisis budget was adopted in this country only in late April 2009. Moreover, the injections of liquidity into the economy, which first were made through the budget channel, were then sterilized by putting them through the monetary channel. Thus, the credits received by commercial banks from the Bank of Russia at the time of devaluation were returned to it in an amount that was practically equivalent to the volume of money emission related to budget expenditure. As a consequence, up until recently, there had been a constant shortage of liquidity which resulted in the stocks of finished products dwindling to 7.5 % of GDP, while the rate of inflation in the second half-year 2009 dropped almost to zero. It can be expected, however, that in 2010 this situation will change, because the banks have practically completely repaid their unsecured credits, while the Bank of Russia has been repeatedly cutting the inter-

est rates on mortgage transactions, thus increasing the demand for them. In 2010, the nominal expenditures of the federal budget will remain high - at the level of the year 2009 (the budget is balanced when the average annual price of oil amounts to about 105 USD per barrel).

The banking sector

A number of measures designed to *support the banking sector* actually enabled it to keep afloat without any serious shocks. As in the case of the real sector, the emphasis was placed on preserving the existing institutions and owners. As regards the banking sector, this could be achieved by providing them with the necessary liquidity. It was for the first time that the RF Central Bank actually assumed the role of a full-fledged creditor of the last resort. In so doing, it prevented the destabilization of the banking sector. In a striking contrast to the situation of 1998, the bank panic was resolutely nipped in the bud.

Nevertheless, in the medium-term perspective, this policy can have some negative consequences, because the banking environment has not been properly cleaned up. However, it can be assumed that the Central Bank simply decided not to try to deal with structural problems at the peak of a crisis. If this is the case, we can expect that, in 2010, unless any new banking shocks take place, some measures will be taken to make the banking sector more healthy.

There have been no significant changes in the situation with bad debts as yet. Because the standards of capital regulation have been made more lax, it is now possible to disguise the real state of affairs and to make the banking sector appear stable, while in reality the quality of its assets may actually be worsening. In the autumn of 2009, a law came into force that authorized the banks to increase their capital by federal savings bonds in order to write off bad assets. However, the law has turned out to be a dud: with demands towards capital's quality being too lenient and the policy of bad-debt prolongation remaining intact, the banking sector is still able to indefinitely postpone the resolution of this very unpleasant problem. Thus, the danger of a banking crisis has not been averted.

Monetary policy

As far as its *monetary policy* is concerned, Russia embarked on the course of smooth devaluation of the ruble which was completed in January 2009, and (for the most part) discontinued the targeting of the exchange rate of the national currency. It was indeed a very important and difficult decision. Throughout Russia's post-communist history, its monetary authorities devoted much more attention to economic growth than the RF Constitution required them to do. Beginning with the low rates of refinancing and the technical credits of 1992, and then ending up with the policy of curbing the strengthening of the ruble in the 2000s, Russia's monetary authorities were always ready to sacrifice the goal of lowering the rate of inflation to the needs of supporting the real sector. The negative effects of this policy were being routinely sterilized by the actions of the RF Ministry of Finance[1]. Nowadays attempts are being made to develop an anti-inflationary policy by means of smoothing the fluctuations of the ruble's exchange rate. When implementing this policy, the monetary authori-

[1] For more details concerning the paradoxes of Russian economic policy – when the Central Bank is concerned with economic growth, and the Ministry of Finance with the stability of the national currency, see Iudaeva K., Godunova M. *Uroki krizisa dlia Rossii: makroekonomicheskaia politkca* [The Lesson of the Crisis to be Learnt by Russia: Macroeconomic Policy] // Ekonomicheskaia Politika [Macroeconomic Policy]. 2009. No 6. Pp. 39 – 40.

ties could encounter serious resistance as soon as it becomes clear that strengthening of the ruble contradicts the current interests of producers oriented to the domestic market, as well as the current interests of politically important exporters. It cannot be denied, though, that low inflation is indeed a crucially important factor from the point of view of the strategic interests of this country's development, and in particular the need to increase labor productivity and the general effectiveness of the national economy.

However, the experience of 2009 has indicated that devaluation is not a panacea against low competitiveness. Many had expected that the miracle of ten years ago would repeat itself, and so the country would once again see a rapid import-substitution growth. Those hopes were dashed. Although the devaluation of the ruble has conduced to some growth in the production of food commodities (meat, milk, butter), as well as textiles, footwear, cellulose and chemical fertilizers, the restoration of growth will not be as spontaneous as it was in 1999, and some new forms and instruments of regulation will, apparently, also have to be found.

There were several reasons for the old success story failing to repeat itself. Firstly, ten years ago the world's economy was on the rise, and so demand for Russian exports was practically unlimited, while what we are faced with now is global recession. Secondly, in the late 1990s, Russia was experiencing the beginning of recovery growth, which means that it was in possession of considerable idle industrial capacities, and almost no new investments were required to achieve industrial growth. Whenever the occasion required, such investments were available at the world market. Thirdly, at present, devaluation has taken place in most of Russia's trade partners in Eastern Europe and in the territory of the former USSR. In other words, the competitiveness of these countries has increased, and Russian goods have become less attractive in price. Fourthly, as a result of the almost ten-year-long boom, part of Russia's real sector has become more dependent on deliveries of bought-in foreign parts and equipment; the position of these enterprises is adversely affected by the ruble's devaluation. And finally and fifthly, the scale of the 2008 – 2009 devaluation was incomparable with 1998 (40 % vs. almost 400 % drop in the value of the ruble).

Although the adopted anti-crisis policy has indeed made it possible for Russia to stabilize the situation and to bring it under control, it is still not free from some serious flaws and limitations. Its major flaw is the absence of real steps toward anti-crisis modernization. In late 2008 and early 2009, a lot was being said of the necessity to take advantage of the crisis in order to accelerate the process of modernization and to single-out the modernization aspect from among the anti-crisis measures being taken. However, in practice, attention was mainly focused on the attempts to avoid destabilization, which in fact implied the preservation of the status quo.

However, it should be said that achieving an effective combination of an anti-crisis (or even a post-crisis recovery) policy and a modernization policy is actually a very difficult task, and so this goal could hardly be achieved within the framework of one calendar year. As a rule, anti-crisis measures must be launched without delay, which means that they cannot be thoroughly elaborated and accurately adjusted to a long-term strategy of development. Unlike anti-crisis measures, modernization requires some serious conceptual elaboration.

Especially noteworthy in this context is the warning offered by Nouriel Roubini, Professor of Economics at the Stern School of Business, New York University. He noted that, in the course of the 2009 recovery, 'markets have gone up too much, too soon, too fast'. Such a recovery is fraught with the risk of a new bubble and some very unpleasant social cataclysms that may follow in a number of countries.

1.1.4. The priorities of Russia's economic policy in 2010

The top general priorities of Russia's socio-economic development are modernization and diversification of its economy. However, modernization is a long-term issue that deserves to become a subject of a special public discussion. For modernization to get under way, it is necessary that, along with relevant theoretical studies and practical recommendations, there should be a demand for modernization on the part of society's elite – or even society as a whole. Meanwhile, in present-day Russia, the predominant attitudes and political instincts are, as before, inclined towards rent-oriented behavior based on the expectation that high prices for energy carriers and the finance flows of the previous decade will come back sooner or later.

Yet another problem is associated with the necessity to comprehend the all-embracing character of modernization. Modernization cannot actually be limited to some individual sectors of the national economy (primarily the military-industrial complex), or even to the whole of the economy; instead, it should encompass all the spheres of the vital activity of society, including its economic, political and social aspects. In its turn, this will cause a cultural (ideological) renaissance as well.

As far as anti-crisis modernization is concerned, the following high-priority areas can be singled out.

First. The sustenance of macroeconomic stability; the pursuance of the course toward cutting inflation to the level of below 5 % and then keeping it at that level; the development of strategies for discontinuing fiscal assistance to the economy and for gradually reducing the budget deficit; the coordination of the monetary and budget measures designed to prevent an uncontrollable growth of money in circulation and a new upsurge of inflation in 2011 – 2012.

The contours of Russia's monetary policy should also reflect these tasks. It should take into account the prospects for transferring the ruble into a regional reserve currency. Even if at present this task may seem to be fantastic to some persons, its implementation in the medium-term perspective is actually quite possible. However, at the same time it is necessary to avoid anything that can make these prospects more remote (for instance, launching uncontrollable inflation or introducing currency controls). What is needed is the development of a phased program of measures designed to strengthen the international position of the ruble, with the phases being logically interlinked while no being anchored to any specific dates.

Second. An increase in the effectiveness of budget expenditures. The solution to this many-sided issue should be achieved by several means, including the development of mechanisms for singling-out the high-priority expenditures – instead of rapidly increasing such expenditures in times of boom, and then sequestering them in times of crisis; the improvement of the budgetary process and the sustenance of its continuity, when expenditures cover the work performed or the services delivered, and are not anchored to the formal framework of a calendar year; a reform of the budget-funded institutions, the singling-out of treasury enterprises and budget-funded and autonomous institutions and the change of mechanisms of their financing; the improvement of the system of state procurement.

Third. A transition from the policy of employment conservation to the policy of stimulating the creation of new jobs and increasing the mobility of labor force, which will involve a reduction in the administrative pressure on the enterprises for the purpose of employment conservation; an increase in the funding of the programs of support for the jobless and their re-training, a more intensive attraction of investments and a more robust stimulation (including fiscal) of green-field investments and other forms of creating new jobs; the development

of a program of resettlement and retraining for the residents of unpromising mono-function (single-enterprise) towns.

When implementing measures of social stabilization, the government should abide by the principle that the State should help people – and not enterprises and their top managers and owners. This help should not be limited to the payment of unemployment benefits: people must be actively drawn into various educational projects oriented to professional retraining or improvement. In order to emphasize the importance of providing support to enterprises (especially the big ones), it if often argued that by doing so the government supports huge groups of workforce. However, the goals of structural renovation of the economy by no means imply that it is indeed necessary to keep the whole lot of the existing enterprises and to sustain the current level of employment. Moreover, modernization inevitably leads to a rise in unemployment and to a jobless recovery. Therefore, the provision of support to redundant workers is an imperative element of any sound modernization policy.

Fourth. Stimulation of modernization and the development of the medium- and long-tem crediting of medium and moderately large (non-oligarchic) businesses; the implementation of the privatization program which will favor such businesses; a reduction in the administrative load on businesses (especially large and medium-sized ones), including tax administering; the adoption of administrative regulations addressing the provision of government services.

Fifth. Two aspects of antimonopoly policy should be singled out: the overcoming of monopolism per se (anti-trust) and the stimulation of competition. The first aspect is of limited importance; sometimes it can even be dangerous (with regard to new rapidly growing sectors and enterprises) because it hampers the introduction of innovations. Anti-trust as such cannot attract new companies to the market and cannot stimulate an inflow of investments and innovations. These tasks can be solved only by some positive means – that is, by actions in favor of business, not against it. The number one priority should be the creation of proper conditions for the development of competition, such as the lowering of hurdles for business, the formation of the necessary infrastructure and the provision of support for innovations.

Sixth. The financial sector should be reformed with taking into account the globalization of financial markets and the recommendations of the G-20. From the institutional point of view, it should be necessary to switch over to the financial market standards adopted by all major financial centers of the world.

Seventh. Privatization of part of the assets nationalized or acquired by Vneshekonombank (Bank for Development and Foreign Economic Activity), which can be achieved, among other things, by establishing share funds or by transferring these assets to the trust fund of the pension system. This move can help to overcome the consequences of the revolutionary privatization of the 1990s which, while being very effective from a political point of view, did not ensure the proper legitimacy of the newly-established private ownership relationships.

Eighth. The development of integration processes, from finalizing the establishment of the Customs Union to the creation of the Common Economic Space (CES). When forming the CES, it would be advisable to focus on the harmonization of the corresponding legislation with that of the EU (to an extent that is not harmful to economic growth), which would make it possible to intensify the process of integration between the CES and the EU. It is equally important for Russia to complete the negotiations on its accession to the WTO and to join the OECD. This process, provided that it is carried out step by step, will make some long-term impact on institutional modernization in Russia, because the integration associations will pro-

vide a framework for competition between relevant jurisdictions, which would urge the partner countries to create more favorable conditions for businesses and citizens alike.

Ninth. Clarification of approaches to pension and medical insurance reforms; an increase in social demand for the funded pension system and to the long-term stability of the distribution system; an increase in the length of the period of transition to new rates and tariffs.

Tenth. Elimination of the problem of mono-function (single-enterprise) towns.

Eleventh, and last (but not least) – giving high priority to all areas of human capital, primarily education, health care and the pension system. The crisis has only increased the importance of the development of the socio-humanitarian sector as a key area and base of modernization.

1.1.5. The risks of the forthcoming period

The general characteristic of the current global crisis is the vagueness of its major parameters[1]. Numerous different forecasts have been offered to date, but still nobody can say with confidence just how long the crisis will last, and whether or not there will a 'second wave', and if it indeed comes, what shape it will take. 'I have never known such a prolonged period where the lack of visibility about future orders is so pronounced'[2] – this statement of one European industrialist clearly reflects the mood which is prevalent today among the intellectual and business elite.

The recession is coming to an end and economic growth rates are recovering, which inspires certain optimism. The governments and money authorities have proved their ability to rapidly respond to a very grave situation and to prevent a serious economic destabilization and a collapse of the banking system – which would otherwise certainly have been followed by a full-blown catastrophe.

However, there still exist some serious doubts. On the one hand, the crisis did not begin with a recession – it was only in a number of countries including Russia that a slump in production and the onset of the financial crisis coincided in time. Correspondingly, the end of the current recession does not necessarily mean the end of the crisis. On the other hand, economic growth so far has been associated mainly with efforts initiated by authorities. The main contributing factor is the budget incentives being introduced in the USA and China, and so the current growth is actually, to a great extent, rather artificial. Massive injections of liquidity can easily lead to a serious macroeconomic destabilization and inflate yet another financial bubble. Although less loud than before, there is still a lot of talk about a new wave of the crisis. And these misgivings are totally justified.

The financial difficulties being experienced by Dubai and Greece indicate that the crisis is far from over. The problem of sovereign debts has again resurfaced, although so far this has not been noted in the most developed countries. However, the rates of debt growth in developed countries are so high that one cannot exclude the possibility of sovereign debts emerging even there, which could cause a chain reaction in various countries and in various sectors of the economy. The problem of bad debt accumulation in the banking system remains acute. For the time being, these debts are being disguised and not written off , which can become – in a not so distant future – a serious factor of macroeconomic destabilization.

[1] See Ye. Gaidar, *Krizis v Rossii* [The Crisis in Russia] Ekonomicheskaia Politika [Economic Policy]. 2009. No 6.
[2] Milne R.. *EU Business Wary over Recovery* // Financial Times. 2009. Nov. 12. P. 6.

However, the case in point is not the individual spheres of economic life that remain unregulated and so can trigger a second wave of the crisis. There exist some systemic risks which can become a source of serious destabilization both in Russia and across the global economy. So, it is worthwhile to consider these risks in more detail.

The most important among these risks appears to be macroeconomic destabilization, substantial growth of the public sector (mass-scale nationalization) and moral hazards (the risks of dishonest behavior or irresponsibility), which can result in conservation of the existing economic structure. We believe that the most important of these risks are as follows:

– macroeconomic destabilization;
– substantial growth of the public sector (mass-scale nationalization) and moral hazards (the risks of dishonest behavior or irresponsibility);
– restoration of the ideology and practices of Big Government;
– the tendency to preserve the status quo and the abandonment of any plans for true modernization of the country's economy and individual enterprises (business as usual).

The key problem is the accumulation of potential risks of macroeconomic instability, which can give rise to political instability. Last year, the governments of many highly-developed countries pursued expansionist budgetary and monetary policies designed to resist deflation. The currently pursued policy of cheap money and budget injections will inevitably result in significant growth of the sovereign debt of a majority of developed market economies, and it can also make high inflation more than probable in the not-so-distant future. In the latter half of 2009, the press was becoming increasingly optimistic about the situation, as reflected by the statements like 'Time has come for us to declare victory over the crisis and to abandon stimulating policies'[1]. This is actually the reason why the issue of an *exit strategy* – that is, the ways and methods of achieving disinflation and reducing state debt – is periodically being raised today in the discussions carried on by politicians and economists. At the same time, doubts as to the reality of the risks of uncontrollable inflation are still vociferously expressed by some experts[2].

The political problems associated with such a policy are no less evident; these have to do not only with the switchover to an *exit strategy*, but also with the political and economic consequences of its implementation. Politicians in developed countries (and first and foremost in the USA) are urging their colleagues to persist in their efforts aimed at maintaining budget incentives. An early reversal to budgetary conservatism may result in launching a recession, as it indeed happened in 1937. However, an excessively active large-scale inflow of money into the economy is fraught with the risk of high future inflation[3]. As demonstrated by the experience of the 1970s, it can become increasingly difficult to escape from this trap.

Two models of public authorities behavior have come into being by now. For instance, the United Kingdom, which previously has pursued a policy of huge financial injections into the economy, will now apparently be forced to increase taxes and cut budget expenditure. Germany, which has traditionally pursued a very cautious economic policy, is now going to bal-

[1] *Goodhart Ch.* It Is Time to Declare Victory and Withdraw Easing // Financial Times. 2009. Dec. 1. P. 28.

[2] Some international organizations and a number of prominent economists argue in favor of the inflation-proofness of the current monetary policies. See, for example, *Trade and Commodity Report, 2009* / UNCTAD. Geneva, 2009. P. 39, and the articles by Paul Krugman and Robert Skidelsky published in the *Financial Times* in May - June 2009. For a detailed argumentative backing for this viewpoint, see Richard Koo: a Personal View of the Macroeconomy / Nomura Securities. 2009. July 30.

[3] См.: *Giles Ch.* BIS Calls for Wide Global Financial Reforms // The Financial Times. 2009. June 30. P. 3.

ance her state budget while having the tax burden reduced in order to stimulate production and to achieve an increase in tax receipts on this basis. The USA, as a country in possession of a world reserve currency, and as such capable of monetizing its state debt, will apparently continue the current stimulating policy for a very long period of time.

It is even more difficult to correctly assess the political and economic problems and obstacles in the way of implementing the post-anti-crisis policy. A policy combining a tough attitude to budget expenditure with increasing interest rates would produce painful effects under any regime, but such a policy is even mode dangerous from the point of view of immature democracies – that is, those countries where the voters, because of their poverty, are strongly inclined to succumb to populist slogans. It can be already noticed, in the behavior of the governments of those countries that are preparing for elections, that they are somewhat prone to populism – which can now be said even of those who until recently have been actively opposed to it. The politicians exercising a prudent attitude to state expansion are, in fact, extremely rare.

There clearly exists a real danger for developed countries to get into a vicious circle of populism – and possibly to start going though this circle again and again. The situation is, in fact, rather simple – and it has becobe well-known from the experience of Latin America of the 20th century[1]. Of course, one should not overestimate the experience of the 20th century by regarding it in absolute terms, but nevertheless, this experience can provide some important information concerning the potential course of events.

Another serious problem is mass nationalization – be it implicit (hidden) or explicit (open), as well as the increasingly dirigiste trends observed in the economic policies of the world's leaders. When the State saves debtors and fills banks with capital by increasing its guarantees against private deposits, it thereby assumes the risks arising as a result of the actions of all the main participants in economic life – bankers, depositors and borrowers. In their struggle against the effects of the global crisis, the governments of the majority of developed countries often resort to measures that can discredit the fundamental principles of a market economy – that is, personal responsibility (meaning primarily the responsibility of entrepreneurs) for the consequences of private decision-making. The policy of nationalizing losses in its next phase inevitably leads to nationalization of risks.

Effective nationalization of companies faced with a difficult situation is thus achieved through granting financial aid to them. Nationalization is carried out through at least three channels: by buying-out the debts of individual companies; by recapitalization in exchange for shares; and by inflating the accumulated obligations. The governments are inclined to take over the liabilities (obligations) of financial institutions – both by granting guarantees and by

[1] There exists a classical description of the populist Latin American cycle suggested in the 1990s by R. Dornnbusch and S. Edwards. *Phase 1* – the initial government measures aimed at implementing a populist policy in response to depression or stagnation result in significant industrial growth and, accordingly, growth of the real incomes of the population which are satisfied by both domestic production and imports. *Phase 2* – there emerge macroeconomic bottlenecks associated with shortages of goods or the balance of payments deficit; the foreign exchange reserves allocated to support the national currency exchange rate gradually shrink. *Phase 3* is characterized by a rapidly increasing inflation and / or shortages of goods, and also by further deterioration of the balance of payments, as well as by capital flight and demonetization of the economy, which inevitably results in devaluation, a considerable drop in the revenues of the population, and – almost always – in the government losing political control. *Phase 4* – the transition to orthodox stabilization carried out by the new authorities (not infrequently, a military regime). (For more details, see *The Macroeconomics of Populism in Latin America* / R. Dornbusch, S. Edwards (eds.). Chicago and London: The University of Chicago Press, 1991. P. 11–12.)

direct capital inflow. True, the present-day nationalization has one specifically distinctive feature: it is something that is desperately needed. The nationalizations of the 20th century were ideologically motivated. Their authors – from the Russian Bolsheviks to the British Laborites – were convinced of that state property is always managed more efficiently than private property. By the turn of the century, the world had already got rid of that illusion, and so mass-scale nationalizations gave way to the policies of deregulation and privatization. And now there has emerged one entirely new phenomenon: nobody (or almost nobody) believes that the institution of state property can indeed ensure efficient economic performance. However, throughout the civilized world the anti-crisis policy has resulted in serous strengthening of the state sector[1].

In addition to direct nationalization, there occurs an overall growth of dirigisme; in other words, the number of individual decisions made by power institutions is increasing; it is they (and not the market) that decide who is right and who is wrong; and the State is prepared to instruct economic agents as to which services they must provide and which commodities produce. The bankruptcy of *Lehman Brothers*, on the one hand, and government aid to *Bear Stearns, AIG* and *CitiBank* on the other, which can hardly be viewed as market measures, were the outcome of some individually taken decisions – a situation that is fully compatible with the logic of a centrally managed economy.

And finally, systemic risks are associated with the emergence, among market players, of those who are 'too big to fail'. In the contemporary Russian terminology, this phenomenon has been named 'a system-forming enterprise'. There exist two major arguments in favor of their preservation. Firstly, the commodities or services produced by them are very important for society. Secondly, their closure may have some grave social (and sometimes even political) consequences.

Of course, in any historical period there existed enterprises whose collapse could entail some big social and political losses for society. However, the modern economic growth phenomenon *per se* implies not only the emergence of some new businesses (and companies) but also their departure from the scene as a result of competition. Competition – and no 'untouchables' – are the two fundamental principles of modern economic and – more broadly – social progress. Those who are granted government support find themselves in a privileged position – despite being less effective, they are able to prevail over their more effective competitors.

Also, there emerge moral hazards. If the State contributes to lowering the risks faced by a private form, the latter can indeed afford it to risk even more recklessly because it always hopes to be bailed out by the State.

There is yet another problem. While in the second half of the 19th century small business forms were seen as a source of innovation and dynamism ('small is beautiful'), nowadays most of the governments have demonstrated by their actions that, however wonderful small firms might be, it is always better and more secure for a firm to be big. This can significantly change the paradigm of economic development by hampering (at least temporarily) the dynamism of post-industrial renovation.

The current policies across the globe are largely focused on preserving many of those 'giants' which actually are remnants of the economy of the past. This became especially visible

[1] "…Political labels lost all meaning. With governments of all persuasions nationalizing banks and pumping money into the economy what now distinguishes left from right, liberal from conservative, socialist from capitalist, Keynesian from monetarist?" (*Thornhill J.* A Year of Chocolate Box Politic // The Financial Times. 2008. Dec. 24. P. 6).

in the case of the Russian Government's granting its guarantees to a number of companies, as practically none of those who had received state guarantees or money managed to produce in return any coherent modernization program.

Yet another serious problem dealing with the 'too big to fail' paradigm is the resurrection of the ideology of the Big Government. As the problems of the current global crises are frequently explained by insufficient regulation, the State is regularly called on to increase its interference in economic life. It is true that so far the proponents of such views have mainly been pointing to the 'necessity' of toughening the regulation of financial markets and institutions, including at the international scale. However, such a move can easily be followed by a return to state regulation of production and commerce. Russia is particularly vulnerable in this respect because of her tradition of the State's participation in the economy. In any case, the RF Law on Trade adopted in late 2009 and the State's desire to actively interfere in the process of pricing created a dangerous precedent for the future, especially bearing in mind Russia's 'credit history' of dirigism.

It is not only in Russia but in developed market democracies as well, that the wave of criticism of the liberal model of the past thirty years has brought popularity to the thesis of the necessity for the State to more actively interfere in the economy in order to overcome the risks of its spontaneous development. However, a balanced analysis of the current situation testifies to the questionability of such a solution, because state regulation *per se* implies certain systemic risks. 'Top government officials … are calling for the creation of a powerful systemic risk regulator. to reign in systemic risk in the private sector. But their [the US] government is now the most serious source of systemic risk', wrote, and not without justification, John B. Taylor, Professor of Economics at Stanford University[1]. This accusation holds true not only in regard of the US Government alone.

Finally, it should be pointed out that Russian society has so far failed to develop any pronounced demand for renovation and modernization. As far as contemporary Russia is concerned, the desire to preserve the status quo means waiting for the prices of Russian exports (fuel-and-energy resources and metals) to rebound and for the economy to return to the pre-crisis model of growth. 'Preserving the status quo on belief that oil prices will move higher and that fiscal can be tightened later…Moscow is trying to live through this crisis without visible reforms in fiscal, banking, natural monopolies or any other area'[2]. This is how the situation in this country was described by J P Morgan's analysts who visited Russia in June 2009. Theirs was a rather accurate assessment of the feelings expressed by the political elite and the public at large. These feelings are hardly surprising: in the public mind the economic boom of 1999 – 2007 – just as the onset of the current crisis – was formally linked to the movement of oil prices (as well as prices for natural gas and metals). Naturally, the exit from the crisis is also viewed as being dependent on growth of prices for energy carriers. The hope that soon 'everything would be all right once again', and we would return to the policy of 'well-being growth management' was clearly predominant in 2009.

It should be emphasized that it is extremely dangerous for Russia to remain resource-dependent and that this danger has only increased over the past forty years. The Russian economy has always been dependent on the export of resources. However, from the 1970's onwards a fundamentally new reality has come into being in Russia: her dependence on natural

[1] Taylor J. *Exploding Debt Threatens America* // The Financial Times. 2009. May 27. P. 9.
[2] Russia. *Emerging Markets Research* / JP Morgan Securities Inc. June 12, 2009.

resources which yield revenues totally unrelated to the country's economic development and the growth of labor productivity. Such a situation has never existed before. And it is this new reality that poses the main, strategic danger to Russia's future. This dependence on resources quantitatively differs from the previous heavy reliance of the Russian economy on raw materials, when Russia's exports were mainly agricultural. *The political risks of Russia's current dependence on resources are really huge, because such a dependence will inevitably result in the degradation of her main social institutions.* Resource dependence has already caused the collapse of the USSR – at the very moment of its becoming a seemingly impregnable[1].

1.1.6. Systemic challenges and new tasks

The current global crisis has clearly gone beyond the framework of the standard cyclic crisis; its emergence and development reflect the deepest underlying problems of the socio-economic development of the world's leading economic powers. In this respect, it indeed resembles the events of the 1930s and 1970s, when crises were followed by quantitative shifts in the political, economic and ideological complexion of the world. Crises of this type should give answers to a number of fundamental questions that capable of determining the character of the world's development for several decades.

The emergence of a trajectory of new stable growth becomes possible only when the government of a given country is capable of providing solutions to the root causes of the crisis. These root-cause problems are technological, economic, regulatory, social and, possibly, geopolitical in nature. Such changes for the better are always relatively slow, and it is practically impossible to speed them up. Their progress, however, can be made even slower by sticking to obsolescent economic and technological modes. So what are the root causes of the crisis?

Technological challenge. There have emerged new technologies which deepen man's penetration into the world of nature and the social organization of humankind. Bio- and nanotechnologies, as well as the newest IC systems, are forming a new technological base of social development. This process will soon require some serious institutional changes to be introduced that will push developed countries further and farther away from the heritage of industrial society. This new base will play the same role as large-scale machine industry was playing in the 1930s, and as micro-electronics and computer systems were playing in the 1970s.

The current crisis envisages a technological renovation that would reflect the transformation of demand for goods for many industrial purpose products and consumer goods, especially for investment goods, fuel and energy carriers. Naturally, this will have an effect on prices for the majority of goods traded on the market, and so will eventually bring prices to new balanced levels, which would result in a change of political configuration.

Motivation. One of the most deeply rooted problems of the crisis is the predominance of the interests of capitalization interests over the interests of increasing the effectiveness of production factors (or labor productivity growth factors). It is exactly this indicator that primarily concerns the owner-shareholders who thus assess the effectiveness of their managers. The indicator forming the target function became predominant with respect to the other pa-

[1] This phenomenon was noticed and described very long ago by Adam Smith: 'The rate of profit does not … rise with the prosperity, and fall with the declension of the society. On the contrary, it is naturally low in rich, and high in poor countries, and it is always highest in the countries which are going fastest to ruin' (Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, Book I, Chapter XI, On the Rent of Land, Conclusion of the Chapter).

rameters of activity – labor productivity and renovation of production – which indeed played an important role, provided it did not interfere with capitalization growth. In practical terms, this situation reflects a tendency towards maximum concentration of production in the hands of a few global players (firms), the impossibility of closing ineffective enterprises, and, on the contrary, the owners' readiness to include them into big holding companies as a factor of market expansion and capitalization growth. Such a motivation of today's top management leads to a rise in monopolism (as a result of mergers and takeovers), to a deceleration of labor productivity growth and eventually to a destimulation of innovation activities.

The main issue of regulation put on the agenda by the current global crisis consists in the necessity to change the motivation of company owners and top managers in order to focus their attention on the quantitative aspects of their firms' development. It is exactly the task of finding an adequate solution to this issue that the current discussion on the bonuses paid to CEOs is concentrated on. After all, the problem of bonuses is not only (and even not so much) moral and ethical, but also (and primarily) an economic one: it can be reduced to the question of how a bonus should be formed in order to orient the managers to solving the long-term issues of their company's functioning. This problem is more profound than that of financial markets regulation, because the latter, however important it might be, is a derivative of the conflict between capitalization and effectiveness.

Structural modernization. The governments of the world's leading countries must find a solution to a very complex problem – how to help the development of new sectors of their economies and new businesses, while at the same time keeping down the level of social discontent and thus preventing social upheaval; incidentally, the source of that discontent are the 'system-forming enterprises' – big old companies whose post-crisis prospects are rather dubious, to say the least. In essence, the crux of the problem is how to reconcile the current and strategic interests. This is what the US Administration is faced with when it attempts to achieve two effectively opposite goals: to create incentives for boosting household consumption and thus to avoid the deflation trap, while simultaneously to promote savings growth – that is, to bring the level of household expenditures into line with the results of their production activity. Meanwhile, it is this latter goal that appears to be strategic: if it is not achieved – that is, if the 'consumption bubble' is not deflated, the former trajectory of stable economic growth will likewise remain unattainable.

Similar contradictions can be observed in the anti-crisis policy of Russia, whose government wants simultaneously to prevent unemployment growth and to implement structural modernization. However, the crisis of the first half of the 1990s clearly demonstrated that maintaining a high level of employment can help make social conflicts less acute but puts a barrier in the way of structural renovation and performance improvement[1].

A new model of regulation. The global crisis will inevitably lead to the emergence of new models of regulation. So far, debate on the crisis has been confined to the framework of the

[1] It is all the more important to remove the barriers standing in the way of employment restructuring because enterprises are reluctant to make an unproductive workforce redundant: in 2009 (like in the early 1990s), instead of labor-market restructuring, we witnessed labor-market adaptation which expressed itself in retaining the existing level of employment and in cutting wages, the working day and the working week, etc. (For more details, see *Zarabotnaia plata v Rossii: evoliutsiia i differentsiatsiia* [Russia's wage system: its evolution and differentiation] / V. E. Gimpelson and R. I. Kapeliushnikov, Eds. M.: Gu-VShE, 2007. Pp. 21 – 25; Kapeliushnikov R. I. *Konets rossiiskoi modeli truda?* [Is it an end of the Russia labor-market model?]. M.: Fond "Liberal'naia Missiia", 2009.)

logic and models of the past century – monetarism versus Keynesianism and deregulation versus dirigism. This paradigm range has become outdated, and the expert community needs to find new forms and instruments of regulation. It should concentrate on the issues of regulating global financial markets, not the production activities of enterprises. In this field, there emerged several critically important challenges and innovations that should be urgently comprehended and regulated in order to completely overcome the current crisis.

Firstly, there arose the issue of global regulation in the absence of a global government, i.e., the issue of finding the ways of coordinating the activities of the authorities and businesses that belong to different national legal and political systems. This task is by no means trivial: it does not have any precedents in economic history.

Secondly, the role and the possibility of regulating the new financial instruments which have essentially provoked the current global crisis remain to be comprehended.

Thirdly, as far as market regulation is concerned, a fundamentally new phenomenon of financialization, which eliminates the previously insurmountable barriers between the commodity and financial markets and between trade in commodities and securities, is visibly pushing its way onto the agenda[1]. Apparently, these markets are merging ever more closely, because in conditions of a contemporary information society both trading products can be used for solving purely financial issues, primarily for hedging risks. Especially interesting in this respect is the phenomenon of the oil market, where the price of oil is getting ever more disconnected from its production basis – the ratio between the demand for oil and its supply as a fuel – and becomes an instrument of placement of spare financial resources[2].

An analysis of financialization processes makes it possible to draw the following conclusion: the emergence of bubbles in such a situation is inevitable, because market participants (profiteers) can considerably influence prices and create speculator bubbles, thus inflicting enormous harm on normal commercial activities and market effectiveness[3]. Therefore, the role of state regulation of financial markets will inevitably expand. However, the question of its principles and instruments still remains open. Apparently, this question will become one of the top priorities on the agenda of future discussions between economists and politicians.

Reserve currency. The adoption of a new model of economic regulation will entail a transformation of the system of financial settlements, which will also imply the emergence of a new configuration of the world (or reserve) currencies. The current discussions of this theme is centered mainly around the following four basic variants.

First, the USD can keep its leading position, alongside the strengthening roles of both the euro and several other traditional regional reserve currencies. Second, the role of the artificial currency for international settlements (SDR) as a world reserve currency can become more important. Third, a new reserve currency can appear – either as an alternative to the USD and the euro or as their equal counterpart, and in this role many envisage the Chinese yuan. And fourth, regional reserve currencies can become more prominent, and among these some new ones may appear (for example, the Russian ruble). It is assumed that multiple reserve currencies will contribute to the world's overall tendency to multi-polarity, and thus conduce to

[1] This term is used in the aforementioned report of the UNCTAD, which contains a special chapter entitled 'The Financialization of Commodity Markets'.

[2] This specific feature of the contemporary oil market and its influence on the prospects of economic growth in Russia was analyzed by Ye. Gaidar in his article *Dizzy with Success* (Ekonomicheskaia Politika [Economic Policy]. 2008. No 3).

[3] Trade and Commodity Report, 2009. Ch. 2.

higher responsibility of the monetary authorities of the relevant countries (as the reserve currencies will be competing).

This issue has given rise mainly to political discussions. However, it is well understood that a reserve currency cannot be 'appointed'. This role is assumed naturally, as a result of a responsible monetary policy being pursued by the authorities of a given country, which is aimed at increasing the attractiveness of their currency on an international plane.

Global disbalances. The issue of global disbalances and of the ways for overcoming them is also far from being solved. In fact, the case in point is the model of the post-crisis world order, the distribution of economic forces and the roles to be played by different countries and regions. Will it be a G-20, a G-8, a G-7 or a G-2? And what would be the reserve currencies of the post-crisis world order?

In this respect, there remains one very important question: what will be the new make-up and prospects of the new make-up of international economic relations? Some politicians (Z. Brzezinski, H. Kissinger) name the G-2[1], while N. Ferguson, rather provocatively, described it as 'Chimerica' (Chimerica = China + America)[2]. What is meant here is the emergence of a global disbalance between the growth of savings in developing countries and the growth of consumption in developed countries, first of all in the USA. In spite of the distinct trend towards adopting this new structure of international economic and political relations, it cannot be perceived as an established fact. There have been too many other trends that in actual practice proved to lead nowhere. However, the reality of the prospects for the materialization of the G-2 will determine many things – both in the mechanisms to be applied in order to engineering an exit from the crisis and in the actual configuration of the post-crisis world.

*** * ***

The systemic problems and challenges described above indicate that the crisis that the world entered in 2008 will last at least ten years. Growth rates, currency regimes and political systems will all be prone to be instable. Apparently, we have entered a 'turbulent decade'. Turbulence, however. does not mean a constant decline and the high tension that was characteristic of the autumn 2008. Instead, there will be fluctuations in the rate of growth, a period of unstable growth with some local ups and downs, with upsurges of inflation and attempts to suppress it.

[1] *Brzezinski Z.* The Group of Two that Could Change the World // The Financial Times. 2009. Jan. 14. P. 9.
[2] *Ferguson N.* The Ascent of Money: A Financial History of the World. The Penguin Press, 2008.

Section 2. Monetary and Budgetary Spheres

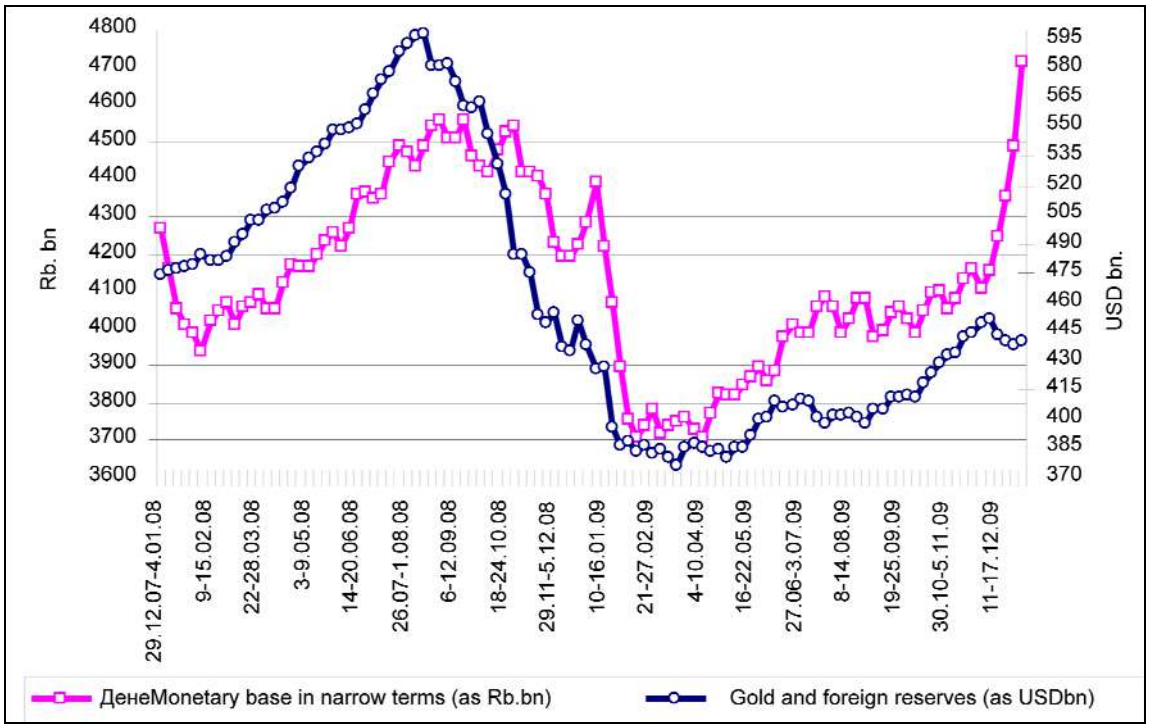
2.1. Monetary Policy in the Crisis Period

2.1.1. Monetary Market

The global financial and economic crisis that burst out in Russia in late 2008 battered primarily the financial sector of the economy. In August, crisis developments on the global financial markets were further aggravated by Russia's military action in the Southern Ossetia and triggered a sizeable capital outflow from the country. Plus, a slowdown in the largest economies' growth resulted in a dramatic deterioration of foreign trade conditions for Russia and a subsequent drastic contraction of the nation's foreign exchange revenues. As a result, Russia's international reserves began to dwindle rapidly, as the Bank of Russia had to throw them on pegging the Rb. exchange rate. In addition, the appreciation of the USD against the Euro on the global forex market has sent the value of the USD-denominated fraction of the reserves nosedive.

A rapid depletion of the volume of international reserves had been continuing through January 2009 and was the result of the Bank of Russia's pursuance of the policy of a gradual devaluation of the Rb. It was just the stabilization of prices for energy sources and the end of a sharp phase of the global economic crisis that allowed one to stop the rapid fall of the reserves. Between February and March 2009 the dynamic of international reserves demonstrated its fluctuating nature, with their minimum value reported in mid-March, when they stood at USD 376.1bn vis-à-vis a peak of USD 597.5bn back in the early August 2008. So, the gradual devaluation cost the bank of Russia roughly as much as one-third of the nation's international reserves (with account of the fact that the fall in the reserves was partly fueled by the noted appreciation of the USD vs. the Euro). The policy *de facto* enabled economic agents (primarily, commercial banks) to cut it fine with betting on a predictable exchange rate dynamic. It can be suggested that had the authorities opted for a one-time devaluation of the Rb. exchange rate to a level of circa Rb. 35/USD, the equilibrium on the forex market would have been secured anyway, but the price for the monetary authorities would have been less. That said, the gradual nature of depreciation of the Rb. allowed one to somewhat smooth down negative social effects from the process.

With global financial market stabilizing and prices for major Russian exports slightly bouncing back to normality, as early as in May 2009 the volume of the nation's international reserves was back on track of growth and by November-December accounted already for USD 440bn-plus. So, despite a sizeable contraction of the reserves, their volume remained fairly considerable by international standards (as of December 2009, Russia had the world's third greatest volume of the reserves after China and Japan). In all likelihood, should oil prices in the medium term remain within the corridor of USD 60-70/bbl or above that, the nation's international reserves would stabilize or slightly grow.



Source: the CBR

Fig. 1. The Dynamic of the Monetary Base and International Reserves in 2008−2009

The dynamic of money supply over the crisis period also allows singling out several sub-periods. As already noted above, in the second half 2008 Russia's gold and foreign reserves were in decline, as the CBR had to sell forex to keep the Rb. exchange rate buoyant. But a considerable increase in the CBR's volume of lending to commercial banks (between July and December 2008 the increase in loans credit organizations had received from the CBR accounted for over Rb. 3.3trln), nonetheless, resulted in a slight growth (+2.9%) of the monetary base over the 2nd half 2008. In January 2009, in the conditions of a full-scale capital outflow form the private sector, there took place the most significant contraction of the monetary base over the crisis period (-22.4%). It was fueled by the fall in the volume of cash (-14.5%) in the first place and that of balances of the credit organizations' corresponding accounts with the CBR (more than twice) due to a USD 40.2bn-worth contraction of Russia's gold and foreign reserves (*Table 2*). The CBR partly damped the liquidity outflow from the banking sector in January by boosting up the volume lending to Russian banks. More specifically, in January 2009 alone, the aggregate volume of loans disbursed to the national banking sector surged by Rb. 325.3bn (up 8.8%).

Between February and March 2009, the amount of the monetary base in broad terms has not undergone any substantial changes due to some stabilization on the exchange market and remained at the level of a. Rb. 4.3trln. Between April and December 2009, with the global economy recovering, prices for main Russian exports soaring, and the Rb. rate appreciating, the volume of the monetary base rose at 50.4% against the background of growing budget expenditures. It was the spending of the Reserve Fund's resources and the CBR's purchases of foreign exchange that formed main factors contributing to the growth in the monetary base. Specifically, the use of the resources from the Reserve Fund on financing

the budget deficit has increased money supply by more than Rb. 2 trln. Meanwhile, the CBR's cutting back on the volume of lending to commercial banks helped slightly inhibit the increase of the monetary base.

So, spending the Reserve Fund's resources in 2009 began to contribute substantially to the growth in money supply. Given that as of January 1, 2009, the aggregate volume of the National Welfare Fund and the Reserve Fund combined accounted for Rb. 6,612.1bn (USD 225.1bn, or 15.9% of GDP) (+ Rb. 2,763bn when compared with January 1, 2008), as of January 1, 2010, the respective value was Rb. 4,599.5bn (USD 152.4bn, or 13.6% of GDP). A rapid increase of budget expenditures may once again fuel an impetuous surge of money supply – by results of December 2009, the monetary base increase rate has already hit 24% and proved to be the most substantial one since December 2003. Meanwhile, the CBR's capability to sterilize an excessive money supply by virtue of recovery of the earlier extended to commercial banks credits will be smaller than between March and August 2009.

Table1

Dynamics of Monetary Base in Broad Terms between 2008–2009 (as Rb bn)

	1.07.2008	1.10.2008	1.01.2009	1.04.2009	1.07.2009	1.10.2009	1.01.2010
Monetary base (in broad terms) including:	5 422.9	5 317.8	5578.7	4298.8	4967.6	4803.7	6467.3
Cash in circulation, with account of credit organizations' cash balances	4 077.2	4 285.3	4372.1	3658	3908.1	3869.2	4622.9
Commercial organizations' corresponding accounts with the CBR	592.4	702.9	1027.6	431.7	471.4	545.4	900.3
Emergency funds	360.3	152.1	29.9	33.3	61.8	153.9	151.4
Commercial organizations' deposits with the CBR	369.3	154	136.6	163.4	508.8	216.9	509
The CBR's obligations in hands of commercial organizations	23.7	23.5	12.5	12.4	17.5	18.4	283.7

Source: the CBR

An analysis of the change in the structure of assets in the CBR's balance (see *Table 2*) allows one to note that in the critical phase of the crisis (between the autumn 2008 and the winter 2009) it was credits and deposits disbursed to Russian credit organizations that demonstrated the highest increase rate. By contrast, capital placed with non-residents was shrinking[1]. Once between the spring and summer 2009 the global financial market began recovering, the CBR has been gradually shutting off its lending pipe. In parallel with that, the RF Government had found by then its resources drying up, as were the CBR's accounts. In other words, because of the crisis phenomena, it was the CBR's operations on refinancing credit institutions that formed the principal source of formation of money supply. This is consistent with the most developed nations' practice. In the circumstances it is interest rates of the CBR's credits that gain a far greater role than before, as employing them, the Bank of Russia can exert a substantial influence on the situation in the monetary sphere. Meanwhile, as long as resources were being spent from the Reserve Fund, the money supply in the country was on the rise, and the Bank of Russia precludes it from a further excessive growth by cutting back on the net lending to commercial banks. But its capability to do so is limited,

[1] This paper highlights on changes in the Bank of Russia's international reserve assets.

while further appropriations from the accounts of the RF Government with the CBR might result in an acceleration of growth rates of money supply, which, in the event of a sharp aggravation of the situation on financial markets in the form of a growing financial instability, could create a downward pressure on the Rb. exchange rate and trigger inflation escalation.

Let us note that the lending fragmentation to credit institutions in the autumn 2008 (in anticipation of a looming devaluation) did not allow one both to solve the problem with liquidity in the banking sector and the problem of lending to the real sector, as at the expense of the *de-facto* predetermined gradual devaluation the CBR has generated very lucrative assets, that is, foreign exchange, that has proved to be more rewarding and less risky than alternative avenues for investment. As a result, once bankers received the CBR's transfers, the latter were immediately channeled onto the forex market and ultimately back to the reserves-bleeding CBR. So, the gradual devaluation allowed the financial sector to generate extra profits, which mitigated the liquidity crisis in the banking system, albeit, as already noted, it cost the CBR one-third of its international reserve assets and triggered a boom on the forex market.

Table 2

The Balance Sheet of the Bank of Russia in 2008–2009

	1.08.2008		1.01.2009		1.12.2009	
	USDbn.	**% assets / liabilities**	**USDbn.**	**% assets / liabilities**	**USDbn.**	**% assets / liabilities**
Funds placed with non-residents and foreign issuers' securities	13653.9	93.2	12091.1	71.3	12448.2	80,4
Loans and deposits	69.2	0.5	3871.3	22.8	1707.7	11.0
Precious metals	382.2	2.6	450.3	2.7	746.4	4.8
Securities	442	3.0	441	2.6	459.7	3.0
Other assets	103.1	0.7	110	0.6	120.8	0.8
Total, by assets	**14650.3**	**100**	**16963.7**	**100**	**15482.6**	**100**
Cash in circulation	4153.9	28.4	4378.2	25.8	4024.9	26.0
Funds deposited in accounts with the CBR	9729.8	66.4	10237.6	60.4	8520.7	55.0
including the RF Government's	7145.9	48.8	7093.9	41.8	5441.6	35.1
resident credit institutions'	1097.6	7.5	2010.1	11.8	1214	7.8
Receivables	50.3	0.3	16.1	0.1	52.2	0.3
Issued securities	40.7	0.3	12.5	0.1	111	0.7
Other liabilities	201.6	1.4	319.2	1.9	823.7	5.3
Capital	474.1	3.2	1902.4	11.2	1950.1	12.6
Profit in the banking year	0	0.0	97.8	0.6	0	0.0
Total by liabilities	**14650.3**	**100**	**16963.7**	**100**	**15482.6**	**100**

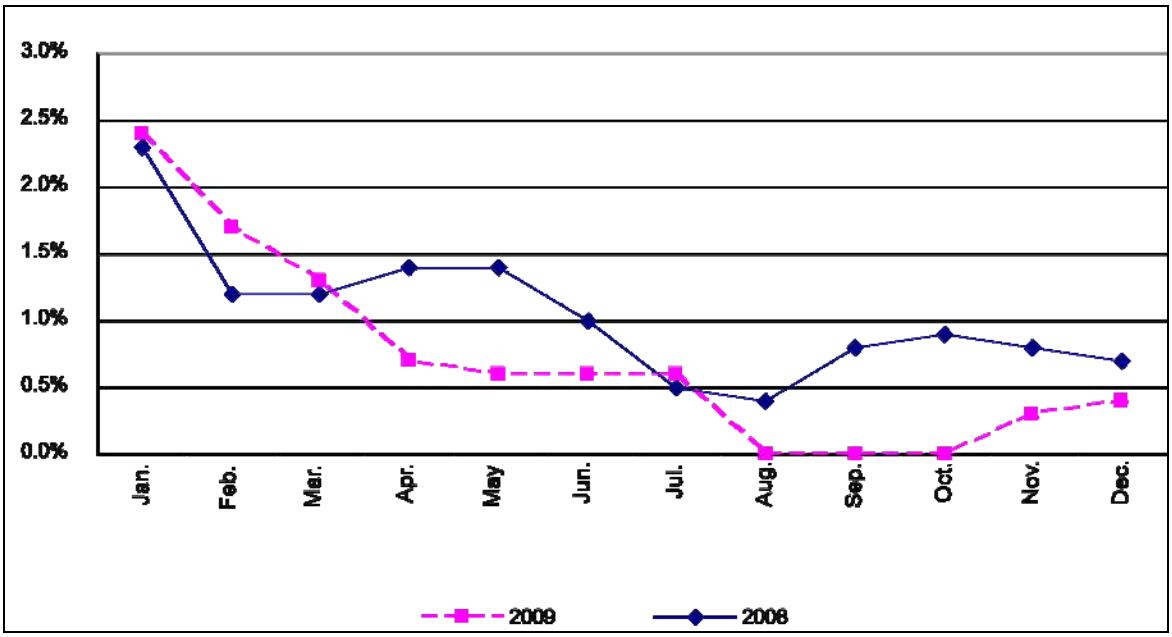
Source: the CBR

Money supply M_2 in national terms increased in 2008 just at 1.7% and as of January 1, 2009, accounted for Rb. 13, 493.2bn, or 32.5% of GDP (as of January 1, 2008, M_2 equaled Rb.1,3272.1bn, or 40.2% of GDP). Main reasons behind such a slow rise of money supply were the CBR's sales of international reserve assets for the sake of protecting the Rb. exchange rate and a fall of the lending activity in the banking system due to the crisis. In 2009, money supply tumbled by 1.4% and by September 1 had hit the level of Rb. 13,305bn (32.5% of GDP). So, in 2009, the monetization rate of Russia's GDP remained at its 2008 level. Compression of money supply in 2009 was noted only in January – at the time, by results of the month it plunged by 11.1% resulting from the CBR's large-scale forex interventions. In the conditions of a high uncertainty about further trends of Russia's economic development, an increase in money supply in the medium term will be determined largely by the situation in the foreign trade sector, velocity of the economy's recovery, and the lending activity in the banking sector.

2.1.2. Inflationary processes

In the first half 2008 inflation remained high compared with the same period of the previous year (*Fig. 2*), with a rapid increase of money supply in late 2007 accelerating the price rise. But in the second half 2008, due to the contraction in international reserve assets the CBR was selling to buoy the Rb. exchange rate, money supply began to contract and the price rise rate started slowing down. In all, by results of the year the CPI hit 13.3% vs. 11.9% reported in 2007, with consumer prices nationwide rising at an average 3.2% between September and December (vs. 4.8% over the same period of the prior year).

But the depreciation of the Rb. in early 2009 triggered an acceleration of the price rise, when the contracting domestic and external demand continued inhibiting it. With the Rb. exchange rate stabilizing, the decline in economic activity has formed a critical factor fanning up inflationary processes and the CPI in Russia accounted for 8.8% by results of the year. Let us examine the 2009 dynamic of the CPI in a greater detail.



Source: the Rosstat

Fig. 2. The Dynamic of Russia's CPI (Monthly Values) in 2008–2009

Costs of paid services to the population gained 11.6% in 2009 (15.9% в 2008 г.). Between January and December it was prices for housing and utilities (+19.6%), preschool education services (+16.2%), medical services (+13.9%) that posted the highest growth rates. So, the paid services to the population became the greatest contributor to the 2009 increase in the CPI. Prices of non-food goods soared at 9.7% (+ 8% - in 2008). Between January and December it was prices for tobacco goods (+ 18.7%), medicines (+17.6%), washing and cleaning goods (+12.6%), and clothing and linen (+11%) that demonstrated the highest growth rates. Between January and December 2009 food prices surged by 6.1% (16.5% over the same period of the prior year) (*Table 3*). In 2009, it was prices for white sugar (+42.7%), fish and seafood (+10.6%), and liquors (+8.9%) whose contribution to the price rise for foods was the greatest one. The 2009 growth in the basic consumer price index made up 8.3% (13.6% - over the same period in 2008). So, the main factors behind the 2009 inflation slowdown were the

declining domestic demand as a result of the crisis, a slow rise of money supply over the first three quarters, and the price downfall for an array of import goods (foods, primarily) on the global market.

As evidenced by data of *Table 3*, it was the rise in the housing and utilities tariffs that has formed the principal inflation component between 2006 and 2009. The respective payments account for a substantial fraction of the households' expenses, particularly because prices of the said services nearly doubled between 2006 and 2009. As concerns the group of non-food goods, it is worth noting the price rise for gas on the backdrop of bouncing upwards prices for energy sources and a very moderate price rise for construction materials, because of an intense slump in the construction sector. Finally, it is important to note a sharp deceleration of price rise rates for foods in 2009.

Table 3

The Annual Price Increate Rates for Individual Kinds of Goods and in 2006–2009 (%)

	2006	2007	2008	2009	2006–2009
CPI	**9.0**	**11.9**	**13.3**	**8.8**	**50.4**
Foods	8.7	15.6	16.5	6.1	55.3
Cream butter	6.8	40.3	10.5	7.9	78.7
Pasta	4.7	23.6	33.8	1.6	75.9
Bread and bakery	11.1	22.4	25.9	2.4	75.3
Gruels and legumes	12.1	24.7	25.8	-2.5	71.5
Milk and dairy products	8.7	30.4	12.2	2.3	62.7
Fish and seafood	7.8	9.0	15.1	10.6	49.6
Sunflower seed oil	-1.2	52.3	22.1	-19.8	47.3
Meat and poultry	5.9	8.4	22.2	5.0	47.3
Non-food goods	6.0	6.5	8.0	9.7	33.7
Construction materials	11.5	16.2	11.3	2.1	47.2
Gasoline	10.9	8.5	1.2	8.0	31.5
Paid services for the population	13.9	13.3	15.9	11.6	66.9
Pre-schooling services	28.5	11.8	20.7	16.2	101.5
Housing and utilities	17.9	14.0	16.4	19.6	87.1
Sanatorium and rehabilitation services	15.2	15.6	21.2	9.5	76.7
Services by organizations of culture	15.6	14.5	15.5	11.3	70.2
Passenger transportation services	14.2	13.6	22.5	6.5	69.3

Source: Rosstat

In conclusion let us compare the price rise rates in Russia with those across the CIS (*Table 4*).

Table 4

Consumer Price Indexes in the CIS in 2000−2009 гг., as % to the Same Period of the Prior Year

	2000	2001	2002	2003	2004	2005	2006	2007	2008	Jan.-Sep. 2009
Azerbaijan	2	2	3	2	7	10	8	17	21	2.1
Armenia	−1	3	1	5	7	1	3	4	9	2.9
Belarus	169	61	43	28	18	10	7	8	15	13.9
Kazakhstan	13	8	6	6	7	8	9	11	17	7.8
Kyrgystan	19	7	2	3	4	4	6	10	25	9.1
Moldova	31	10	5	12	12	12	13	12	13	0.2
Russia	20	19	15	12	12	11	9	12	14	12.5
Tajikistan	24	37	10	17	7	8	12	22	20	7.2
Ukraine	28	12	1	5	9	14	9	13	25	16.8

Souurce: The CIS Intergovernmental Statistics Committee (http://www.cisstat.com/).

It can be noted that the 2009 inflation slowed down in all the CIS countries, while the impact of the global financial crisis on the inflationary processes in Russia and other CIS countries was two-fold.

For one part, the depreciation of the national currency drove up the price rise for imports and the rise in inflationary expectations. The latter were also stirred by the growing financial instability. Finally, the slowdown of the economic activity resulted in a lesser demand for cash, as economic agents lost confidence in the national banking system and were transferring their Rb.-denominated savings into the forex ones.

On the other hand, a sharp slowdown of money supply growth rates sent the monetary inflation down. Let us note that the compression of money supply during the critical phase of the crisis was taking place regardless of sizeable anticrisis public expenditures, as a consequence of economic agents' transferring their savings in forex and the money multiplier being in decline. Finally, a sharp compression of the aggregate demand also exerted a substantial downward pressure on prices.

So, in Russia's conditions, contraction in money supply and in the aggregate demand has led to inflation deceleration. Meanwhile, the stabilization of the state of affairs on the global markets that kicked off in April and the price rise for energy sources have resulted in a significant decline in expectations of a further depreciation of the Rb. exchange rate as early as in the spring 2009. The prices for main Russian exports bounced back, the private capital inflow in Russia was noted in the 4th quarter of the year, while the budget deficit was financed out of the Reserve Fund – all this caused a spike of money supply at the end of the year. Should these inflationary trends be further unfolding in 2010, inflation may not demonstrate its further decline and its rate may account for 8-9%.

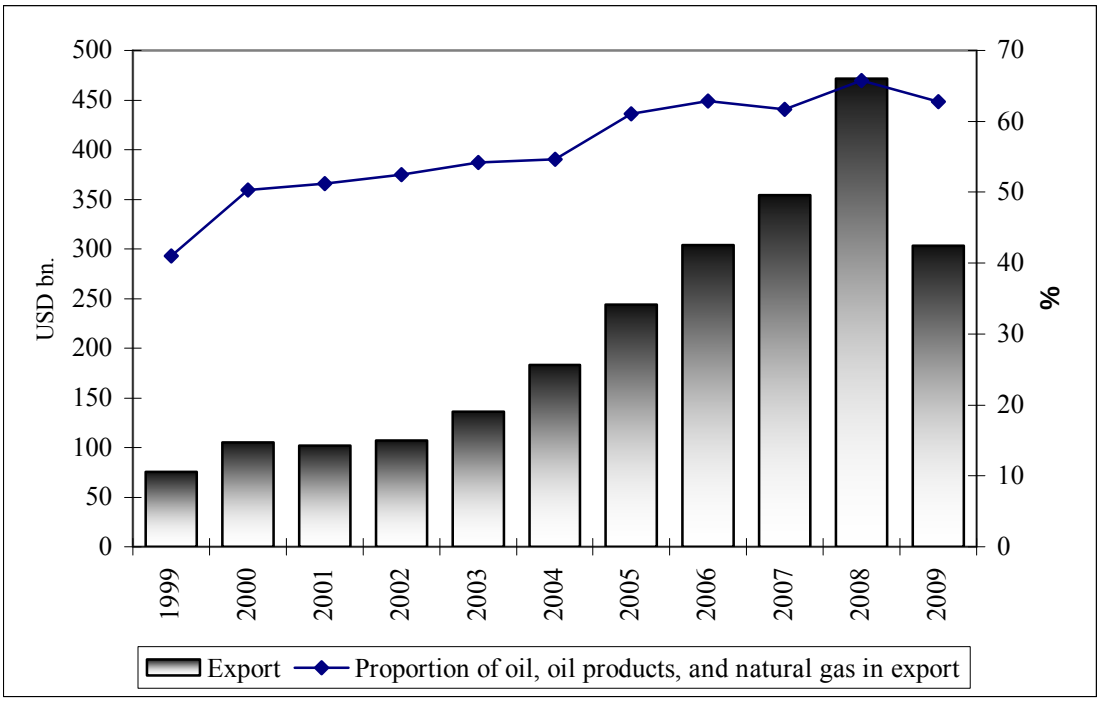
2.1.3. The State of the Balance of Payments[1] and the Forex Market

The sustainability of Russia's balance of payments in 2009 was traditionally secured by its exports, primarily the fuel and energy goods. Meanwhile, the global financial crisis has led to a price downfall for main Russian exports, which is why their ultimate 2009 export volume from RF plunged by 35.7% vs. the prior year. But the restoration of the prices and improve-

[1] Evaluation of the balance of payments was conducted on the basis of preliminary data of the CBR. http://cbr.ru/statistics/credit_statistics/print.asp?file=bal_of_payments_est.htm

ment of the global economy's health since the spring 2009 have resulted in a stabilization of the nation's balance of payments. Ultimately, by the 2009 results, Russia's balance of payments appears fairly sustainable; however in the medium-term the sustainability of the balance of payments will remain exposed to an intensification of the global crisis and an advanced growth in imports in RF vis-à-vis the nation's exports.

According to the published by the CBR's preliminary estimation of the nation's 2009 balance of payments, the positive balance of the current account was USD 47.5bn., i.e. 53.6% down compared with 2008 (*Table 5*). More specifically, down at 38.5% was the positive balance of trade (from USD 139.7bn to 110.6bn), with exports down by 35.7% (from USD 371.6bn to 303.3bn) and imports shrinking at 34% (from USD 291.9bn to 192.7bn). The proportion of oil, petroleum derivatives and natural gas in the aggregate volume of Russia's export was 62.8% (in 2006- 62.8%, 2007 – 61.7%, 2008- 65.8%) (*Fig. 3*). So, like in the recent years, it was the balance of trade that formed a main factor behind the value of the balance of current account. Meanwhile, the balance of the balance in trade in turn is strongly dependent on the dynamic of world prices for energy sources and other main Russian exports. The data presented in *Fig. 4* evidence that the correlation between the world oil prices for oil and the balance of Russia's balance of trade, which was noted between 2002-2008, was still there in 2009.



Source: The CBR.

Fig. 3. Dynamic of Export and Proportion of Products of the Fuel and Energy Complex in 1999–2009

The deficit of the balance of services accounted for USD 19.8bn and tumbled (by its absolute value) by 20.8% vs. its respective value of 2008. Export of services made up USD

42.4bn, thus being USD8.9bn (17.4%) down compared with the prior year. The 2009 value of import of services plunged by 18.6% and accounted for USD 62.1bn.

The 2009 labor compensation balance fell by the absolute value and made up USD -8.7bn (vs. -14.2bn in 2008). The deficit of the balance of investment revenues in 2009 tumbled by 10.4% vis-à-vis 2008 and was USD 31.4bn. Investment incomes due slid from USD 52.2bn to 30bn, which was determined by a substantial drop of the indicator by non-financial enterprises (from USD 28.2bn to 14.2bn) and monetary regulators (from USD 18.3bn to 6.9bn). The fall in incomes due can be ascribed to the global financial crisis and the plunge in the volume of overseas investment. The drop of incomes due across non-financial corporations from USD 73.7bn to 46.4bn was determined by the fall in the aggregate income due from USD 90.2bn to 61.4bn.

The 2009 balance of current transfers[1] accounted for USD -3.2bn (up 4.2% compared with 2008).

So, the main factors underlying the retaining of a considerable positive balance of the current account of Russia's balance of payments in 2009 were prices for main Russian exports that bounced back to their high values in the 2nd-4th quarters of the year. It is worth noting that, despite concerns of potential difficulties the crisis engendered with respect to servicing the private sector's external debt, the national banks and the non-financial sector's indebtedness to overseas economic agents contracted (see *Table 5*) as a consequence of a partial debt restructuring against the background of a notable reduction in the volume of attraction of new debts. One can expect a renewal of the growth rate of the foreign debt in the medium term, and the process should encompass both the private sector and the public one, as the country lacks domestic financial resources which are very costly.

In 2009, determined by stabilization of the state of affairs in the global economy, the absolute value of the balance of the capital account plunged considerably and accounted for USD – 45.2bn. The 2009 balance of capital transfers was -11.7 USDbn. So, without regard to the capital transfers, the 2009 financial account deficit was -33.5 USDbn.

The 2009 ultimate increase in the domestic economic agents' liabilities before overseas economic agents was just USD 6.3bn, or 14.6 times less than in 2008 (USD 92.4bn).

In 2009, the federal public administration agencies became net borrowers before non-residents, with their external liabilities standing at USD 0.8bn resulting from sales of T-bonds to the non-residents. Meanwhile, the balance of external liabilities of the RF Subjects remained practically unchanged. The 2009 rise in the monetary regulatory agencies' liabilities hit USD 11.6bn chiefly due to the Bank of Russia's conducting REPO with foreign counterparts.

[1] According to the CBR, current transfers, e.g. humanitarian relief in the form of consumer goods and services, bolster the level of the disposable income and consumption of goods and services by the recipient and diminish the donor's disposable income and consumption capacity. Current transfers are reflected in the current account. Transfers that are not current by default form capital transfers. Capital transfers result in a change of both the donor and recipient's volume of assets or liabilities and are reflected in the capital account. In the event the donor and the recipient are non-residents towards each other, the capital transfer entails a change in the level of the national wealth of the economies they represent. An example of capital transfers is a non-repayable reassignment of property rights for capital assets, debt forgiveness.

Table 5

Main Items of the Balance of Payments and the Dynamic of the Foreign Debt in 2007–2009 (as USDbn)

Items of the balance	2007					2008					2009				
	I Q	II Q	III Q	IV Q	*Год*	I Q	II Q	III Q	IV Q	*Year*	I Q	II Q	III Q	IV Q*	*year**
Current account	22.6	14.5	15.7	24.2	*77*	38.0	26.2	29.7	8.5	*102.4*	9.3	7.6	15.0	15.6	*47.5*
Capital account**	14.5	48.4	–3.7	26.5	*85.7*	–25.6	35.7	–9.6	–135.5	*–135.2*	–32.0	3.2	–25.4	9.0	*–45.2*
Change in forex reserves («+» means reserves are down, «–» – рост reserves are up)	–32.9	–65.5	–7.9	–42.6	*–148.9*	–6.4	–64.2	–15.0	131.1	*45.3*	30.5	–14.2	9.1	–28.8	*–3.5*
Net errors and omissions	–4.1	2.6	–4.1	–8.2	*–13.8*	–6.0	2.4	–5.0	–4.0	*–12.6*	–7.7	3.5	1.3	4.1	*1.1*
Change in Russia's foreign debt («+» means the debt is up, «–» the debt is down)	41.8	44.2	38.6	33.2	*157.8*	13.6	51.1	12.5	–67.7	*9.5*	–32.8	21.3	9.8	–8.5	*–10.2*
Change in Russia's foreign public debt	3.6	–3.2	3.5	–6.1	*–2.2*	–5.4	–2.1	3.9	–10	*–13.6*	–2.4	4	9.5	0.9	*12*
Change in Russia's foreign debt of the private sector	38.3	47.3	35.2	39.3	*160.1*	18.9	53.3	8.6	–57.8	*23*	–30.5	17.3	0.4	–9.5	*–22.3*

* Preliminary estimate
** With regard to forex reserves.
Source: the CBR.

The continuance of the global financial crisis that has seriously derailed the Russian economic agents' possibilities to attract borrowings for overseas and a vehement restructuring of already attracted loans have led to a USD 43.7bn-worth contraction in the banking sector's liabilities towards non-residents. The overseas economic agents' investment in the Russian non-financial sector made up USD 37.4bn (vs. 97.1bn in 2008). So, the 2009 volume of non-resident investments plunged drastically vs. the respective indicator of 2008, albeit it proved to be far in excess of that to the banking sector. That said, the volume of direct investment in the non-financial sector over the year accounted for USD 38.2bn vs. 63bn. in 2008, while the increase in portfolio investment was in the prior year. In 2009, the volume of the non-financial sector's debt by loans and credits towards non-residents dropped by USD 5.2bn.

Residents' foreign assets (liabilities of foreign economic agents before Russian ones) grew by USD 39.8bn in 2009 (in 2008 – by USD 228bn).

Meanwhile, foreign assets of the federal public administration agencies plunged by USD 10.2bn, while those of banks – by 11.2bn. In contrast, foreign assets of monetary regulatory institutions remained practically unchanged.

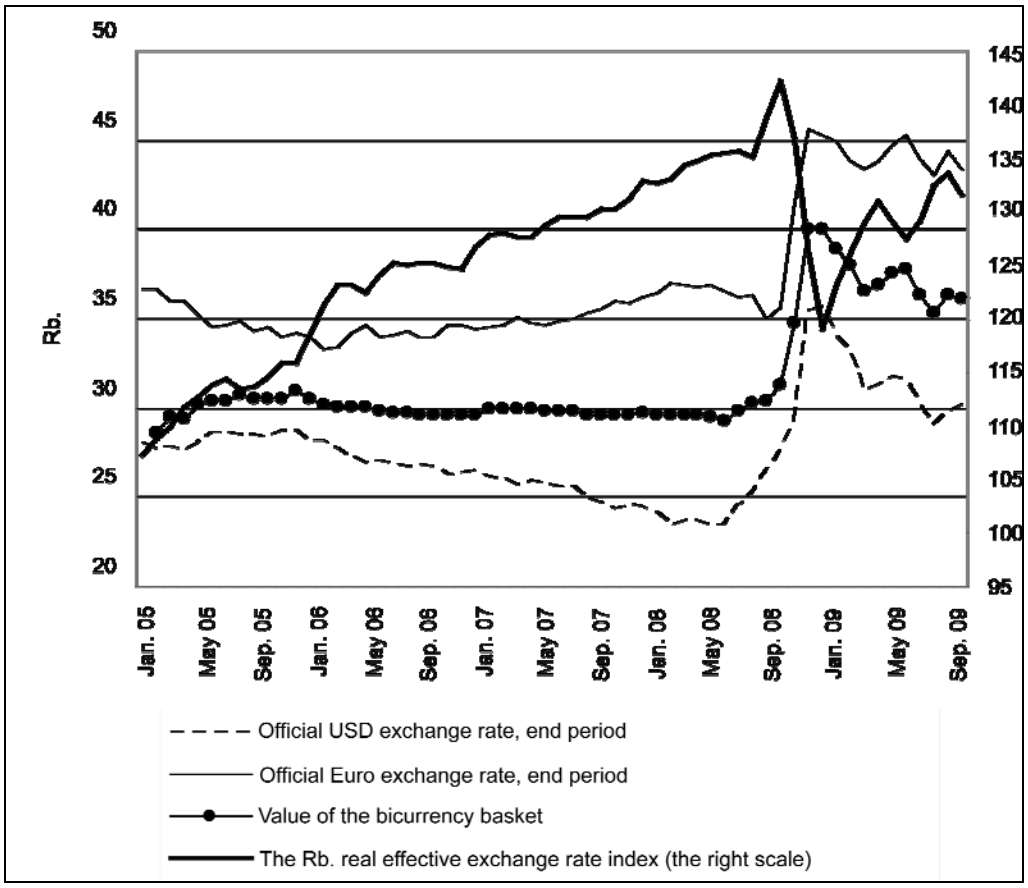
Capital export from the sector of non-financial corporations and households fell by 61.8% vs. 2008 and accounted for USD 61.2bn. The volume of the "not collected on time export proceeds, goods and services not received against monetary transfers by import contracts, transfers by fictitious transactions with securities" also tumbled compared with 2008 and accounted for USD 26.5bn. At this point, it is worth noting that the dynamic of the item "cash foreign exchange" underwent considerable changes – in 2009, Russia saw a USD 3.9bn-worth export of foreign exchange in the cash form, while in 2008 as much as USD 25bn was imported into the country. In other words, once in the autumn of 2008 the Rb. showed the first signs of depreciation towards the bicurrency basket (both in the nominal and real terms), the population and the non-financial sector once again, for the first time since 1997, began vehemently buying foreign exchange. But in 2009, with the situation on the financial markets gradually stabilizing and the Rb. renewing its appreciation trend, the boom on the forex market subsided.

Let us note that during the acute phase of the crisis, that is between November 2008 and February 2009, which was characterized by a large-scale capital outflow and a non-stop price downfall for energy sources, the Bank of Russia allowed a gradual decline of the Rb. rate against the bicurrency basket. In the situation of a considerable fall of Russia's forex revenues, the earlier exchange rate could have been sustained only over a limited period of time by wasting the international reserve assets. That said, as the Bank of Russia was depreciating the Rb. gradually, economic agents found buying forex a relatively low-risk and highly lucrative investment instrument, which led to an increasing demand for forex and the need to spend an increasing amount of the international reserve assets.

We believe in the circumstances a one-time depreciation of the Rb. with a subsequent pegging of the new declared level was the best *modus operandi*, as it would have enabled the CBR to avoid a further waste of reserves and to lower inflationary expectations. We question just the moment picked for a sharp devaluation of the Rb – it can be suggested that in order to save the gold and forex reserves one could have opted for this move far earlier than in early 2009.

As a result, in all between December 2008 and February 2009 the real effective rate of the Rb. slid by 16.3% (see *Fig. 5*). But, driven by the stabilization on the Russian and global financial markets in the spring 2009 and the subsequent price rise for energy sources, the real effective rate of the Rb. renewed its rise and by October had won back over 40% of its value lost due to the earlier drop. Once investors' appetite for risk increased, the USD/Euro rate began to descend, and as a consequence, between March and December the official USD/Rb rate tumbled by Rb. 5.48 – by late December 2009 the USD/Rb exchange rate was 30.24 vs. 35.72 as of February 28, 2009. Meanwhile, the Rb. has grown relative to the bicurrency basket[1] – the value of the bicurrency basket slid by 3.90Rb between March and December – from 40.05Rb. to 36.16 Rb. As a result, the Euro/Rb. rate in the late December was 43.39.

[1] The bicurrency basket constitutes a CBR's forex policy operational benchmark, with the proportion of the Euro in the basket currently accounting for 45% and, accordingly, 55% that of the USD.



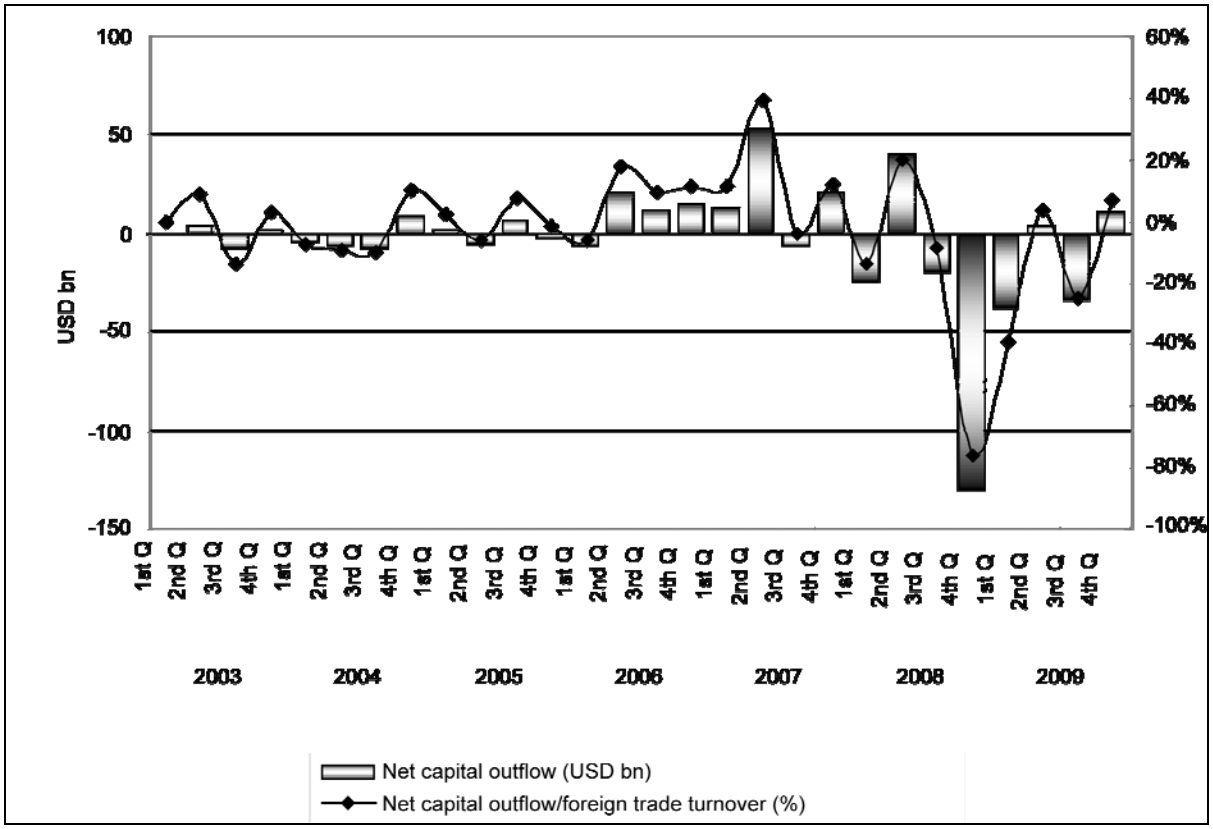
Note: While calculating the Rb. real effective exchange rate, 100= the level as of January 2002
Source: the CBR, the author's calculations.

Fig. 5. Indexes of the Rb. Exchange Rate Between January 2005 – December 2009

So, the CBR's forex policy in the crisis period has basically been smoothing down exchange rate fluctuations without creating obstacles to fundamental changes of exchange rate. More specifically, in the second half 2009, the amplitude of the exchange rate fluctuations was over 15%. By increasing the exchange rate volatility, the CBR creates disincentives for economic agents to play on the forex market. The CBR is going to stick to this tactic in the medium term, too. However, it should be noted that in the event of a further price rise for energy sources and renewal of a large-scale capital inflow, the Rb. will find itself under a considerable upward pressure and the CBR may once again start buying forex in order not to let the Rb. nominal rate surge. In such circumstances, the monetary policy will de-facto replicate the pre-crisis one, which once again will give rise to bubbles on the financial markets, unless the government succeeds in creating additional mechanisms of sterilization of an excessive money supply.

In addition to the contraction of the balance of current account, one of the pivotal trends in the dynamic of indicators of the nation's 2009 balance of payments was the dynamic of net capital outflow from the non-financial sector, which by results of the year hit USD 52.2bn. (in 2008, stirred by the crisis, the respective figure was 132.8bn) (see *Fig. 6*). Meanwhile, the dynamic of the private capital flow was uneven during the crisis. Between the 3rd quarter 2008 and the 1st quarter 2009 the net private capital outflow accounted for USD 186.6bn. In the 2nd

quarter 2009, there was noted its insignificant inflow worth a total of USD 4.2bn, which once again was replaced by a -32.2bn outflow in the 3rd quarter of the year. In the 4th quarter 2009, against the investors' growing confidence in stability of Russia's economy (at least, in the short run) and their desire to make money on the appreciation of the Rb, the private capital inflow accounted for USD 11.1bn.

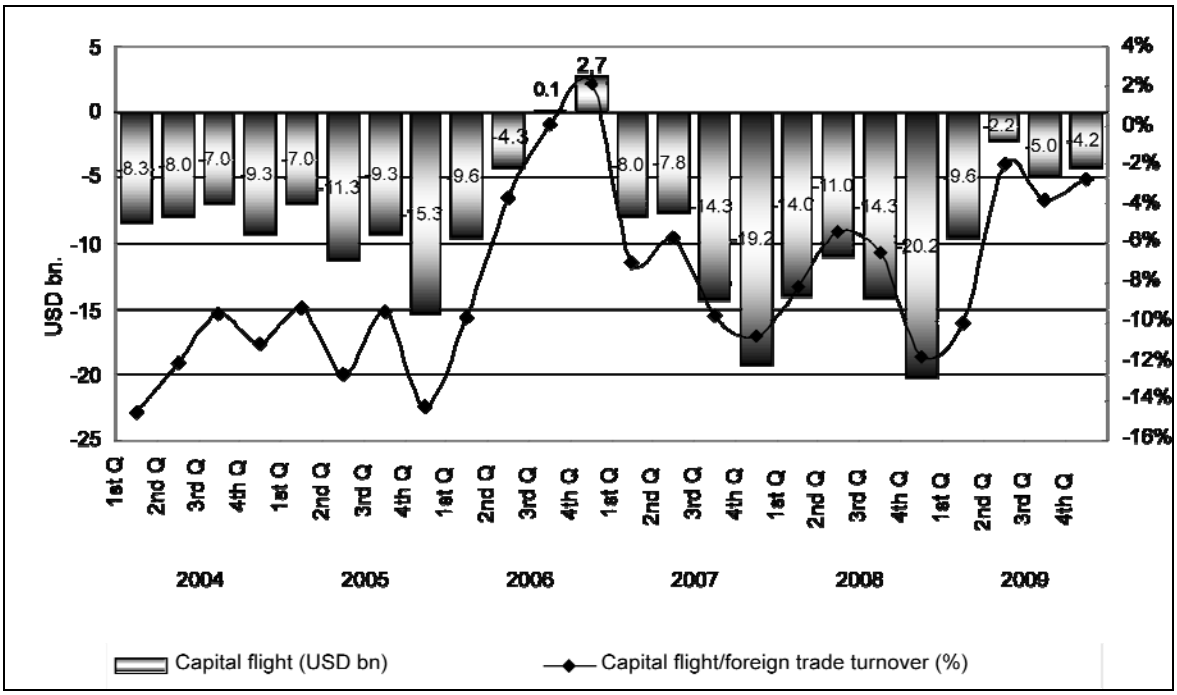


Source: the CBR; the IET calculations.

Fig. 6. Dynamic of the Net Capital Outflow in 2003–2009

The 2009 unofficial capital outflow (capital flight) (*Fig. 7*) also dropped significantly vs. 2008 and accounts, by our estimates[1], for some USD 21bn, or at 38.5bn. less than in 2008. Accordingly, the proportion of capital flight in the nation's foreign trade turnover slid from 7.8% in 2008 to 4.2%.

[1] We calculate capital flight with the use of the IMF methodology, according to which it constitutes the sum of "trade loans and down payments", "not received on time export proceeds and goods and services not supplied against money transfers by import contracts" and "net errors and omissions".



Source: the CBR; the IET calculations.

Fig. 7. Dynamics of the Capital Flight in 2004–2009

As for other peculiarities of the 2009 balance of payments, it is worth noting a remaining high proportion of revenues from energy sources in export of goods. The price downfall for energy sources in the late 2009 exposed the vulnerability of the nation's balance of payments. The oil prices recovery in 2009 and the Rb. depreciation allowed Russia to stabilize its balance of payments, but, with the situation in the economy gradually improving, import began to recover, too. That said, given that between the 2nd and 3rd quarters 2009 the pace of its recovery has been falling behind the one of export, in the 4th quarter of the year the import increase rate practically accounted for 24%, while that of export - just for 15%. Should the tendency persist further on, the positive balance of current account may renew its plunge, which, other conditions being equal, would create a downward pressure on the Rb. exchange rate. However, it should be noted that traditionally, the 4th quarter is the period of seasonal import hikes, and given the current economic stagnation, a further rapid growth in import appears unlikely.

As to the balance of capital account, in the medium term, the dynamic of capital flows to a significant degree will be driven by the situation on the global financial markets. Should the trend of a gradual recovery of the world economy persist, one may expect a net private capital inflow in Russia by results of 2010.

2.1.4. Main Steps in the Monetary Policy

Whatever moves the CBR was undertaking to ensure the financial system's stability, they can be provisionally split into two groups- namely, *the interest rate policy and other measures*.

Speaking of the CBR's interest rate policy in 2008-2009, it can be further broken into two stages. At the first stage, the CBR has been raising the refinancing rate four times (Nov 12,

Dec 1, 2008; Feb 2 and 9, 2009). That said, prior to the first raising of the refinancing rate in the crisis period the CBR had lowered rates on a series of liquidity lending instruments without changing the refinancing rate. The move was made in pursuance of facilitation of the access to liquidity for commercial banks. As a result of the four consequent moves, the refinancing rate rose from 11 to 13% annualized and the CBR's lending rates to commercial banks were raised by a comparable value.

Underlying the increase in the interest rates largely was the CBR's desire to increase costs of the resources credit institutions attracted from the Bank of Russia and subsequently invested in forex assets. As a reminder, since January 23, 2009, the CBR set the upper margin of the technical band of the bicurrency basket at the level of Rb 41/USD and declared its readiness to maintain the rate by the margin for a minimum of several months. Meanwhile, already on January 30, after the tax payment period was over and banks had free Rb-denominated liquidity at hand, the value of the bicurrency basket was over Rb. 40. Given that yet back in November 2008 the value of the bicurrency basket was below Rb. 30, buying forex became a very lucrative direction of investment for the domestic economic agents. Expectations of devaluation were fueled by low oil prices that engendered fewer forex revenues in the country and the capital outflow from emerging markets. At that juncture the CBR decided to constrain the banks' capacity for buying forex by increasing for them costs of attraction of Rb.-denominated resources. This move was simultaneously aimed at demonstration of the CBR's commitment to keep the Rb. exchange rate at the selected level, which contributed to a fall of forex buys by economic agents and the subsidence of speculative activities on the forex market. Given that the CBR's resources have increasingly been playing a greater role in the domestic credit organizations' liabilities (see sub-section 2.1.1), the policy indeed helped lower the attractiveness of forex purchases against the background of statements made by the CBR leadership that a dramatic contraction of import between late 2008 and early 2009 enabled it to balance the current account of the nation's balance of payments.

Once the state of affairs on the financial markets began stabilizing, the CBR started to gradually soften its monetary policy. Specifically, between April and December 2009, the CBR lowered interest rates seven times, with the refinancing rate ultimately being brought down from 13% to 8.75% annualized, while rates on the CBR's operations were down at 3.5-4.5 p.p. Underpinning these moves was a drastic deceleration of the pace of lending to the real sector against the background of a lowering inflation. The inflation deceleration enabled the Bank of Russia to lower the costs of resources disbursed to commercial banks without a serious change of the value of the rates in real terms, as the nominal rates were maintained at a level roughly equaling that of inflation.

The decline in interest rates was also fueled by the renewal of influx of forex revenues in the country due to the price rise for Russia's main exports and stabilization of the economic situation worldwide. In the event of a further slowdown of inflation, the CBR may once again lower its interest rates. But we believe an overly drastic softening of the monetary policy in the current circumstances appears unjustified, as it may once again trigger escalation of inflation against the backdrop of the growing budget deficit. Plus, it should be borne in mind that high credit rates banks set for the real sector mirror not only costs of attraction of financial resources, but high credit risks associated with the uncertainty of the future economic dynamic. Hence, renewal of lending to the real sector will become consequent to stabilization of Russia's economy and the recovery of the external demand.

Let us also note that in the crisis period, the CBR's interest rates for the first time ever have grown into an effective monetary policy instrument. That was the result of the growth of the share of the CBR's credits in commercial banks' liabilities, as for them the CBR's resources in the crisis conditions formed practically a sole source of relatively inexpensive funds. Meanwhile, it proved impossible to boost the domestic money supply by purchasing forex by the CBR, either, due to a large-scale capital outflow out of the country and the price downfall for major Russian exports. In other words, the CBR's monetary policy has increasingly become similar to that of the developed nations' central banks that manage the situation on the monetary market by means of interest rates. The CBR's ability to pursue this policy in the future will be determined by the situation on the domestic forex market (the absence of considerable fluctuations in forex flows in and out of the country) and the Bank of Russia's readiness to allow fluctuations of the Rb. exchange rate and to transit to the inflation targeting regime.

As for the CBR's non-interest policy, the shortage of liquidity in the banking system in the autumn 2008 compelled the CBR to undertake a series of extraordinary moves aimed at preclusion of the rise of instability in the national banking sector.

Thus, on October 10, 2008, the State Duma promulgated an act that granted the CBR with the powers to disburse unsecured loans to Russian commercial banks. Such loans can be extended for the term of 6 months to credit organizations whose credit rating is not below a set level. The measure was aimed at supporting the national banking sector that had found itself in a dire situation because of a large-scale capital outflow from the country, a sizeable external debt (under growing expectations of devaluation) accumulated over the previous years, and the crisis in the real sector. Until the adoption of the new act the CBR had been able to disburse loans to Russian commercial banks against securities, forex, receivables under loan agreements or credit institutions' guarantees. But as the banks were in a great need in credit resources, they lacked assets against which they could receive a loan from the Bank of Russia. At that juncture the granting of the possibility to the CBR for disbursement of unsecured loans enabled it to support Russian banks, albeit the move increased risks of an inequitable conduct by the banks that were recipients of such loans. With the financial markets stabilizing, the credit institutions' debt to the CBR was gradually declining. As of January 1, 2010, their aggregate debt before the CBR was Rb. 190 bn, or down by Rb. 1.6trln over the whole 2009. Let us note that in order to maintain the banking system's stability it proved possible to support just a handful of large banks. Most Russian credit institutions *de facto* are not engaged in the classical banking. Rather, they are engaged in schemes related to optimization of taxation, which allows one to tolerate their bankruptcy without serious ramifications for the whole domestic financial system.

To buoy the banking sector in the conditions of the unfolding financial crisis, the CBR began enter into agreements with large Russian banks on compensating a part of their prospective losses due to interbank lending. The Bank of Russia has also assumed an obligation to compensate to the banks a part of their losses with regard to their transactions with other banks whose licenses were subsequently revoked. As of October 1, 2009, the CBR had concluded 18 such agreements. As well, the CBR has also undertaken such measures as provision of the REPO financing against the collateral in the form of an extended list of assets, extension of the term of the REPO lending, provision of subordinated loans to strategic banks, and adoption of the legislation on guarantees by corporate loans. In addition, in order to conduct a bailout of the banking system, the Deposit Insurance Agency has been recapitalized.

Let us note that in order to tame speculations on the forex market, on December 25, 2008, the CBR offered recommendations to credit institutions not to boost up their foreign assets and net balance positions by foreign exchange, whose exercise the Bank of Russia accounted while imposing limits on the credit institutions' participation in forex auctions. The recommendations have failed to preclude mass purchases of forex during the acute phase of the crisis, but they contributed to subdue the boom on the forex market in the course of the stabilization of the financial markets. On July 2, 2009, the CBR announced that due to stabilization of the situation on the domestic forex market, it ruled not to extend the effect of the recommendations. Thus the Bank of Russia demonstrated it was confident that a large-scale capital outflow and depreciation of the Rb. exchange rate in the second half 2009 were unlikely developments.

Finally, on December 30 2009, the CBR modified procedures of the credit institutions' building provisions for losses on loans and advances. In compliance with the effective procedures, credit institutions are bound to provide reserves for possible losses on loans depending on the degree of credit risk. That said, the exercise diminishes the volume of resources available for commercial banks to carry out their current operations.

According to the decisions, credit institutions were granted the right not to increase their reserves on loans through December 31, 2009, in the event:

- the delinquency by the principal debt or interest on the debt has extended for no more than 30 calendar days relative to the effective term;
- the loan is restructured (e.g. in the event of a change of the currency in which the loan has been denominated, modified (the principal debt and/or interest repayment timelines) in the period since October 1, 2008;
- the loan received since October 1, 2008, is used for repayment of an earlier extended loan.

The move was devised to help the banks cope with yet another challenge they had faced when the unfolding crisis battered the national real sector, that is, growth in arrears by earlier disbursed loans. While the arrears growth rates fell in the fall of 2009, the problem of "bad" assets still appears a fairly persisting one and may aggravate once again, should the state of affairs in the national economy deteriorate.

In 2009, the mechanism of extension of subordinated loans to banks has proved to be fairly efficient one, as far as the recapitalization function is concerned, at least, for the largest banks. Provision of the first-level capital to banks with government participation in the current volume is most likely to satisfy their need in capital even in the event the situation develop according to the negative scenario. As to the backbone private banks, should they face capital shortages, there exists a mechanism of implanting the temporary administration therein represented by the Deposit Insurance Agency, which was commissioned to conduct their rehabilitation.

Let us note that without cleaning the banks' balances from problematic assets, regalvanizing the lending to the real sector may take long. Anyway, while tacking this challenge, the government's participation will allow a substantial simplification of the process. To maintain the budget stability, it seems appropriate to replace a fraction of problematic assets with long-term securities backed by the government agencies' guarantees. This can form a plausible mechanism to solve the problem.

Other key monetary policy measures aimed at bolstering the financial stability the Bank of Russia implemented during the financial crisis were:

1. The Board of the Bank of Russia twice (on January 19 and April 23, 2009) ruled to extend the timelines for a stage-by-stage increase of the effective standards of contributions to the Compulsory Reservation Fund (CRF). As a reminder, since October 15, 2008, the Bank of Russia lowered the respective contribution rates – they were set at 0.5% across all kinds of reserved liabilities. On the same date it was ruled to lower the rates for a certain period of time – they should be raised up to 1.5% since February 1, 2009 and to a further 2.5% - since March 1, 2009. On January 19, the Bank of Russia decided to shift the timelines for increase of the standards from the said dates to May 1 and June 1, 2009, respectively. According to decisions made in April, the standards were set for a stage-by-stage 0.5% increase- that is, on May 1, June 1 and August 1. So, the level of all the standards had hit 2.5% by August 1.

   The CBR took the decision because of a complex situation in the domestic financial sector, which was spurred by the global financial crisis. Russian credit institutions may soon face a rise of arrears on extended loans, which would derail their financial standing. Withdrawing liquidity from banks in the form of deductions to the CRF would add to their financial instability. We think that in the event there are no signs of improvement of the state of affairs in the banking sector in the summer 2010, the timelines of the increase of compulsory reservation rates may once again be modified.

   In addition, the Bank of Russia offered credit organizations, regardless of classification groups they are awarded with resulting from their economic standing, the possibility to use the averaging of emergency funds[1]. Lastly, in August 2009 the CBR ruled to shift, since November 2009, timelines of conduct of regulation of emergency funds in such a fashion so that the end of a regulation period would not coincide in time with the period when bank's need in liquidity on the dates of tax payments to the budget is the greatest one.
2. On January 19, 2009, the CBR's Board took a decision to extend the term of asset-backed lending available to banks up to 365 calendar days, while the earlier set maximum timeline for such loans had been 181 days. Besides, on June 15, 2009, there was held the first ever direct REPO auction for the term of 1 year.

   Let us note that in the spring 2009 the CBR has been gradually cutting back on volumes of unsecured lending, and with the economy stabilizing, the Bank of Russia is in transition towards "long" loans backed by papers. We find this move to be a right one – it will contribute to solidification of the financial stability and increase in the CBR's influence on interest rates.
3. On February 9, the CBR's Board decided to extend the Bank's Lombard list, ie the list of securities against which commercial banks may attract the Bank of Russia's resources. Added to the list were stock and bonds issued by companies enumerated in the list of strategic backbone corporations approved by the government commission on increase of stability of the Russian economy's development. That said, such papers should be included in the quotation list of at least one exchange operating in the territory of the Russian Federation. The CBR started to accept such corporations' promissory notes and credit contracts as a security against disbursed loans.

[1] The averaging of emergency funds enables credit institutions to hold on their corresponding accounts and use in settlements a fraction of emergency funds equaling the averaging coefficient.

The move pursues the goal of boosting the banking system's demand for these issuers' papers and, accordingly of bolstering the opportunity for them to attract financing. Meanwhile, it should be remembered that while providing liquidity to banks against such papers, the CBR assumes the risks associated with a possible aggravation of the strategic corporations' standing. Plus, the extension of the Lombard list should improve the standing of those credit institutions on whose balance sheet there are securities issued by backbone corporations whose papers were not previously been included in the Lombard list, as such banks can now get financing against such papers.

4. On March 27, the Bank of Russia announced changes in the methodology of calculation of the Russian commercial banks' statutory requirements. In compliance with the ruling, first, participation of public corporations in legal entities' authorized capital is not regarded as the grounds for classification of these legal entities as a group of associated borrowers for the sake of calculation of a rate of the maximum size of the risk per borrower or a group of associated borrowers (N6). The rate is calculated as the bank's calls to the group of associated borrowers to the bank's capital ratio. In all likelihood a number of banks have found it hard to comply with N6 due to the financial crisis and the public companies' participation in numerous corporations' capital. So, the decision can be regarded as a softening of regulation for such banks.

   Second, the Bank of Russia decided to set a 50% risk coefficient with regard to credit calls to open-end joint-stock companies that meet the natural monopoly criteria, providing they are included in section 2 of the List of Strategic Corporations and Strategic Joint-Stock Companies as well as providing the companies' securities have been included in the Bank of Russia's Lombard list. The measure, too, is to soften for banks restrictions on lending to such corporations from the perspective of the credit risk rate.

5. On April 10, the CBR ruled to raise credit limits by unsecured loans extended to credit organizations that, at the same time, meet the following criteria:

- their long-term international credit rating is not below B (by the S&P and Fitch's classification) or below B3 (by the Moody's classification);
- they have decided to convene the general shareholder meeting of the credit organization, with the issue of its reorganization in the form of merger or acquisition on its agenda, and submitted the respective information to the Bank of Russia;
- they have got agreements by which creditors lodged a claim to the said credit organizations on an early execution of their obligations in connection with the rise of developments determined by the reorganization, and submitted the respective information to the Bank of Russia.

So, the CBR has extended its possibilities to provide financial aid to credit organizations engaged in M&A processes. This move can be regarded as a positive one, as Russia's banking system appears overly fragmented, with most banks not actually exercising the classical banking functions. In the circumstances, encouraging consolidation in the sector proves to be a fairly justifiable move on the part of the monetary regulator.

On May 26, the CBR approved modifications of the methodology of calculation of credit institutions' capital. In compliance with the novelties, banks can increase their Core Tier 1 capital at the expense of a string of subordinated loans that must satisfy the conditions of longevity (for the term of not less than 30 years), non-cumulativity (the unpaid interest on them is not refunded, nor accumulated), as well as the possibility to cover the credit organization's

losses. Meanwhile, the overall volume of included in the capital subordinated loans with additional conditions is capped at the level of 15% of the value of the Tier 1 capital.

Thus, the CBR has de facto softened its requirements to sufficiency of the credit organizations' capital. The move was dictated by the growth of arrears and, accordingly, the need for securing reserves against potential losses. In so doing, it is important to bear in mind that such moves do not resolve the problem of growth in arrears debts *per se* nor they give banks additional resources to overcome that. Rather, they were devised to preclude the rise of an inconsistency between the large banks' reporting and the regulator's requirements, which may trigger negative systemic effects on the financial market.

7. On June 19, the Board of the Bank of Russia introduced a number of amendments to the Instruction "On compulsory standards for banks" which is one of the pivotal ones for the domestic credit organizations, as it sets compulsory standards failure to comply with which can result in the license revoking. The main amendments are:

- a considerable increase in the minimum amount of the credit institution's own capital (from euro 500,000 up to Rb. 180m);
- setting a 70% risk coefficient by mortgage loans that meet the following conditions combined – the bank's own capital sufficiency rate (N1) and the maximum amount of risk per one borrower or a group of associated borrowers (N6);
- setting a 10% decreasing coefficient on calls by mortgage loans extended to the military who partake in the savings-and-mortgage system;
- exclusion of an increased (1.3) risk coefficient with regard to calculation of N1 standard by calls to credit institutions that are members of the same group as the lending bank;
-Vnesheconombank, which, in compliance with the federal act "On the development bank", is a public corporation that performs banking operations while exercising its function, has become subject to the same approaches to risk (credit, liquidity) assessment as the ones applied to resident banks of RF;
- calls towards resident banks of RF that have arisen with respect to transactions completed between October 14, 2008 and December 31, 2009, in the part subject to the CBR's compensation have been now classified as risk-free assets;
- calculation of the acid test ratio (N2) encompasses liquidity placed with resident banks of RF for the term of 1 day or on demand that are on the balance sheet for no longer than 10 calendar days discharge of obligations by which as per an agreement is provided for not later than on the date following the day of their demand and on condition the said assets are recognized as the 1st –class quality loans;
- the international development banks' committed loans have been classified as liquid assets for the sake of calculation of the current liquidity (N3);
- classification as highly liquid and liquid of cast interest claims with respect to the 2nd-class quality assets as per CBR's Statute of March 26, 2004, №254-П and on the 1st- and 2nd – class quality assets as per CBR's Statute of March 20, 2006, №283-П for the sake of calculation of standards N2, N3.

Overall, the amendments were of a qualifying nature and have brought the law on compulsory standards in consistency with the realities of the crisis. We regard their introduction as an attempt to spur concentration in Russia's banking system for one part, and to soften to some degree standards in the crisis conditions, on the other hand.

8. In compliance with federal act of October 13, 2008, № 173-FZ "On additional measures on support of the financial system of the Russian Federation", the CBR extended Rb. 500bn

in subordinated loans to Sberbank of Russia under 8% annualized with the term of credit until December 31, 2009. Besides, in compliance with the federal act, Rb. 410bn (resources of the National Welfare Fund) may be deposited with the VEB in order to disburse loans to Russian credit institutions. As of October 1, 2009, as many as 14 banks were granted subordinated loans worth a total of Rb. 267.4bn, including 225bn. extended in loans to two banks in 2008 and another 42.4bn. – to twelve banks in 2009.

The moves have boosted recapitalization of a number of large banks that had found themselves under pressure of a rapidly mounting delinquency. It should be noted though that with the economic situation stabilizing, demand for such loans plunged considerably.

2.2. The State Budget

In 2009 Russia's economy has completed its journey from the recession noted in the first half of the year to the stabilization with initial signs of revival. The latter phenomenon was mirrored in some improvement of economic indicators vis-à-vis expectations, particularly the ones in the area of public finance. Behind the improvement there had been huge injections of public funds into the economy. Quite illustratively, the enlarged government's aggregate expenditures hit a record-breaking value ever reported in the '2000s. In tandem with a sizeable fall in budget revenues, that had resulted in the budgets of all levels running deficit by the end of the year.

It was the Reserve Fund whose resources in 2009 formed a major cushion ensuring a greater balance of the budget system in 2009. However, it is envisaged that the Fund would be completely run out of its resources this year already. The imperative to pursue an anticrisis fiscal policy in 2010 paired with the necessity to fulfill the earlier assumed expenditure obligations have compelled the RF government to revise their public borrowing program towards its extension. So, with the current correlation between the robustness of the budget system and the situation in the foreign trade area, the state of affairs in the sphere of public finance has remained challenging and far from its pre-crisis fairly balanced state.

2.2.1. Overview of the Budget System of the Russian Federation

The slump in the real sector in the late 2008 with a subsequent recession since the early 2009 has had an adverse effect on the state of the public finance, which resulted in the rise of a steady budget deficit at all the tiers of the government. The 2009 volume of revenues to the budget of the enlarged government plunged ay 4.4 p.p. of GDP vs the respective figures of the same period of 2008 (see *Table 1*). Behind the nosedive was chiefly a considerable fall in the federal budget revenues (by 3.7 p.p. of the nation's GDP).

The crisis period made the domestic corporations' survival a critical imperative. That is why the RF government devised a set of measures to support various industries and the social sphere. Within a fairly short time (practically since November 2008) the government introduced a broad package of anti-crisis measures, unprecedented by the variety of forms and avenues of the government's influence on the economy, as well as by the volume of resources deployed. In the autumn 2008, given tight timelines, the anti-crisis measures were more of "pin-point response" ones and required largely the use of "manual- control" mechanisms. The RF government's 2009 comprehensive anti-crisis Program had been developed by March 2009.

The need to finance the Program's priority avenues necessitated amending the act on the federal budget. Subsequently, the earlier approved budget appropriations were axed by Rb.

943.3bn, while as much as Rb. 1.61trln, including thus available funds, was earmarked to stabilize the financial market, support the strategic nationwide and local backbone corporations as well as individual, particularly vulnerable to the crisis, industries in the real sector, and the social protection of the population. The measures, to some extent, had been implemented in the pre-crisis period, but it is in the crisis conditions that they emerged as the priority ones. As a result, the enlarged government's budget expenditures rose at 6.7 p.p. of GDP vs the prior year, with the rise driven primarily by growth in the expenditure volume of the federal budget (some 6.4 p.p. of GDP). With the gap between collection and spending of budget funds widening, 2009 has become the first year over the past decade when the budget deficit of the enlarged government was reported to account for 6.2% of GDP.

Table 1

Execution of Revenues and Expenditures of Budgets of All the Tiers of the Government in 2008–2009

	2009		2008 г.		Bias as p.p. of GDP
	As Rb.bn.	As % of GDP	As Rb.bn.	As % of GDP	
Federal budget					
Revenues	7336.8	18.8	9274.1	22.5	–3.7
Expenditures	9636.8	24.7	7566.6	18.3	+6.4
Deficit (–) /Surplus(+)	–2300.0	–5.9	1707.5	4.2	– 10.1
Consolidated budgets of the RF Subjects					
Revenues	5927.2	15.2	6199.1	15.0	+0.2
Expenditures	6256.3	16.0	6253.5	15.2	+0.8
Deficit (–) /Surplus(+)	–329.1	–0.8	–54.4	–0.2	–0.6
Budget of the enlarged government					
Revenues	13420.7	34.4	16003.4	38.8	–4.4
Expenditures	15847.3	40.6	13989.2	33.9	+6.7
Deficit (–) /Surplus(+)	–2426.6	–6.2	2014.2	4.9	–11.1
For reference: GDP. as Rb. bn.	*39016.1*		*41256.0*		

Source: The RF Ministry of Finance; IET calculations

Notwithstanding the gravity and scale of budget infusions in the domestic economy, the measures not only came late (their real financing and an immediate delivery of the funds to recipients under the auspices of the anti-crisis program kicked off only between May and June 2009), but suffered a lack of consistency and, in certain instances, the absence of the much-needed for their implementation legal base.

2.2.2. An Analysis of Main Parameters of Execution of the Budget of the Enlarged Government

A sizeable contraction of the volume of revenues to the national budget system (*Table 2*) took place under the impact of negative ramifications of the global financial crisis and debilitation of the economy against the backdrop of the earlier emerged, extremely exposed to external shocks, mineral structure of Russia's exports. It was revenues from taxes and levies that directly depend on the prices of, and demand for Russian exports – namely, revenues from *the mineral tax* and from *foreign trade*, that plunged most drastically. When compared with 2008, these revenues to the budget of the enlarged government slid by 1.3 p.p. and 1.7 p.p. of GDP, respectively. The main cause for such a fall in revenues became a drastic price downfall for energy sources: the 2009 average price of Urals on world markets was some USD 61/bbl, or down by 35.5% relative to the average 2008 price level. The effect from the price drop was aggravated by the contraction of the physical volumes of production and export of carbohy-

drates (mostly natural gas). A rapid plunge of revenues from the said taxes and levies was registered in the first half 2009, when contracts concluded in late 2008 by compulsory low prices were due to be exercised. But the depreciation of the Rb. against the USD between late 2008 and early 2009 to some extent mitigated the dynamic of the fall of revenues from the mineral tax to the budget[1]. With the price situation improving between the 1st and the 3rd quarters last year, the dynamic of collection of revenues from the oil-and-gas taxes once again became positive.

Table 2

Dynamic of the Level of Tax Burden and Collection of Main Taxes to the Budget of the Enlarged Government of RF in 2004–2009 (as % of GDP)

	2004	2005	2006	2007	2008	2009
The level of tax burden (1+2+3)	**35.8**	**36.3**	**35.9**	**36.1**	**35.6**	**30.8**
1. Tax revenues, including:	27.5	25.7	24.4	25.7	23.9	20.5
Corporate profit tax	5.1	6.2	6.2	6.6	6.0	3.2
Personal income tax	3.4	3.3	3.5	3.8	4.0	4.3
Uniform social tax*	3.5	2.0	1.9	2.0	1.9	2.1
VAT	6.3	6.8	5.6	6.9	5.1	5.3
Excise taxes	1.4	1.2	1.0	1.0	0.8	0.9
Mineral tax	3.0	4.2	4.1	3.6	4.1	2.8
2. Insurance contributions to the compulsory pension insurance	2.8	2.9	2.9	3.1	3.1	3.4
3. Foreign trade revenues	5.5	7.8	8.6	7.3	8.6	6.9

*Without regard to insurance contributions to the compulsory pension insurance.
Source: The RF Ministry of Finance; IET calculations

The export duty rates for oil were revised following the improvement of the situation with the world oil prices. More specifically, between January and June 2009 the figure has been fluctuating within the range of USD 100-135 per ton of crude oil. Between July and August it was raised up to USD 222/t, while between September and December it was fluctuating between USD 231-271/t. The increase in the export duty rate has inevitably resulted in growing revenues from foreign trade, but failed to attain the 2008 relative volumes of tax revenues, nonetheless.

In addition to external factors, the amount of oil-and-gas revenues in 2009 found itself affected by changes in the mineral tax administration procedures, including the following ones:

- increase of the exempt minimum threshold from 9 USD/bbl to 15 USD/bbl;
- since 2009 for the sake of taxation the volume of the extracted oil was identified in net mass units;
- the list of fields subject to application of zero rate of the mineral tax was extended;
- the subsoil use license write-off procedure was modified for all the oil companies.

As well, the year of 2009 saw adoption and promulgation of a new procedure of collection of the mineral tax-based revenues. The revenues from the carbohydrate minerals, oil and gas condensate in full have now become subject to collection to the federal budget. As a reminder, the tax was previously collected to the federal budget at a rate of 95%. Whereas the respective proportion of revenues from the mineral tax in the revenue structure of budgets of

[1] The USD/RB exchange rate is used to calculate the coefficient of the oil price dynamic, which is used to set the mineral tax rate with respect to oil.

the Subjects of the Federation has recently accounted for a meager 1.5-2%, such redistribution has not entailed any considerable fall in the said revenues. Plus, the increase of rates of individual regional taxes (the transport tax, state levies, excise taxes) effective since 2010 may offset a possible withdrawal of a fraction of regional resources due to the modification of the mineral tax distribution procedure.

Declining revenues, primarily in the oil-and-gas sector and the general slump of business activity in other industries have resulted in a plunge of revenues from *the corporate profit tax*. Between January and December 2009 the revenues to the enlarged government's budget accounted for 3.2% of GDP compared with 6% of GDP in 2008. As of early 2010, financially, most enterprises have found themselves in dire straits, while the government stimulus package was delivered to a limited number of the most critical, backbone corporations and fell short of securing a mass positive effect. Meanwhile, it is worth noting some stabilization of the financial health of corporations in individual sectors over the last months of 2009.

In all, according to the preliminary data, over 11 months of 2009 the real sector posted an aggregate financial result of Rb. 3,639,3bn, or more than 1.2 times lower than the respective figure of 2008, while the proportion of profit-making organizations in their overall number dwindled by 5.8 p.p. and accounted for some 67%.

In addition, the corporate profit tax underwent some reform in 2009. Specifically, its rate slid from 24% to 20%, while the regional component soared to 18% instead of the previous 17.5%. As well, the year of 2009 saw some amendments to Art. 25 of the Tax Code in the part of administering the corporate profit tax levied on organizations and improvement of the taxpayers' situation come in force. More specifically, the following novelties are worth notion:

- simplification of the procedure of payment of the corporate profit tax by virtue of transition from the quarterly-advance arrangement to its monthly payment on the basis of effective profit;
- increase of the bonus depreciation rate (attribution of a part of the initial costs of capital assets to expenses in the ongoing tax period) from 10 to 30%;
- provision of the possibility for amortization of capital assets identified as a result of stock-taking;
- granting organizations the right to factor in costs of training of their staff by major, as well as complementary professional programs;
- possibility to consider individual kinds of R&D costs with the use of an increasing coefficient -1.5.

The above modifications of the procedure of administration and accounting of the corporate profit tax reduce the tax base. But that was counterbalanced by some new modifications, including:

- obligation to restore the bonus depreciation by capital assets which are sold prior to the 5-year deadline of their use;
- payments to members of the Board of Directors are not subject to their accounting as costs.

Overall, the above measures aimed at expansion of the tax base of the corporate profit tax failed to substantially reverse the unfolding in 2009 tendency to contraction of the volume of payments by the corporate profit tax.

On the backdrop of a substantial fall of revenues by main taxes to the country's budget system, the 2009 volume of the *VAT*-based revenues rose by 0.2 p.p. of GDP. But considered in absolute terms, it tumbled. The tax revenues in question slid due to the deteriorated business activity in the domestic and national economies and under an adverse effect of measures devised to improve calculation and administration of the tax. More specifically, they include the abrogation of the obligation to pay VAT in cash equivalent under non-cash kinds of settlements, exemption from VAT of payments for technological equipment, granting the right to deduct VAT from advances.

But in some months the VAT collection rate would outpace the respective figures of the prior year. The trend does not mirror an improvement of its collection - rather, it can be ascribed to modifications of the respective payment and refund timelines. Given that in 2008 VAT was paid on the quarterly basis, ie the whole amount of tax obligations was payable as a single payment in a month following the reporting quarter, in 2009 the taxpayer was able to effect the payments at his discretion - that is, either quarterly, or monthly, in equal installments. The novelty secured some equalizing of revenues from the tax in the span of the year, but, at the same time, has complicated comparison of the annual dynamic of the 2008 with that of 2009.

The 2009 volume of revenues from *excise taxes* did not undergo any substantial changes and remained at the level of 0.9% of GDP, notwithstanding a traditional indexation of its rates. To exemplify, the excise rate on straight-run gas surged up to Rb 3,900 per ton vs. the previous 2,657/t; excise rates on liquors were indexed by the inflation rate on average, while those on cigarettes soared by 20 to 25% relative to the prior year. The excise rates on passenger cars with the engine capacity of over 67.5kW (90 HP) and motorcycles with the engine capacity over 112.5 kW (150 HP) were raised roughly by 9%.

An important move in 2009 became the RF government's decision to drastically index excise rates on low-alcoholic and tobacco products since 2010. Specifically, excise rates on low-alcoholic goods with the volume ratio of up to 9%, alcohol-containing products and wine were indexed at 30% on average, and those on beer – at 50%. As concerns cigarettes (including Russian cigarettes), the ad-valorem component of the respective excise tax on them calculated proceeding from the maximum retail prices is envisaged to rise by 0.5%; meanwhile, the specific component of the excise rate on the filter cigarettes should be raised by 30% on average, while that on Russian cigarettes – by 50%. We believe such a drastic increase of excise rates on low-alcoholic and tobacco goods is a quite timely move and it appears fairly justifiable from the fiscal perspective and from the perspective of promotion of a healthier lifestyle in Russia. But the move should not entail a substantial decline of demand for these excised products, nor should it derail the investment attractiveness of the respective sectors.

The 2009 revenues from *the personal income tax* to the budgets accounted for 4.3% of GDP, up by 0.3 p.p. of GDP vis-à-vis the respective figures of 2008. Meanwhile, the revenue volume declined slightly in absolute terms. Some growth in the PIT-based revenues in relative terms does not at all evidence its collection has improved. Rather, it was driven by a higher dynamic of deceleration of the economy's growth rates compared with revenue volumes from the tax. More specifically, according to preliminary estimates, the 2009 increase in the population's real disposable incomes (incomes less compulsory payments adjusted by the CPI) followed the 2008 dynamic and accounted for 1.9% relative to the prior year. Meanwhile, real salaries and wages tumbled by 2.8% vs. the respective figures of 2008, while a number of benefits reducing the PIT tax base were put in effect, including:

– increase of the child benefit up to Rb. 1,000 and the respective amount of the annual income eligibility threshold (up to Rb. 280,000);
– increase of the upper marginal amount of the social tax benefit by the PIT with regard to expenses on the savings part of the labor pension from Rb. 100,000 up to 120,000;
– calculation of income in the form of interest on Rb.-denominated bank deposits is made using the CBR refinancing rate +5%, which to a significant degree reduces the tax base vis-à-vis the earlier set one;

In addition to the tax novelties associated with individual taxes and levies, the year of 2009 saw introduction of amendments that regulate the basic procedure of provision of a tax credit:

– In September, the RF government approved a bill "On introducing amendments to Section One of the Tax Code of the Russian Federation with regard to regulation of tax, levy, penalty and fine arrears". With the amendments in place, it has become possible to grant the taxpayer determent of payment, installment of date in connection with the threat of the rise of insolvency (bankruptcy), should the tax payment be nonrecurrent. However, the risk of bankruptcy should be proved by documented evidence;
– the credit ceiling of the investment tax loan extended to the taxpayer in the event he runs R&D projects, pilot-plan works, or technical rearmament is increased from 30% of his assets to 100%.

Affected by the domestic and external factors, the 2009 aggregate indicator of tax burden on the economy slid by nearly 5% of GDP and accounted for not more than 31% of GDP (see *Table 2*).

With the revenues to the enlarged government's budget being in decline, its expenditure component demonstrated an opposite dynamic and posted growth equivalent to 6.7 p.p. of GDP (see *Table 3*). Interestingly, in the last months of 2009 budget funds were spent more intensively than in the beginning of the year.

Table 3

Execution of Expenditure Obligations of the Budget of the Enlarged Government in 2008–2009, as % to GDP

	2009		2008		Bias, as p.p. of GDP
	As Rb. bn.	As% of GDP	As Rb. bn.	As% of GDP	
Expenditures, total	15847.3	40.6	13989.2	33.9	+6.7
including					
General public administration matters	1290.6	3.3	1287.6	3.1	+0.2
including the public and municipal debts servicing	236.6	0.6	189.3	0.5	+0.1
National defense	1191.2	3.1	1043.6	2.5	+0.6
National security and law enforcement	1245.9	3.2	1092.1	2.6	+0.6
National economy	2782.3	7.1	2253.1	5.5	+1.6
Housing and utilities sector	1005.9	2.6	1149.2	2.8	–0.2
Environmental protection	29.7	0.08	31.2	0.1	–0.2
Education	1777.9	4.6	1665.5	4.0	+0.6
Culture, the motion picture industry, mass media	324.4	0.8	310.6	0.8	–
Health care and sport	1653.1	4.2	1548.6	3.8	+0.4
Social policy	4546.1	11.7	3607.7	8.7	+3.0

Source: the RF Treasury, the IET calculations

As far as expenditure management is concerned, the RF government's budget policy rested upon the "anti-cyclic" principle. With a significant fall in budget revenues, there were no expenditure cutbacks. But already in the beginning of the year the structure of expenditures by directions of their use displayed notable modifications, with investment expenditures being cut vis-à-vis extra funds being earmarked for the sake of financial support of the population and domestic businesses. The funding by the item "Social policy" hit a record-breaking value of 11.7% of GDP vs. 8.7% of GDP reported in 2008. A considerable increase in expenditures was noted by the item "National economy" – up to 7.1% of GDP in 2009 vs. 5.5% of GDP in 2008. As well, substantial funds were earmarked to finance the items "National defense" and "National security and law enforcement activity" – 3.1% and 3.2% of GDP, respectively, each up by 0.6 p.p. compared with the respective figures of 2008.

2.2.3. Execution of the Federal Budget of Russian Federation

The global crisis has battered the revenue collection to the federal budget – the revenues found themselves in a steady decline since October 2008. Notably, it was not just oil-and-gas revenues, which directly depend on oil prices, that tumbled considerably, but non-oil-and-gas ones too, due to the general deterioration of business activity indicators in the country.

According to the Federal Treasury, between January and December 2009 revenues to the federal budget accounted for 18.8% of GDP, or down by 3.7 p.p. compared with the respective 2008 figures, while expenditures outran the prior year's level at 6.4 p.p. of GDP and hit the mark of 24.7% of GDP (*Table 4*). Such a drastic increase in expenditures is explained by a large-scale funding of the anti-crisis measures set for accomplishment in 2009, as well as by a far smaller nominal volume of GDP in 2009.

The key cause behind the absolute and relative contraction in the volume of the federal budget revenues in the period in question vis-à-vis the same period of the prior year was the fall of the proportion of oil-and-gas revenues in the budget. At this point, it should be noted that while the volume of revenues from the mineral tax and foreign trade activities are directly dependant on the dynamic of the world carbohydrate prices, the rate of their production and the exchange rate of the Rb., the size of the structural (non-oil-and-gas) revenues is determined by the current state of the national economy.

The federal budget revenues, without regard to investment revenues to the Reserve Fund and the National Welfare Fund (NWF), worth a total of Rb. 205.1bn and 63.4bn, respectively, collected to the budget in January 2009, as well as Rb. 4.1bn-worth interest on the NWF's deposits with the VEB, proved to be substantially smaller than in 2008.

Table 4

Main Parameters of the Federal Budget of RF in 2008–2009

	2008		2009		As % to the budget estimate	Bias	
	As Rb. bn.	As% of GDP	As Rb. bn.	As% of GDP		As Rb. bn.	As p.p. of GDP
Revenues, including:	9274.1	22.5	7336.8	18.8	109.3	–1937.3	–3.7
Oil-and revenues	4389.4	10.6	2983.9	7.6	145.1	–1405.5	–3.0
Expenditures	7566.6	18.3	9636.8	24.7	97.0	2070.2	+6.4
Surplus (deficit) of the federal budget	1707.5	4.2	–2300.0	–5.9	78.1	–4007.6	–10.1
Non-oil-and-gas deficit	–2681.9	–6.5	–5283.9	–13.5	95.7	–2628.2	–7.0
GDP estimate	41256.0		39016.1				

Source: the RF Ministry of Finance (preliminary estimates), the IET calculations

As concerns execution of the expenditure part of the federal budget, their financing was extremely uneven and erratic. *Table 5* presents the dynamic of spending of the federal budget funds in 2009 according to the functional classification of budget expenditures. As evidenced by the Table, the rate of spending was lower than in 2008; however, the bias the federal budget funds in spending on the whole was not as significant on average as the one across individual directions of spending. More specifically, the 2009 federal budget expenditures were executed in a proportion of some 97% of the specified budget estimate, or just at 0.8 p.p. lower than the prior year's rate. It was items "General public administration matters", "Culture, the motion picture industry", and "National economy" by which the federal budget spending lagged behind the 2008 figures at most, with the respective cutbacks accounting for 3.1-6.3 p.p. of GDP. By contrast, the advanced rate of spending (by 0.4-5.7 p.p. of GDP vs. the 2008 figures) was posted by financing of items "Housing and utilities sector", "Interbudgetary transfers", and "Healthcare and sport".

Table 5

Cash Execution of the Federal Budget in 2008–2009
(as % to the Annual Budget Estimate)

	2009 г.	2008 г.
Expenditures, total	**97.0**	**97.8**
Including:		
General public administration matters	85.3	91.6
the public and municipal debts servicing	86.9	97.4
National defense	98.7	99.7
National security and law enforcement	99.7	99.9
National economy	93.5	96.3
Housing and utilities sector	99.3	93.6
Environmental protection	97.5	98.8
Education	100.6	101.1
Culture, the motion picture industry, mass media	97.4	100.5
Health care and sport	99.3	98.9
Social policy	97.7	98.4
Interbudgetary transfers	99.7	98.6

Source: the RF Ministry of Finance (preliminary estimates), the IET calculations

The main cause behind a substantial increase in the federal budget expenditures became the need for implementation of stimulus measures aimed at mitigation of the adverse effects from the global financial crisis and their economic and social consequences. It is particularly worth noting that in addition to the financing of the anti-crisis program out of the budget, the RF government vigorously deployed quasibudgetary sources, including funds of the Central Bank, extrabudgetary funds, public corporations, tax credits, etc. (*Table 6*).

Table 6

Structure of the Financial Anti-Crisis Measures in 2008–2009

Budgetary anti-crisis measures	Planned for execution in 2008–2009, as Rb. bn	Executed as of January 1, 2010, as Rb. bn.
Measures on securing the economy's financial stability		
Out of the federal budget		
On balancing regional budgets (subsidies, subventions, budget loans)	363.4	363.4
Vneshekonombank	175.0	175.0
VTB	180.0	180.0
Rosselkhozbank	45.0	45.0
JSC Rosagrolizing	25.0	25.0
AIZHK	80.0	80.0
Out of the federal budget, subtotal	*868.4*	*868.4*
Extrabudgetary sources (quasi-budgetary)		
Subordinated loan to Sberbank of Russia (source- the CBR)	500.0	500.0
Extended to Vneshekonombank to disburse subordinated loans to other banks (14 banks, source -NWF)	410.0	404.0
Placement of funds on deposits at Vneshekonombank for the sake of lending to small and medium-sized (source -NWF)	30.0	30.0
Banks' debts restructuring (source- the CBR and the Deposit Insurance Agency)	n/a	297.1
Extrabudgetary sources, subtotal	–	*1 231.1*
On securing the economy's financial stability, subtotal	**–**	***2 099.5***
Measures on support of the real sector		
Out of the federal budget		
Support to car makers	68.0	69.0
Support to aircraft makers	15.9	21.9
Support to shipbuilding	3.0	3.0
Subsidizing interest rates for agrarian and fishery corporations	18.1	60.4
Support of export	6.0	6.1
Development of small and medium-sized businesses	13.6	18.0
Support to the defense and industrial complex	73.3	79.0
Support to transport complex	53.0	56.4
Имущественный contribution to the public corporation "Rostekhnologii"	1.0	1.5
Government guarantees to backbone enterprises	300.0	300.0
Out of the federal budget, subtotal	*551.9*	*615.3*
Extrabudgetary sources (quasi-budgetary		
Support to housing construction (source- the Fund for Assistance to the Housing and Utilities Sector Reform)	n/a	136.5
On support of the real sector, subtotal	–	*751.8*
Social measures		
Out of the federal budget		
Support to the labor market and assistance to employment	43.7	43.7
Raising unemployment benefits	37.0	80.5
Possibility to use the "maternity allowance" to improve housing conditions and for one-time Rb. 12,000-worth allowance for ongoing needs	44.3	44.3
Additional measures in the health care area (combating the A/H1N1 pandemic, provision of necessary medicines, delivery of high-tech medical assistance, etc.)	9.7	9.7
Procurement of housing for veterans	55.8	55.8
Provision of transfers to extrabudgetary funds and the EAEC' s anti-crisis fund	427.7	443.0
On social measures, subtotal	*618.2*	*677.0*
On anti-crisis measures, TOTAL		**3 528.4**

As evidenced by the Tables, the anti-crisis measures on securing financial stability in the economy were being implemented at the expense of both the federal budget and extrabudgetary sources. The proportion of the latter accounted for over 2/3 of the respective expenditures. Other support measures were financed exclusively out of the budget funds.

In all, between 2088 and 2009 the anti-crisis measures cost a total of some Rb. 3.5 trln.

Main objectives of moves ***to secure financial stability of Russia's economy*** were reduced to combating liquidity shortages, recapitalizing the largest banks, having banks and corporations repay their external corporate debts and regions get their budgets balanced.

The government support to the banking system was exercised by means of boosting the largest banks' capital and providing liquidity in the form of subordinated loans. These measures combined cost some Rb. 2.1trln, with the the federal budget's contribution accounting for Rb. 500bn. In the frame of this bloc of measures the government invested in Vnesheknombank (Rb. 175bn), Rosselkhozbank (45bn), VTB (180bkn), JSC Rosagrolizing (25bn). In addition, the CBR disbursed subordinated loans to Sberbank of Russia (a total of Rb. 500 bn), completed a Rb. 300bn-worth debt restructuring of 18 other banks, which were recognized as being significant for the national banking system or backbone for their respective regions, including: KIT Finans investment bank (JSC), AKB ROSSIYSKY KAPITAL (JSC), Bank Vefk-Sibir (JSC), Gubernsky Bank Tarkhany (JSC), KB Moskovsky Kapital (Ltd, AKB Soyuz (JSC), SEVERNAYA KAZNA (JSC), Nizhny Novgorod (JSC), to name a few.

In the frame of ***support of the industrial and technological sectors*** the RF government employed both a direct aid from the budget and issuance of government guarantees and provision of tax benefits. The volume of funding on support of corporations from different sectors over the crisis period 2008-09 accounted for some Rb. 750bn, including Rb. 300 bn in government guarantees.

The following programs were to be financed out of the federal budget: the technological rearmament of backbone DIC enterprises (to this effect Rb. 50.7bn. was earmarked); innovation-oriented federal target programs on development of the infrastructure for small- and medium-sized business (Rb. 18bn.); automakers' investment projects (a. Rb. 69bn.).

As well, the government practiced a widespread support of corporations by means of *subsidized interest rates*. This form of support was provided for beef and dairy husbandry enterprises, and fishery companies (Rb. 60.4bn), DIC corporations (20.3bn), etc. In addition the government provided for subsidizing interest rates across individual kinds of economic activity, including refinancing of investment loans, interest rates with respect to transactions on leasing of the domestic automobile hardware, for exporters (Rb. 6.1bn), among others.

Additional financing out of the federal budget was exercised by means of *granting subsidies and subventions*: more specifically, to prevent the strategic DIC objects from going bankrupt (Rb. 7.9bn); subsidies to air carriers to continue passenger transportation in the event their licenses had been revoked (5.0bn), etc.

To support individual industries, the government employed the public procurement mechanism, which formed the bulk of funds spent on procurement of motor vehicles for the federal and territorial public agencies and renewal of other special hardware (circa Rb. 15.5bn).

The government also provided *guarantees* on backbone corporations' loans worth a total of Rb. 300bn.

Support to the construction sector was exercised through the Fund for Assistance of the Housing and Utilities Sector Reform, which contributed to the Subjects of the Federation with some Rb. 136bn, to co-finance regional target programs.

As concerns measures on ***support of the most vulnerable strata of the population***, the following ones should be particularly referenced to:

- support to the labor market and assistance to employment measures (some Rb. 44bn);
- increase of unemployment benefits (some Rb. 80bn);
- possibility to use the "maternity allowance" to improve housing conditions and for one-time Rb. 12,000-worth allowance for urgent needs (Rb. 44.3bn);
- Provision of transfers to extrabudgetary funds and the EAEC' s anti-crisis fund (Rb. 443bn);
- Procurement of housing for veterans (Rb.55.8bn)

The social measures also included co-financing of special programs in the housing and utilities sector, that is, restructuring the private individuals' mortgage arrears. This measure is implemented by means of an additional capitalization of the AHML's authorized capital (Rb. 80bn).

The analysis of the system of anti-crisis measures allows one to assert that they have centered mostly on securing the financial stability and support of strategic corporations, while just an meager fraction of them was to be spent on improvement of the situation on the labor market. The target approach to allocation of the budget aid is laudable; however not all the measures were implemented in a timely fashion. Furthermore, some of them latently derailed economic agents' incentives to conduct a more sound policy and more adequately assess risks.

Because of the expansion of volumes of financing out of the federal budget in 2009 and given the persistence of the negative tendency to contraction of revenues to the budget that started yet in 2008, the 2009 federal budget posted deficit amounting to 5.9% of GDP, with the size of the oil-and-gas deficit equivalent to -13.5% of GDP.

The funding of the large-scale measures on support of the economy without attracting external borrowing became possible thanks to financial reserves accumulated in the period of economic growth. It was resources of the oil-and-gas Funds that formed the major pool securing the 2009 federal budget equilibrium. As evidenced by *Table 7*, as much as some Rb. 3.0trln was allocated out of the Reserve Fund alone to finance budget expenditures. This allows to reckon that the concept of formation of the oil-and-gas Funds has been absolutely sound and the current fiscal policy should be given a due credited for that.

Table 7

Dynamic of Formation and Use of the Oil-and-Gas Funds in 2009, as Rb. bn.

Indicator	Cash balances as of end-2008*	Collected in 2009		Spent in 2009 on:		Cash balances as of end-2009.*
		Oil-and-gas revenues	Revenues from capital management	Securing the balanced budget	Securing the oil-and-gas transfer	
Reserve Fund	4027.6 (9.8% of GDP)	488.5	205.0	2964.8	179.4	1830.5 (4.7% of GDP)
National Welfare Fund	2584.5 (6.3% of GDP)	–	92.5	–	–	2769.0 (7.1% of GDP)
Total	6612.1 (16.0% of GDP)	488.5	297.5	2964.8	179.4	4599.5 (11.8% of GDP)

* balances recalculated using the exchange rate as of January 1, 2009, and January 1, 201, respectively

The year of 2009 saw introduction of amendments to the Budget Code of RF with respect to administration of the Reserve Fund and the National Welfare Fund. More specifically, it was ruled to detest using funds from management of both Funds on their replenishment. Hence since January 1, 2010 and though February 1, 2012 the said funds have become subject to an immediate collection to the federal budget. The measure will enable one to compensate for the fall of the revenue component of the federal budget and narrow its deficit.

2.2.4. Main Parameters of Russia's Federal Budget for 2010-2012

The year 2009 has de-facto marked a turning point of trends of main budget indicators and the discontinuation of a long-term policy of boosting expenditures in particular (*Fig.1*). In 2009, the federal budget expenditures hit their peak value both in constant prices and as percentage of GDP (some 24.7% of GDP – for reference, the 2004 indicator did not exceed 16% of GDP). The fact of the matter is that in order to secure the financial sustainability of the budget system in the medium term, the RF government has focused on curtailing volumes of expenditure obligations in shares of GDP together with a parallel increase of their efficacy.

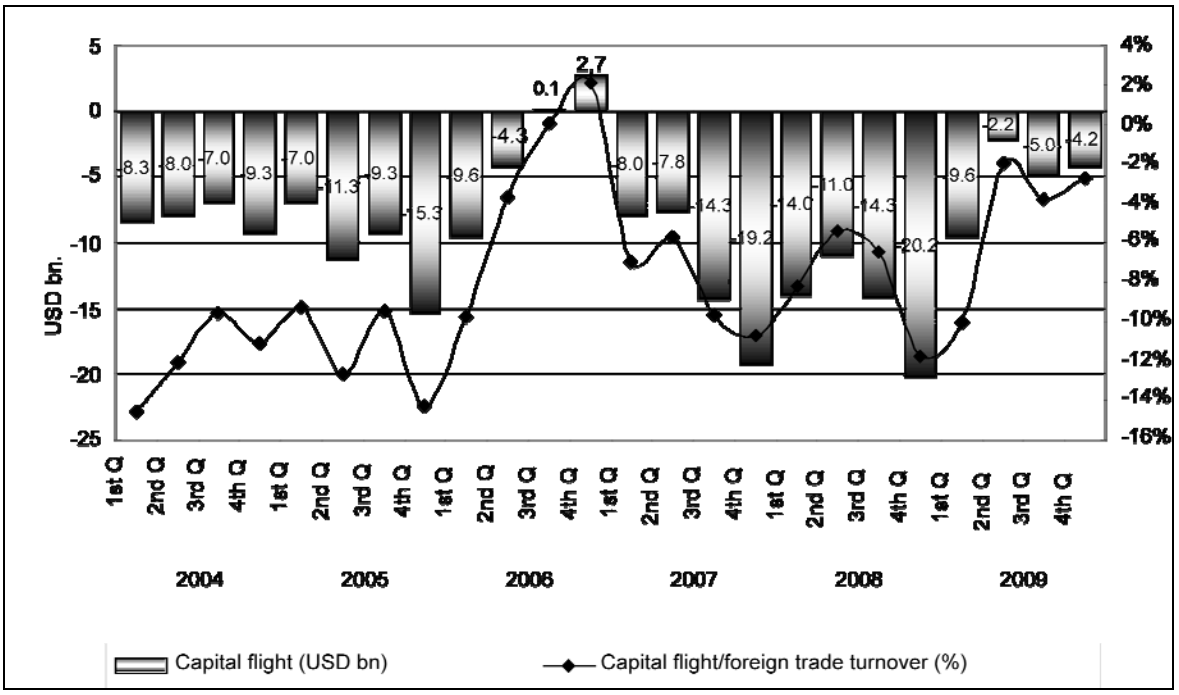


Fig. 1. Dynamic of the Federal Budget Revenues and Expenditures (in the 2006 prices), as Rb. bn.

The volume of revenues to the federal budget is expected to plunge to 15% of GDP by 2012, while the volume of government obligations will be consistently sequestrated from nearly 23% in 2010 to 18% of GDP by 2012.

During the period in question the federal budget revenues should tumble substantially due to the projected relative downfall in the world prices for oil and gas, deceleration of the increase rate of extraction and export of carbohydrates and appreciation of the Rb. against the USD under conservation of the earlier emerged mineral structure of Russia's export. The fed-

eral budget act provides for a decline in the volume of oil-and-gas revenues by 0.7 p.p. of GDP over the three-year period concerned. It should be noted that a surge of structural revenues would fall short of duly compensating for the contraction in oil-and-gas revenues. The volume of collection of non-oil-and-gas revenues to the budget would plunge by 1.5 p.p. of GDP over the period in question.

While the volume of expenditure obligations is projected to decline, they would still remain on a fairly high level. Such a structure of the federal budget should give rise to a steady deficit whose size would be fluctuating within the range of 3-5% of GDP. To run a balanced federal budget, the respective act provides for the financing of the deficit out of domestic and external sources, with the Reserve Fund and domestic borrowings constituting major ones. Meanwhile, there has emerged the need for borrowing from overseas – it is planned to attract some USD 18bn already in 2010 alone, while the overall volume of borrowings for 2010-2012 was set at the level of USD 60bn. It may also become possible to introduce some adjustment to the value of annual borrowing in the period in question, should the change in the oil price level display a negative dynamic. In light of the prospective borrowings in 2009 Russia faces a critical challenge of a full repayment of its debt to the London Club and of another USD 400-500mln-worth commercial debt of the former USSR.

An analysis of the revenue part of the act on the 2010-2012 federal budget of RF

According to the federal budget act, the period between 2010 and 2012 would witness a decline in, or a lower dynamic of revenues from most taxes and levies compared with the period of 2006-2008 (*Table 8*). The tendency is characteristic of both the oil-and-gas- and infrastructure-based taxes. The projected decline would be driven chiefly by a relative deterioration of the situation with prices and demand for Russian exports. Specifically, according to forecasts of main macro indicators of the economy's health, through the end of 2011 the world oil prices should not exceed USD 60/bbl, being in a stark contrast with the USD70-120/bbl noted between 2006 and 2008. Likewise the growth rate of production of oil and natural gas should slow down and export of the oil-and-gas complex products should contract. Given that customs duties still account for a fairly substantial proportion in the overall volume of the federal budget revenues, in the medium perspective the level of revenue collection to the federal budget will remain directly correlated with prices for the nation's exports.

Table 8

Dynamic of Tax Revenues to the Federal Budget in 2006–2012 (as % of GDP)

Name of tax	Actual collection rate				As per the federal budget act		
	2006	2007	2008	2009	2010	2011	2012
Revenues, total:	23.6	20.4	22.5	18.8	16.1	15.5	15.0
Corporate profit tax	1.9	1.9	1.8	0.5	0.5	0.5	0.4
VAT	5.6	6.8	5.1	5.3	5.1	5.2	5.3
Excise taxes	0.4	0.4	0.4	0.3	0.3	0.3	0.4
Customs duties	8.3	7.0	8.6	6.9	6.2	5.9	5.7
Mineral tax	4.1	3.4	3.9	2.5	2.5	2.3	2.2
Proportion of the above taxes in the federal budget revenues, as %	87.0	83.4	88.0	82.5	90.5	91.6	92.9

In addition, the global financial crisis has continued exerting an adverse impact on the financial standing and business activity in the real sector. It is still very likely that renewal of their operational performance, that is, bouncing back to the pre-crisis rates of production of

goods and services may take long, which does not at all make it certain that non-oil-and-gas tax revenues would be on the rise any time soon.

An analysis of the expenditure part of the act on the 2010-2012 federal budget of RF

As concerns the dynamic of the federal budget expenditures in 2010-2012, the respective act has outlined a consistent capped-spending policy, which contrasts the recent one that would suggest the expenditure increase rate should outpace the economy's growth rate. Originally, the 2010-2012 federal budget blueprint implied a budget for development; however, presented in the act, main estimates of its expenditure part suggest a continuous policy aimed at social support to the population and target subsidizing of the largest corporations and individual industries vis-a-vis curtailing investment expenditures.

It is assumed that in 2010 the federal budget expenditures should be cut by 1.8% of GDP compared with the 2009 figures. But once the 2010 expenditure volume is compared with parameters of the pre-crisis years, it appears quite significant, and it is going to be 2012 when it will catch up with relative figures of 2007-08.

Table 9

Structure of the Federal Budget Expenditure in 2007–2012 (as % of GDP)

	Actual execution			The act		
	2007	**2008**	**2009**	**2010**	**2011***	**2012***
Expenditures, total:	18.1	18.3	24.7	22.9	19.5	18.0
including:						
General public administration matters	2.5	2.0	2.1	2.7		
of which the public debt servicing	0.4	0.4	0.5	0.7		
National defense	2.5	2.5	3.1	2.9		
National security and law enforcement activity	2.0	2.0	2.6	2.5		
National economy	2.1	2.5	4.2	3.1		
Expenditures on the social policy and social sphere	2.4	2.5	3.1	2.7		
Interbudgetary transfers	5.8	6.5	9.2	8.6		
Other expenditures (provisionally approved)	–	–	–	–	0.5	0.9

* The budget act comprises projections with regard to the 2010 expenditures in a full volume with the breakdown by items of the classifications. Meanwhile, parameters of the 2011 and 2012 expenditure obligations are presented just by marginal values. Let us note that the previous years' format provided for a detailed stipulation in the federal budget act of assumed expenditure obligations for the three-year span, which enhanced transparency and certainty in the sphere of public financing of expenditures for the citizenry. But it is inappropriate to present a detailed breakdown in the conditions of instability of individual macroeconomic indicators in the post-crisis period.

Source: the RF Ministry of Finance, the IET calculations

With the decimation of expenditures, the most notable changes vis-à-vis the 2009 budget execution parameters are ascribed to cuts in financing of measures in the national economy sphere and expenditures on the social policy.

More specifically, it is planned to curtail expenditures on *the national economy* by 1.1. p.p. of GDP against their 2009 volume. The cuts can be explained by the fact that the biggest measures on supporting various industries in the frame of the government anti-crisis program were envisaged to be complete in 2009. A certain fraction of the measures is due to be accomplished in 2010, but in a far smaller volume.

The volumes of financing of *the social policy expenditures* likewise are subjected to cuts equivalent to 0.4 p.p. of GDP relative to their 2009 figures. Behind the cuts there is imple-

mentation of main measures on pay rises for budget employees and other social monetary allowances in 2009 by means of their advanced indexing.

It should be noted that the 2010 expenditures by item "Interbudgetary transfers" should be cut by 0.6 p.p. of GDP. Such a dynamic is explained primarily by the fall in the volume of transfers to the RF Subjects on balancing their budgets. On this background there should be an increase in transfers to the government extrabudgetary funds (to the greatest extent – to the Pension Fund) to ensure fulfillment of the earlier assumed obligations and conduct the pension reform measures.

Expenditures on general public administration matters (with account of expenditures on the public debt servicing) should also grow from 2.1% of GDP in 2009 to 2.7% of GDP in 2010. The rise is fueled chiefly by growth in newly assumed debt obligations. Relative volumes of financing across other federal budget items should remain unchanged or undergo an insignificant adjustment.

Overall, it can be ascertained that the 2010-2012 federal budget has been formed proceeding from the need to hold the budget system balanced. In the conditions of a substantial fall in budget revenues the government will have to stick to the policy of curtailing its obligations to preclude the budget deficit from rising.

2.2.5. The Medium- and Long Term Prospective Avenues of the Fiscal Policy

Next decade, Russia's tax system will face two major challenges.

First, the effective decisions on the pension reform do not warrant the pension system's balance, unjustifiably mount pressure on the labor compensation fund and imply the need for its constant replenishment out of the federal budget. Accordingly, the tax system as a whole is in need for a certain adjustment, which should help the public finance adapted to the global process of the population ageing.

Secondly, the national economy's advancement along the path of innovation implies contraction of the proportion the mining sector holds in the nation's GDP. But the tax burden on the mining sector has substantially exceeded the one on other sectors. In the medium term Russia will see rental payments to the budgets in decline, which will necessitate revision of the problem of the level of tax burden on the economy and transformation of the revenue structure from main taxes.

Below, we briefly highlight on main measures that may be employed in response to the said challenges.

Pension reform

Recent decisions on the national pension system overhaul– that is, federal act №212-FZ of July 24, 2009 "On insurance premiums to the Pension Fund of the Russian Federation, the Social Insurance Fund of the Russian Federation, the Federal Fund for Compulsory Medical Insurance and territorial funds of the compulsory medical insurance", in our view, are inadequate, as they fail to solve the problem of securing the pension system's balance in the long run, but, at the same time, drastically increase the tax burden and complicate the tax administration.

As most developed nations, Russia likewise experience the basic demographic process-namely, the population's ageing. The negative demographic trend poses a strategic long-term challenge for Russia's pension system.

The rise in the number of pensioners in Russia from 330 per 1,000 able-bodied people in 2007 to 450 in 2020 will necessitate making a fairly complex choice:

- -either to keep expenditures on pension payments as a percentage of GDP at the 2007 level and yield with the decline of the replacement rate to 16% by 2020 (vs. 23.4% in 2007), or
- to maintain the replacement rate at a socially acceptable level of some 30%, but compromise on a rise of expenditures on pension payments up to 8.2% of GDP in 2020 (ie by 3.4% of GDP vs. the 2007 figures).

As a consequence of the increase of the basic rate of pension contributions from 26% up to 34% most corporations would experience a 1.6 p.p. of GDP rise of the tax burden on the labor compensations fund. By most OECD nations' standards the proposed insurance premium tariffs appear abnormally high. Increase of the tax burden on labor contradicts the general international trend which suggests that to boost an economy's competitiveness, one needs to lower the tax burden on labor and capital and increase the one on consumption.

An increase of the tax burden on the labor compensation fund may result in:

- noncompetitiveness of Russia's economy;
- fall in the official employment rate and, accordingly, in the respective contributions;
- migration of salaries and wages into the grey zone.

The reassignment of administration of pension contribution from the Federal Tax Service to the Pension Fund is explained by the need to update the respective data 4 times a year. But the need to accomplish this technical exercise could justify an increase of the burden on businesses by establishing yet another controlling agency can be questioned.

In the short run an increase of the fiscal burden on the labor market in the time of economic crisis appears a *non-licet* exercise. With the employment problems aggravating, one should not increase the said burden on salaries and wages of the least prosperous strata from the current 26% to 34%. The RF Minzdravsotsrazvitiya maintains it is necessary to secure a steady increase of the insurance tariff from up to 42% by 2047[1], which will make Russia's economy uncompetitive. At this juncture it appears urgent to confine oneself to a moderate indexing of the UST scale, which would not increase the fiscal burden on the labor market in 2010-11.

In the medium term it is imperative to attract financial resources into the pension system to complement premiums on compulsory pension insurance plans. In addition, provided a favorable state of affairs, one should use reserve funds for this purpose. It may also become possible to consider *privatization of public assets*, particularly by means of their transfer to the Pension Fund of RF and non-government pension funds as current contributions by the savings component of pension plans.

To secure a long-term balance of the pension system it is also necessary to *raise the pension age*. While fully appreciating the complexity of the issue from the political perspective, it should be noted that this move constitutes the only solution to the problem of balancing the pension system in the long run, which would enable one to effectively increase the replacement rate.

To minimize political costs engendered by the move, it should be implemented in a gradual fashion and concern just relatively young residents.

Export duties

[1] According to the RF Minzdravsotsrazvitiya's documents

Russia's economy restructuring in the long run is interwoven with abrogation of export duties whose existence means subsidizing the domestic mineral and energy sources producers at the expense of the mineral rent, with mineral inventories being owned by the state. Compensated by an increase of the mineral tax, the abolishment of export duties should entail a rise in domestic prices for minerals and energy sources up to the international levels. As a consequence, domestic producers will be compelled to boost resource efficiency of their production to the level of nations that import minerals and energy sources. Without this, an efficient consumption of natural resources and environmental protection would appear an unlikely prospect.

Selling their products on the domestic market under the present system, the national mineral producers pay the mineral tax, export duties and incur losses equivalent to the difference between international prices for their products and domestic ones. Accordingly, an increase of the mineral tax under the abrogation of the duty should be sufficient to compensate for the value of the export duty and benefits corporations consuming minerals and energy sources enjoy from the difference between the domestic and world prices adjusted by the fall in the volume of domestic consumption caused by contraction of demand fueled by rising domestic prices.

But, at the same time, it is understood that any drastic changes in this area are highly unlikely. Transition to taxation of mineral producers on the basis of the mineral tax should be implemented fairly gradually, so that to give mineral- and energy-source consuming corporations, as well as their consumers, a chance to modify their behavior, particularly, by means of introducing innovations.

The mineral tax

In the conditions of the forecasted change in the structure of oil output, primarily an increase in the share of new regions subject to the tax holiday regime, as well as in the proportion of "exhausted" wells subject to a reduced rate, revenues from the mineral tax may fall. This should be taken into account while pursuing a long-term fiscal policy.

The VAT

1. Regulation and simplification of the VAT refund procedures in the conditions of application of zero rate and other cases. More specifically, to prove the fact of export it is necessary to set a sole attribute - that is, the good's crossing the customs border of RF.
2. In the countries practicing VAT, most taxpayers not engaged in complex transactions find this tax easy to calculate and pay. To this effect, one needs to modify procedures for filling out invoices and unify procedures with regard to granting the right for tax rebate.
3. It is appropriate to introduce a uniform VAT rate at a level which would ensure that the budget revenues would remain unchanged or grow. Transition to the uniform rate would help simplify administration of the tax, albeit lower progressiveness of distribution of the tax across the population income groups (in an assumption of shifting of the tax on consumers). Compensation for such groups' losses should be secured at the expense of the respective budget expenditures.

In the conditions of the post-crisis development and, accordingly, given the need for maintaining the financial stability, the public expenditure annual increase model is far from being effective. That is why it is the objective of fiscal deficit cutbacks in tandem with the need to bolster return on each Ruble out of public funds that have come to the front burner. In its quest for attaining such ambitious goals, the government focuses primarily on organizing most agencies' budgets on the basis of program-target methods, which suggests a substantial

increase in the proportion of target programs in the budget and transition to a program-wise classification of budget expenditures. Another vector of improvement of the quality of budget management lies in reforming the public procurement program and its fundamentals, particularly towards a substantial increase in the proportion of public expenditures on the innovational sector.

We believe main avenues of increasing efficacy of the budget expenditures have been picked quite adequately; meanwhile, the overall progress in the quality of control over budget resources may become possible only under a comprehensive approach to the problem, which would enable one not only to embrace a maximum broad array of the employed regulative instruments, but structure their employment in time. More specifically, in the nearest future (2010-2011), it appears mandatory to center primarily on problems of increasing accessibility of the public social services. The objective is realistic and achievable through restructuring the budget network. As well, a focal point will remain incentivizing the grass-root level of the government to consume budget funds more efficiently, improving the public procurements system, optimizing individual budget procedures (introducing assessment of the regulating impact into the technology of managerial decision-making that bear budgetary ramifications).

Once the respective institutional conditions arise in the country, a further improvement of such fairly sophisticated managerial mechanisms as result-oriented budgeting, program-target operations, public-private partnership may evolve into a critical factor of the rationalizing of budget expenditure and increasing of the budget process on the whole. This bloc of measures should be implemented between 2010 and 2015.

As concerns ***the medium-term fiscal policy priority avenues,*** it is worth noting the following ones:

Reforming the budget institution network in main sectors of the budget sphere.

The ultimate objective of the budget institution network reform should be bolstering its operational efficiency by introducing fundamentals of competition and assiduity in public spending, which arises thanks to liquidation of duplication of functions and discontinuation of delivery of similar services by different public agencies. Meanwhile, those institutions which, by their nature or operational conditions, appear unadapted to survival in the market environment or whose reorganization may entail unfavorable socio-economic effects, should not become subject to restructuring.

To attain the ultimate reform objective, the whole budgetary network should be restructured. But there exist objective challenges associated with updates on the state of the regional and municipal budget institutions sub-networks, as well as with the absence of inter-level coordination and the subfederal networks reorganization procedures, etc. That is why an appropriate mission for the upcoming 2-3 years would be centering on the federal element of the budget institutions network.

We believe the main mechanism of optimization of the federal budget institutions (FBI) network lies in the necessity of modifying the legal status of the existing budget organizations. The modification process can be two-fold – either the budget organizations keep their newly affirmed status that would suggest they are granted with the right for a non-restricted control over their income and assets acquired using that, or their transition into treasury enterprises that are subject to estimate-based financing, while their proceeds are to be collected to their founders' budgets.

In tandem with the aforementioned optimization procedures, wherever possible, one should also complete:

- amalgamation of small-sized institutions into larger ones;
- liquidation of poorly performing institutions or those with a thin contingent of customers, with their powers reassigned to peer institutions operating within a given or neighboring territories;
- reassignment of a string of FBIs for the sake of observance with the sectoral operational profile principles;
- reassignment of FBIs, which exercise powers falling under the mandate of public administration agencies of the RF Subjects or under local self-governance bodies' mandate, under control of the RF Subjects' public administration agencies or local self-governance bodies, respectively;
- privatization of FBIs that do not fall within a given department's mandate (e.g. sanatoria, etc.) or their reassignment to respective ministries and agencies (e.g. medical and educational institutions.

While pursuing optimization procedures, one should consider sectoral peculiarities of the FBI network and care to develop a performance monitoring system for restructured institutions.

Increasing efficiency of the public procurement management procedures

In order to shape a uniform integrated cycle of planning and placing of the public order, and executing of public contracts which should secure a peremptory fulfillment of the government's obligations, an adequate to the state needs quality of supplied goods, works and services, an efficient consumption of resources, a reliable management of technological, economic and corruption risks, it appears appropriate to accomplish the following moves:

- optimization of the technology of awarding the public order and conditions of selection of qualified suppliers by means of extending the use of e-auctions. That would allow one to abandon the routine "paper" procedures, give entrepreneurs a chance to take part in such auctions via remote access, substantially lower bid-rigging schemes. These measures should be complemented with the fine-tuning of order placement procedures with regard to complex R&D, development or technological projects that should enable the customer to enjoy the possibility for specifying the subject of a contract with account of alternative technological solutions put forward by bidders;
- -consideration of a possibility for centralization of procurement under the aegis of the general manager of budget funds (to secure economies of scale) and development of a system of incentives to securing an even cash execution of limits granted to customers;
- Fixing with customers the right for an independent spending of funds they have received as a payment of a fine (penalty), as well as funds they have received due to the public agency's failure to honor its obligations with regard to securing a customer's auction bid and fulfillment of the public contract;
- Improvement of procedures of monitoring of, and control over the progress with execution of the public contract by optimizing the inventory system with regard to conditions of concluded public contracts; development of procedures of auditing of efficiency of public procurements and recommendations on bringing to account public customers (penalties, lowering their volume of budget funding, suspension of the contract, etc.), introduction of an automated monitoring system (AMS), which should allow one to evaluate the progress in execution of a public contract in real time, supply necessary information to all the participants and make decisions on correcting measures.

Improving the budget decision-making technology and other result-oriented budgeting instruments

Today, particularly challenging became the problem of organization of assessing the potential impact a regulating act has on the economy and society on the whole yet at the stage of its development. That is why in order to enhance the quality of managerial decisions it appears justifiable to obligate agencies, which are engaged in development of normative documents, to run a comprehensive evaluation of prospective and ongoing socio-economic policy measures. Methodological fundamental of the measures should be formed by the cost-benefit analysis method as the most acceptable vehicle that takes into consideration all significant effects from a proposed regulatory measure.

The need to increase the efficiency of the interdepartmental planning system makes it appropriate to undertake the following steps:

- to form a report on budgeting agents' operational results and main avenues (BA Report) in a hierarchical fashion, by setting objectives for BA as an upper target margin for their subordinated agencies of executive power;
- to include in the final version of the Report only the budget programs underway. Unapproved (under development) programs may be enumerated in the limits of the budget of assumed obligations only until the budget law for next year has been passed; afterwards a program either is granted with the status "in progress", or it is excluded from the Report;
- to modify the form of the register of expenditure obligations by adding margins hereto, to reflect BAs' objectives and programs;
- one should consider departmental target programs (DTPs) as a grouping of measures implemented by BAs to tackle tactical tasks stipulated in the Report, with specification of the aggregate volume of expenditures, the program's control system and possible risks associated with failure to attain performance benchmarks;
- to establish that executive agencies form DTPs on their own, without an external evaluation and approval. It is the agency's performance results fixed in the Report that should become subject to the external evaluation (and control); meanwhile the right to select a mechanism of its implementation - that is, the DTPs' composition and substance, is assigned to the executive agency. Fixing simpler procedures with regard to development, coordination and, essentially, organization of implementation of DTPs (due to their smaller scale vis-à-vis (long-term target programs (LTTPs) will enable one a in the nearest future to formulate a maximum possible number of programs and ensure a faster transition to the program-target principles of budget execution;
- to fix approved DTPs in the register of expenditure obligations as a target budget expenditure item (while individual measures under the aegis of a program are to be fixed as kinds of budget expenditures);
- to form model methodologies of evaluation of a program implementation efficiency of and the respective budget spending by providing for respective forms in the composition of budget reports;
- to specify the role and designation of an agency's analytical programs in order to preclude the civil service from their use only for allocating of the available funds.

Improving the public investment management mechanism, particularly in the frame of development of the public-private partnership.

It is imperative to enhance the operative management of investment projects that have been already selected and are currently financed out of the investment Fund of RF. More specifically, this should imply tightening responsibility for failure to meet the respective timelines. But as with its peculiar procedures for the possibility of transfer of unused cash balances to next year the Investment Fund forms an exception from the general procedures of public finance administration set by the Budget Code of RF, it appears appropriate to relinquish this instrument of organization of the government's investment activity in favor of budget target programs.

It seems appropriate to introduce amendments to the federal act "On special economic zones in the Russian Federation" and the respective bylaws in order to simplify procedures of selection of regions aspiring to have special economic zones within their territories, revise the amount of co-funding of projects on creation of such zones to increase the proportion of regional and municipal budgets in them, bolster incentives for (obligations of) investors with regard to transfer of rights for the use of technologies developed by them upon the 5-year period of their residence and scale of their operations in Russia's territory.

It is imperative to organize training and retraining programs on public private partnership for civil and municipal servants and specialists from the private sector.

Whereas budget resources for encouragement of investments into individual sectors are scarce, an alternative to direct budget expenditures is a mechanism of provision of government guarantees. In order to develop this mechanism, it is necessary to:

- create reserves for the whole term of effect of the guarantee, albeit not in a full volume, but with a due account of risks of a rise of a guarantee event;
- create a reserve fund at the expense of appropriations from the National Welfare Fund;
- exercise flexibility with regard to provision of a collateral for guarantee by the principal on obligations underwritten by the government.

It is equally important to promote the practice of engaging commercial banks in funding and managing investment projects in the infrastructural sphere. More specifically, it seems plausible to more vigorously engage the largest commercial banks in the process of monitoring of implementation of state-funded investment projects and, in the future, to commission the public customer functions to them. It is envisaged that this would allow a greater efficiency of the public investment management and lower construction costs coupled with a greater quality of implementation of such projects.

Dividing expenditure powers between the Russian Federation, its Subjects, and municipal entities

Numerous regions and municipal entities have found themselves in a situation when a sizeable proportion of their budget revenues are formed by subventions on exercise of their respective mandates. The subsequent jeopardy to efforts to increase the quality of control over the state and municipal finance is two-fold. First, regional and municipal authorities may not be keen to ensure a maximal efficiency of exercising a de facto someone else's mandate, while the respective monitoring mechanisms are far from being perfect. Second, funding the delegated mandates inevitably gives rise to certain challenges: there primarily exists a certain information asymmetry, i.e. data that directly affect the volume of subventions is supplied to the federal agencies by the RF Subjects. In addition, in the process of execution of the budget it may well happen that a given RF Subject (municipal entity) has received from the federal

budget (the RF Subject's budget) an excessive amount of financing to exercise some delegated powers, while other powers have remained underfinanced. Given rigorous conditions of using subventions strictly to fund a certain delegated power, this results in an inefficient consumption of budget funds and the need in an urgent introduction of amendments to the RF Subjects' law in the end of a fiscal year.

The division of powers between the tiers of the budget system has recently been revised literally every year. This lowers predictability of the fundamental parameters of the budget system in the eyes of regional governments and local authorities and has an adverse effect on the quality of management of the public and municipal finance.

At this juncture it seems inappropriate to introduce amendments to the division of expenditure powers in 2010. Meanwhile, it is appropriate to use this period to monitor and evaluate efficiency of the effective system of division of powers.

It is imperative to provide for a possibility for revision of the effective system of division of powers for the sake of reducing the number of delegated powers and to fix with each tier of government those powers it is able to exercise in the most efficient way. This move should be completed as early as in 2011-2012. As the decision has been made to finance the Interior Ministry's bodies exclusively out of the federal budget, there arise ample opportunities and room for a "trading of powers" between different tiers of government.

Optimizing mechanisms of management of financial support to the RF Subjects

According to the draft 2010-2012 budget, there are 87 more transfers in the Russian Federation (4 ones – in the subsection on budget transfers per se, 43- in the subsection on subsidies, including federal programs and sub-programs, 21- in the subsection on subventions, and 19 ones- in the subsection on other interbudgetary transfers). Notably, the volume of funding of as many as 35 transfers has been under Rb. 1bn, which means that an array of programs run by given RF Subject are eligible for just a meager financing. Given a strictly targeted nature of most of them (funded by means of subsidies and subventions), the costs of evaluation of the targeted spending of the respective funds, let alone evaluation of efficiency of such a spending, may overweigh their prospective benefits.

Hence the growing appreciation of the need for systematization of interbudgetary transfers, including a rigorous observance with the fundamental principle, which implies that financial aid should be allocated with account of the RF Subjects' budget sufficiency rate.

This problem can be partly resolved by improving the expenditure powers division procedures. At the same time, the need for integration of a big number of small-volume target interbudgetary transfers into blocs has become evident.

The bottom line is that the concept of bloc transfers implies that financial resources in the frame of a given interbudgetary transfer can be spent by several directions, with the level of government from whose budget they are allocated enjoying the right for setting both the formula of their allocation and conditions of their spending by each direction of financing. The said level of government should have the right to opt for certain proportions of spending of the received bloc transfer by each direction included therein.

This should increase the quality of management of public and municipal finance in the course of implementation of the national priorities, particularly by taking into account, to a maximum degree, the local population's preferences. It seems appropriate to gradually replace after 2010 a considerable fraction of funding in the frame of the national projects, as well as the bulk of versatile subsidies to regions, with bloc interbudgetary transfers. Because of a high degree of differentiation of the fiscal capacity and costs of delivery of budget ser-

vices in the RF Subjects, it appears appropriate for the federal level to allocate bloc subsidies with account of the regions' budget sufficiency rate. But the equalizing progressiveness rate should be substantially lower than the one of transfers earmarked from the Fund for Financial Support of Regions. It is proposed to grant bloc transfers in proportion to the size of the gap between the regions' budget sufficiency rate and the one of the most prosperous Subject of RF.

As concerns possible directions that may be integrated into bloc transfers at the regional level, those may be: capital refurbishment of public schools; capital refurbishment of blocs of apartments whose owners have established condominium; upgrading the quality of municipal motorways; population relocation from hardly accessible settlements; the health care reform, to name a few.

2.3. Interbudgetary Relations and Subnational Finance in 2009

2.3.1. Subnational budgets in the grip of economic crisis

Main trends in relations between different tiers of government are mirrored in the revenue and expenditure structure of the consolidated budget of RF. *Table 1* presents data that highlight on the proportion of tax revenues and expenditures of the Subjects of the Federation in the respective indicators of Russia's consolidated budget.

Table 1

Proportion of Some Indicators of Budgets of the RF Subjects in Russia's Consolidated Budget in 1992–2009 (as %)

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

Source: the Federal Treasury, the IET calculations.

Analysis of the data of *Table 1* allows the following notes: between 1998 and 2005 the proportion of tax revenues to the RF Subjects' budgets in the consolidated budget has tumbled from 56.6% to 30.9%. The tendency has been fueled chiefly by the economic factors (specifically, the price rise for energy sources has entailed a greater influx of customs duties and mineral payments to the federal budget), rather than by reallocation of revenue sources between different tiers of the budget system. This is evidenced by the fact that the plunge in the proportion of subnational budgets in tax revenues to the consolidated budget has not been equally drastic – from 53% in 1999 to 49.1% in 2005. Between 2006 and 2007 the proportion of subnational budgets in tax revenues was on the rise due to a faster growth in revenues from taxes fixed with regional budgets vis-à-vis those fixed with the federal budget. In 2008, the proportion slid slightly, but remained on a level substantially in excess of the 2005 one, nonetheless. Meanwhile, the 2008 proportion of regional budgets in tax revenues to the consolidated budget posted a notable growth vs. the respective figure of 2007. The economic crisis has altered the relations in question. The proportion of the RF Subjects' tax revenues in the respective revenues to Russia's consolidated budget posted a dramatic growth from 33.2 to

36.6%, which can be ascribed primarily to a drastic fall in revenues to the federal budget from the mineral tax and custom duties. The proportion of regional budgets without regard to mineral payments and customs duties also was slightly up at 1.1 p.p., from 53.7% to 54.8%. This is largely determined by the steadiness of revenues from the PIT to regional budgets during the crisis period (Rb 1, 666.2bn in 2008 and 1,665.8bn in 2009).

Let us examine the situation with regard to the revenue part of the subnational budgets in a greater detail. Starting from November 2008, the economic crisis has begun intensively affecting revenues to the regional budgets. As noted in the previous review, initially, the crisis most heavily battered those subjects of RF that were more better off economically (Tyumen oblast, Orenburg Oblast, Khanty-Mansy AO, Chelyabinsk oblast, etc.), as their revenues are dependent chiefly on the financial standing of large taxpayers concentrated in the metallurgical, oil, petrochemical and some other sectors. Between November and December 2008 tax revenues to the RF Subjects' consolidated budgets shrank in nominal terms in 34 regions compared with the same period of 2007, with 15 regions suffering a sizeable (over 10%) fall in the revenues (see *Table 2*).

In the 1st quarter 2009, the economic crisis hit budget revenues of most Russia's regions: when compared with the same period of 2008, the tax revenues to the RF Subjects' consolidated budgets tumbled in nominal terms in 54 regions, with already 31 regions suffering the noted drastic 10%-plus fall in their revenues. Meanwhile, it should be noted that the situation with execution of the revenue part of the RF Subjects' budgets was particularly stretching in January and February and improved notably in March.

Between April and May 2009 the situation with execution of the revenue part of the budget remained relatively stable (compared with the 1st quarter of the year). But when compared with the same period of 2008, most Russian regions saw their tax revenues plunge. By results of the first 9 months of the year the magnitude of the fall diminished slightly; however, the number of the RF Subjects that reported a rise in their tax revenues in 2009 dropped vis-à-vis the same period of 2008 (their number proved to be smaller than the one reported by results of the 3 and 5 months of 2009). In the 4th quarter, the situation with tax revenues to the RF Subjects' consolidated budgets somewhat improved. By results of the year only 6 Subjects saw their tax revenues fall by more than 25%, while another 31 Subjects registered their rise. So, it can be argued that it was in the beginning of the year that regional budgets experienced the most serious problems with their revenue part. The situation had slightly improved by the end of the year; however, as many as 52 out of 83 RF regions saw their tax revenues fall vs. the 2008 level.

The main cause behind the rise of problems with execution of the revenue part of the RF Subjects' budgets became a fall in revenues from *the corporate profit tax*, which kicked off in the late 2008. Between November and December 2008 the said revenues to the consolidated budget of the RF Subjects plunged by 30.5% in nominal terms compared with the same period of 2007. The fall encompassed most Subjects of the Federation (65 out of 83 ones), and the negative tendency continued in the first quarter 2009, with the revenues in question slid by 35% in nominal terms vs. the same period of 2007 already in 72 regions. It should be noted that the situation with revenues from the corporate profit tax began to improve in March, but it was extremely daunting in January and February 2009. More specifically, in three regions (Republic of Sakha-Yakutiya, Astrakhan oblast and Yamal-Nenetsky AO) the amount of refunds of the corporate profit tax even exceeded the volume of the respective revenues. In April and May 2009, revenues from the corporate profit tax were substantially (roughly two-

fold) lower than the respective figures of 2008, i.e. the situation continued to aggravate. While it somewhat improved in the second half of the year, the problem remained very pressing, nonetheless. By results of the year revenues from the corporate profit tax to the RF Subjects' consolidated budget shrank by 39% compared with the 2008 figures, with the fall registered in 67 regions.

Table 2

Classification of Russia's Regions by Change in Tax Revenues to Their Consolidated Budgets

The number of regions wherein the change in tax revenues accounted for:	November-December 2008 to the same period of 2007	January-February 2009 to the same period of 2008	January-March 2009 to the same period of 2008	January-May 2009 to the same period of 2008	January-September 2009 to the same period of 2008	January-December 2009 to the same period of 2008
Fall over 25%	3	15	7	11	10	6
Fall between 10 and 25%	12	24	24	24	19	19
Fall less than 10%	19	29	23	21	31	27
Growth	48	14	29	27	23	31

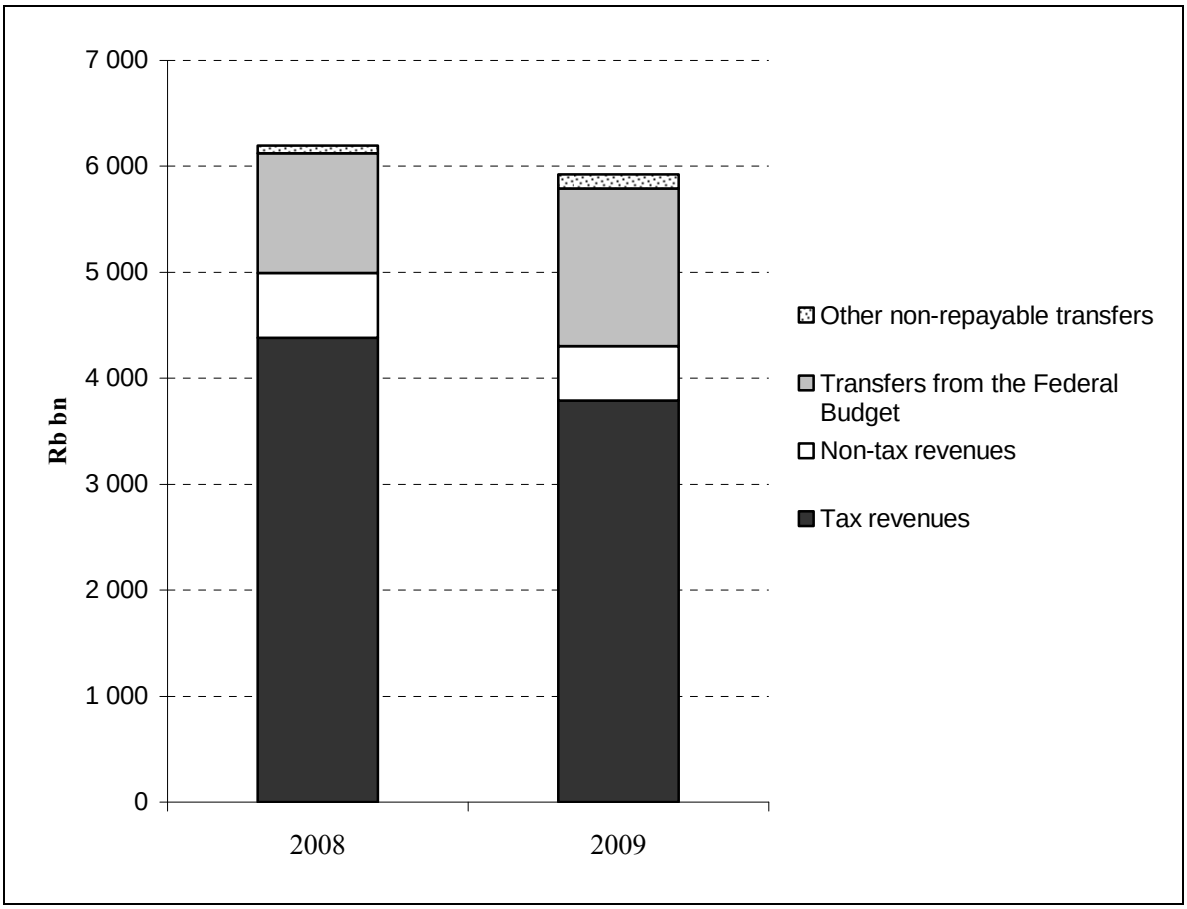
Source: the Federal Treasury, the IET calculations.

By contrast, revenues from *the personal income tax* across the country on the whole proved to be far more stable. In the first quarter 2009 they posted a 5% growth in nominal terms vis-à-vis the first quarter of 2008. But some Subjects of the Federation (Chelyabinsk, Yaroslavl, Kemerovo, Orel, Sverdlovsk oblast) saw their considerable (by more than 5%) plunge. The increase in revenues from the PIT can be partly ascribed to pay rises to budget employees. But the situation aggravated shortly afterwards. As already noted, overall, the 2009 PIT-based revenues remained at the 2008 level, but region-wise the situation appears far less unambiguous. In 36 regions revenues from PIT were down, with 7 regions reporting their 10%-plus fall[1].

Overall, the 2009 revenues to the RF Subjects' consolidated budget fell by 4.4% in nominal terms vs. their 2008 level. That said, different components of the revenues demonstrated a multidirectional dynamic, and, consequently, the revenue structure underwent notable transformations (see *Fig. 1*).

The 2009 tax revenues to the RF Subjects' consolidated budget shrank by 13.5% in nominal terms, while their proportion in the aggregate revenues to regional budgets slid from 71% to 64%. Non-tax revenues also dropped by 15.4%, and their proportion slid from 9.8% to 8.7%. Meanwhile, transfers out of the federal budget grew by 31.4% in nominal terms, with their proportion in the aggregate revenues soaring from 18 to 25%. So, in the conditions of crisis, the role of the federal aid grew substantially. Transfers from the federal budget have formed a cushion, thanks to which regions were able to more painlessly pass the peak of the economic crisis (more on federal transfers below).

[1] Republic of Dagestan, Chelyabinsk, Yaroslavl, Sverdlovsk, Kemerovo oblasts, Republic of Chuvashia, Permsky Krai



Source: the Federal Treasury, the IET calculations.

Fig. 1. Revenues to the Consolidated Budget of the RF Subjects in 2008–2009, by Components

The expenditure part of the RF Subjects' consolidated budget also underwent substantial modifications. It should be noted that the year 2009 saw interruption of the previous 2007-08 trend to growth of regional expenditures in the consolidated budget of RF (see *Table 1*). The proportion of regional expenditures tumbled from 49.2% in 2008 to 43.4% in 2009. This situation emerged due to the fact that expenditures of the RF Subjects' consolidated budget remained practically at their 2008 level (with their increase accounting for a meager 0.04%), while the federal budget expenditures (less transfers to regions) posted a 26% increase compared to the respective figure of the prior year.

But given that the aggregate volume of expenditures has remained unchanged, their 2009 structure underwent certain transformations (see *Table 3*).

The data of *Table 2* evidence that it was regional transfers by sections "Social policy" and "Interbudgetary transfers" (this concerns largely transfers to the CMI Territorial Funds), as well as those on servicing the public and municipal debts, that posted the greatest increase. The rise in the debt servicing expenditures was fueled by more intense subnational borrowings in 2009, while the increase in expenditures on the social policy was driven by greater expenditures on implementation of the government employment policy (funded with subventions out of the federal budget), among other factors.

Table 3

Expenditure Structure of the Consolidated Budget of the RF Subjects in 2008–2009 (as %)

	2008	2009	Change (p.p.)
General public administration matters	7.1	7.3	0.2
Including servicing the public and municipal debts	*0.6*	*1.0*	*0.4*
National security and law enforcement activities	4.1	3.9	–0.2
National economy	19.6	18.1	–1.5
Housing and utilities sector	16.3	13.6	–2.7
Environment	0.3	0.3	–0.1
Education	20.8	21.5	0.7
Culture, motion picture industry, and mass media	3.5	3.4	–0.1
Healthcare and sport	12.7	12.1	– 0.6
Social policy	12.2	15.3	3.1
Interbudgetary transfers (IBT)	3.3	4.4	1.1

Source: the Federal Treasury, the IET calculations

The greatest decrease in the proportion in the aggregate expenditures was noted across sections "Housing and utilities sector" and "National economy", with expenditures on the former being cut in nominal terms by 16.2%, while those on the national economy - curtailed by 8% vis-à-vis the respective figures of 2008. The cuts in the housing and utilities sector occurred largely due a 23% fall in capital investment therein. As concerns support of the national economy, it is important to examine the expenditure dynamic across its subsections. The cuts in expenditures on the national economy can be ascribed primarily to a 3.8% curtailing of the funding of the road construction, maintenance and repair sector (*aka* "the road sector"), which in 2008 accounted for 37% of the aggregate expenditures on this particular sector. Meanwhile, expenditures on the subsection "General economic expenditures" increased substantially (1.7 times). This can be attributed primarily to a greater volume of funding of measures on alleviating the stretching situation on the labor market. As well, expenditures on the support to the agrarian sector were also up (by 8.7%). It should be noted that all the three expenditure directions in the sphere of national economy are funded with subsidies out of the federal budget.

In all, speaking of the dynamic and structure of expenditures of the 2009 RF Subjects' consolidated budget, the following phenomena are worth referencing to: it was capital expenditures that were trimmed most intensively, while expenditures on servicing the public and municipal debts, as well as expenditures on directions that are (co-) financed out of the federal budget posted a substantial increase.

Table 4

Volume of the Public Debt of the Subjects of RF in 2008–2009

	Volume of the public debt, as Rb bn:						
	As of 01.01.08	As of 01.01.09	Increase in 2008	As of 01.07.09	Increase in the 1st half 2009	As of 01.12.09	Increase over the 11 months 2009
All RF Subjects	456.9	599.6	142.7	725.4	125.8	787.7	188.1
The city of Moscow	89.3	121.5	32.2	208.1	86.5	232.3	110.8
Moscow oblast	92.1	156.1	63.9	164.6	8.6	158.1	2.0
RF Subjects (less the city of Moscow and Moscow oblast)	**275.4**	**322.0**	**46.5**	**352.7**	**30.7**	**397.3**	**75.3**

Source: the RF Ministry of Finance, the IET calculations.

With a drastic decline in tax and non-tax revenues to the regional budgets in 2009, the RF Subjects have renewed their pro-active borrowing policy (see *Table 4*).

As evidenced by the data of *Table 4*, the aggregate volume of borrowings over the 11 months of 2009 proved to be up 32% vs. the respective figure of the whole 2008. But worth a particular notice is the fact that 59% of the borrowings falls on the city of Moscow alone. The Moscow mayor office nearly doubled the city's debt over the period in question. Other Russian regions proved to be more conservative in this regard, but as of December 1, 2009, their aggregate debt volume posted a 23% growth compared with the respective figure as of January 1, 2009. The modification of the format of presentation of the RF Subjects' public debt by the RF Ministry of Finance allows tracking down the dynamic of borrowings by their individual kinds only over the first half 2009. That said, just as much as 41% of the volume of the increase of the debt over the 11 months of 2009 (less the city of Moscow) falls on the first half-year. But the respective data give a certain idea of the structure of the RF Subjects' borrowings in 2009, nonetheless (*Table 5*).

Table 5

Volume of the Public Debt of the Subjects of the Federation by Kinds of Liabilities in the First Half of 2009

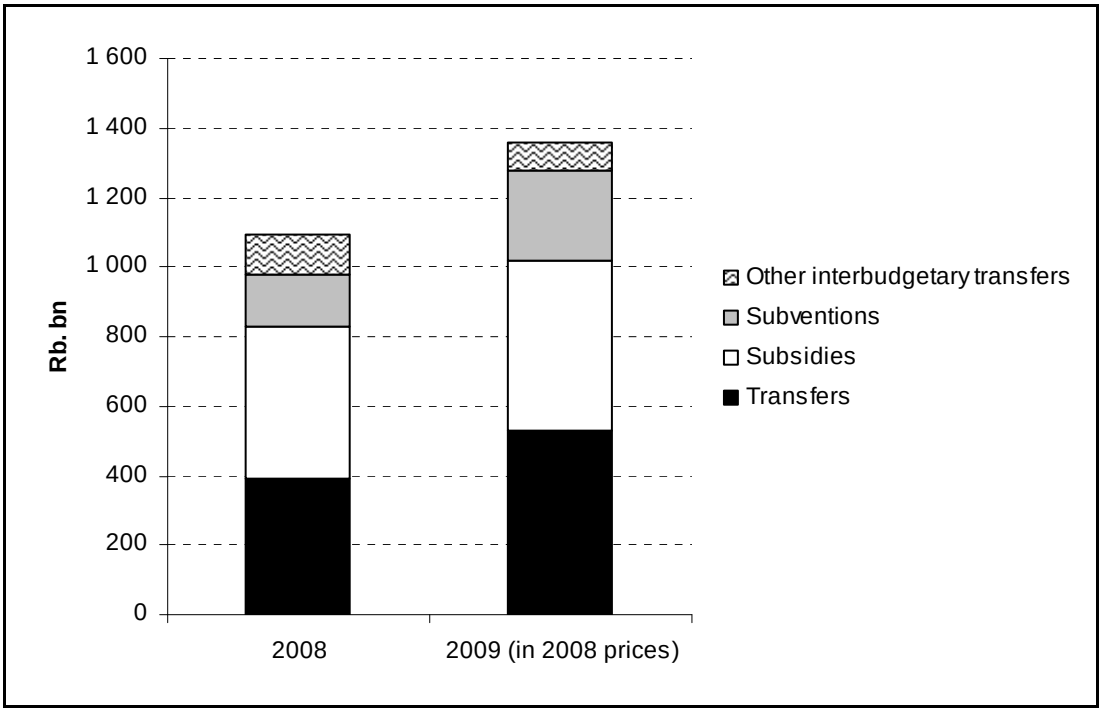
	Total, across the RF Subjects	including:	
		The city of Moscow	Across the RF Subjects (without regard to the city of Moscow)
Loans to the RF Subjects			
as of 01.01.2009, Rb bn	268.9	81.5	187.4
as of 01.07.2009, Rb bn	323.9	152.1	171.7
change (+/–), Rb bn	55.0	70.6	–15.7
increase rate %	20.4	86.7	–8.4
Loan agreements and contracts			
as of 01.01.2009, Rb bn	166.3	32.4	133.9
as of 01.07.2009, Rb bn	180.7	34.2	146.5
change (+/–), Rb bn	14.4	1.8	12.6
increase rate %	8.7	5.6	9.4
Government guarantees			
as of 01.01.2009, Rb bn	123.2	3.2	120.0
as of 01.07.2009, Rb bn	143.8	17.2	126.6
change (+/–), Rb bn	20.6	14.0	6.6
increase rate %	16.7	436.9	5.5
Budget loans			
as of 01.01.2009, Rb bn	40.8	4.5	36.3
as of 01.07.2009, Rb bn	76.8	4.5	72.2
change (+/–), Rb bn	36.0	0.0	35.9
increase rate %	88.2	0.9	99.0
Other debt liabilities			
as of 01.01.2009, Rb bn	0.4	–	0.4
as of 01.07.2009, Rb bn	0.3	–	0.3
change (+/–), Rb bn	–0.1	–	–0.1
increase rate %	–19.3	–	–19.3
Liabilities, total			
as of 01.01.2009, Rb bn	599.6	121.5	478.1
as of 01.07.2009, Rb bn	725.4	208.1	517.3
change (+/–), Rb bn	125.8	86.6	39.2
increase rate %	21.0	71.3	8.2

Source: the RF Ministry of Finance, the IET calculations.

It should be first noted that the volume of bonded loans across Subjects of RF (less the city of Moscow) in the first half 2009 did not post any growth, but even slid by 8.4%. This can be ascribed to several factors. First, the luxury to attract loans on the security market is not within an immediate reach of all the Subjects of the Federation, as there exist technical complexities and the necessity to meet certain criteria. For example, as of late 2009, it was only 19 Subjects that had earned an S&P rating. Second, the overall situation on the financial market had drastically aggravated since the second half 2008. That resulted in higher lending rates and, fairly frequently, the impossibility for second-class borrowers to place their papers. Yet another peculiarity of the RF Subjects' borrowings in 2009 became a growing role of budget loans disbursed from of the federal center's pool. By results of the first half 2009 the budget loans have increased nearly 3-fold compared with banks' commercial loans (on the whole, across the RF Subjects, less the city of Moscow). Thus, in the conditions of a substantial fall of tax and non-tax revenues to regional budgets, and a substantial worsening of conditions of borrowings and an increase of lending rates, budget loans from the federal center, together with transfers, formed one of the pivotal financial pools for the RF Subjects' budgets.

2.3.2. Financial aid from the federal budget

In all, the 2009 volume of financial resources the federal budget transferred to the RF Subjects' ones rose by 34%. The biggest increase was posted by subventions (up 71%) and budget loans whose volume was more than 10-fold greater than the respective figures of 2008. Transfers increased by 36% and subsidies – by 12%. By contrast, the volume of other extrabugetary transfers shrank by 30%. All that resulted in some transformation of the structure of federal transfers to regions (see *Fig. 2*).

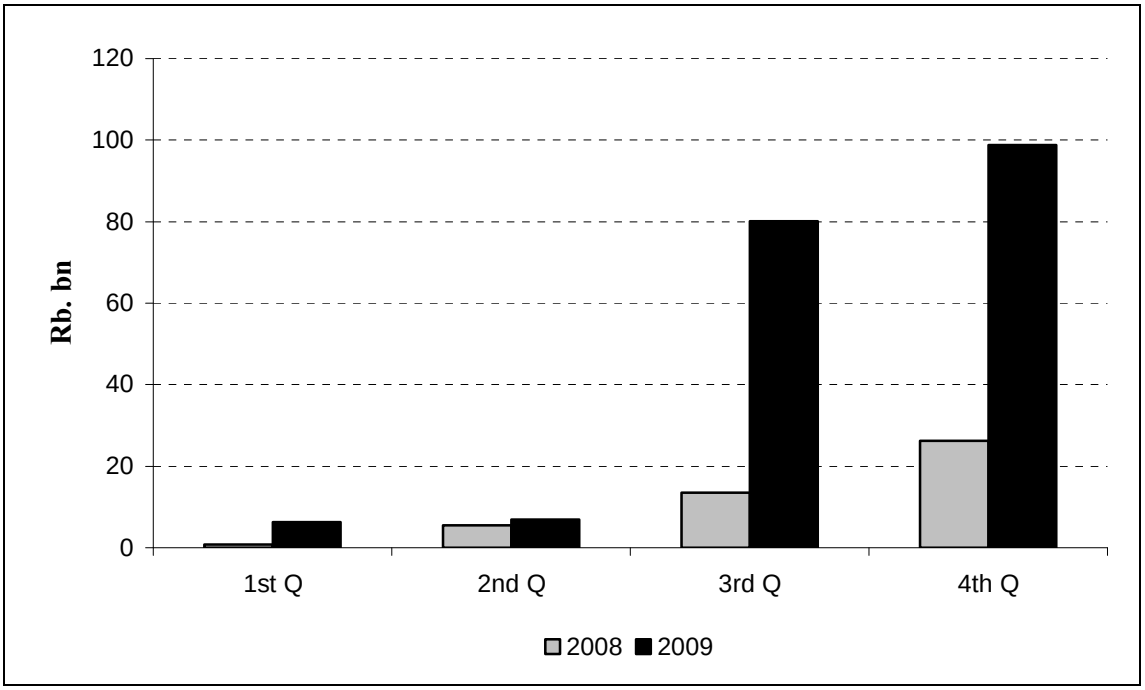


Source: the Federal Treasury, the IET calculations.

Fig. 2. Transfers to Regions out of the Federal Budget in 2008–2009

On the whole, it was the proportion of subventions in the aggregate amount of federal transfers that posted the greatest pace of growth – from 14% in 2008 to 12.9% in 2009. The proportion of transfers was on the rise, too, - from 36% to 39%. In contrast, the proportion of subsidies slid from 40 to 36%, while the one of other interbudgetary transfers plunged by 4.6 p.p., to 5.9% of the aggregate amount of transfers.

Let us examine individual kinds of transfers out of the federal budget in a greater detail (see *Table 5* at the end of the present section). As already noted, their 2009 volume surged in real terms by 36% vs. the respective figures of the prior year. But the growth was fueled primarily by a substantial increase in transfers on getting the regional budgets balanced. While transfers on equalizing the budget sufficiency out of the Federal Fund for Financial Support of Regions increased in real terms just by 4.6%, the volume of the "balancing" transfers soared 3.8 times compared with 2008. Meanwhile, the proportion of the "balancing" transfers in the overall volume of transfers rose from 4% in 2008 to 13% in 2009. It should also be noted that a drastic increase in such transfers to regions fell on the second half 2009 (see *Fig. 3*).



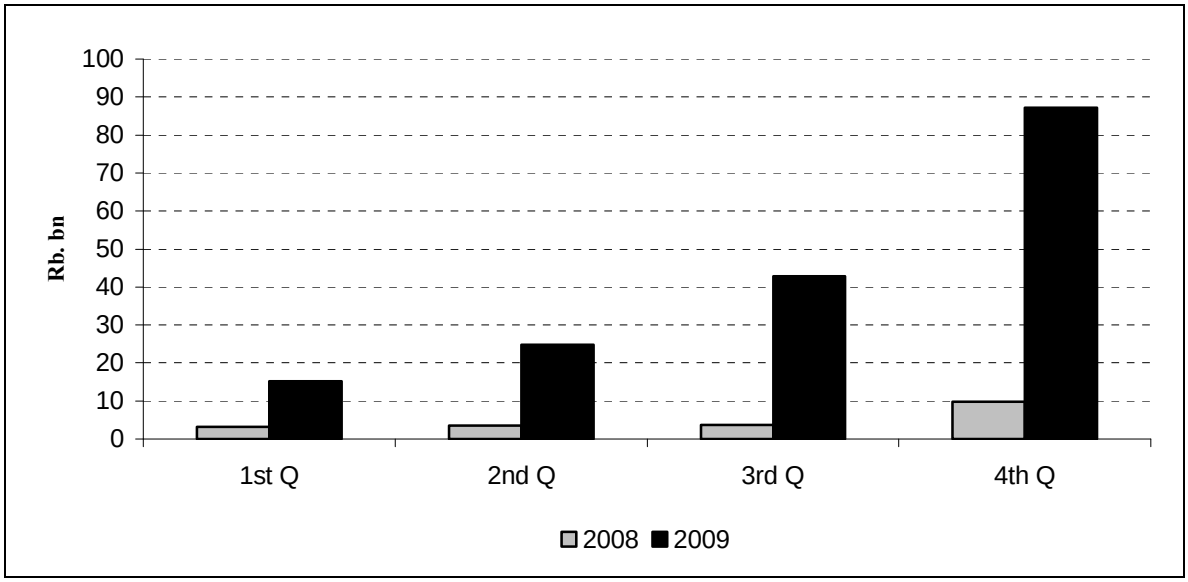
Source: the Federal Treasury, the IET calculations.

Fig. 3. Transfers on Support of the Regional Budgets' Balance in 2008–2009

On the one hand, the increase in transfers on getting the regional budgets balanced is partially justified by grave challenges the subfederal budgets were facing in 2009. On the other hand, as it was repetitiously noted in the earlier reviews, this particular kind of transfers forms one of the most opaque interbudgetary relations instruments and one of main sources of soft budget constraints in the national system of federalism.

Whilst considering the dynamic of budget loans disbursed out of the federal budget to regions in 2009, it is worth noting that it appears similar to the dynamic of the "balancing" transfers (see *Fig. 4*). Their biggest amounts once again fell on the second half-year, with

those allocated in the 4th quarter accounting practically for a half of the annual sum of the respective appropriations. It should be emphasized that since 2009 budget loans have become available for the term of up to three years. In 2009, the federal center extended a total of Rb. 170bn in budget loans vis-à-vis Rb. 20 bn disbursed in 2008. As a result, budget loans accounted for nearly 8% of the aggregate amount of financial aid to the RF Subjects. That said, the 2009 "balancing" transfers and budget loans combined were worth a total of Rb. 319bn, or 20% of the amount earmarked to the regional budgets (in 2008, the respective figure was just 5.2%).



Source: the Federal Treasury, the IET calculations.

Fig. 4. Loans Disbursed out of the Federal Budget in 2008-2009

As noted above, the 2009 volume of subventions out of the federal budget also posted a substantial growth vs. the one of 2008 (up by Rb 136.2bn). The greatest growth rates were registered across the following directions:

- On exercise of the Russian Federation's powers in the area of assistance to the population employment, including expenditures on the exercise of these powers (up by Rb 40bn, or more than twice);
- On provision of individual categories of citizens with housing, as per federal act of January 12, 1995 №5-FZ "On veterans" (up by Rb 31 bn, or more than thrice);
- On payment for housing and utilities to certain categories of citizens (up by Rb 18.4bn, or by 28%);
- On delivery to individual categories of citizens a social service in the form of an extra free medical assistance with regard to provision of medicines, medical items and specialized medical food products for disabled children (up by Rb 6.8bn, or by 27%).

So, it is the 'anti-crisis" subventions allocated to fund the employment measures and those on provision of housing to the GPW veterans due to celebration of the 65th anniversary of the victory in the Great Patriotic War (in compliance with presidential decree of May 7, 2008, № 714 ("On provision of housing to veterans of the Great Patriotic War 1941-1945") that posted the highest growth rates.

The volume of subsidies out of the federal budget was increased in nominal terms by Rb 104bn, or up by 20% compared with 2008. But by some directions the funding was curtailed substantially, while by other ones it was increased, thus giving rise to new kinds of subsidies of which the biggest ones became:

- Subsidies on implementation of additional measures aimed to mitigate the tension on labor markets of the RF Subjects (Rb 35.6bn);
- Subsidies on procurement of motor vehicles and communal equipment (Rb 19.7bn).

It was subsidies on the following directions that posted the greatest increase:

- On the government support to small- and medium-sized businesses, including agrarian (farming) enterprises (by Rb 15bn, or more than five-fold) ;
- On the government support of the agrarian sector (by Rb 21.4bn, or up 37%).

In parallel with that, cuts were made across a string of subsidies. They were most sizeable by the following directions:

- Subsidies on the road construction, maintenance and repair works not included in the federal target programs (Rb 12.6bn, or down 37%);
- Subsidies for allocation of sites with communal infrastructure for the purpose of house construction (by Rb 7bn, or down 90%).

2.3.3. Modifications in the federal law in the area of interbudgetary relations and subnational finance in 2009.

The challenges Russia's budget system has been facing between late 2008 and 2009 in the conditions of economic crisis have required certain amendments to the federal legislation, primarily to the Budget Code of the Russian Federation. Main modifications introduced with federal act № 310-FZ of December 30, 2008, "On introducing amendments to the Budget Code of RF and federal act "On introducing amendments to the Budget Code of RF with regard to regulation of budgeting and bringing individual legislative acts of RF in consistency with the budget law of RF" were analyzed in our 2008 review. But certain amendments were introduced in a number of articles of the Budget Code of RF in 2009, too.

More specifically, on April 9, 2008, federal act № 58-FZ "On introducing amendments to the Budget Code of RF and individual legislative acts of RF", which has modified a number of clauses of the Budget Code of RF, was promulgated.

First, the amendments concerned Art. 92.1 with regard to the provision that sets a cap on the amount of an RF Subject's budget deficit equaling 15% of the approved aggregate volume of revenues to the regional budget without regard to unrequited revenues. This provision was softened already in act № 310-FZ – the RF Subjects were permitted to excess the said cap by the sum of revenues from sales of stock and other forms of participation in capital, as well as by diminishing balances on accounts by accounting the regional budget's funds. Act № 58-FZ allowed an excess of the capped level of budget deficit by the amount of the balance of budget loans out of the federal budget. In contrast with the previous amendments, the effect of this provision is limited in time, with 1 January 2013 as the deadline. In a similar fashion, local self-governance bodies were allowed to excess the cap rate of the municipal budget deficit (10%) by the balance of budget loans out of the federal budget. In addition, requirements of Art. 107 that concern the ultimate size of the RF Subject (municipal entity's) debt were softened, too, and now it can excess the cap set by the Budget Code of RF by the size of budget loans attracted from other tiers of the budget system.

Secondly, caps which Art. 139.1 set on the amount of other interbudgetary transfers provided from the RF Subject's budget to local budgets, were modified, too. The volume of other IBTs may exceed 10% of the aggregate volume of transfers (les subventions) by the amount of transfers on support of measures on getting local budgets balanced.

Certain modifications were likewise introduced into clauses of the Budget Code of RF upon promulgation of federal act № 192-FZ of July 19, 2009 "On introducing amendments to the Budget Code of RF and Art. 45 of the federal act "On the Central Bank of the Russian Federation (Bank of Russia)". The act suspended the effect of a string of clauses of the BC of RF until January 1, 2010:

- the effect of clauses of Art. 53, 59 and 64 that require that acts affecting revenues to the budget system of RF should be promulgated prior to submission of draft budgets of the respective tier of government;
- for the year 2009 the timelines stipulated in Art. 131 and 133 were shifted for a month – the clauses hold federal agencies to complete until July 20 a check-up of original data necessary for allocating transfers on equalization of budget sufficiency and subventions for the next financial year; as well, the said provisions prohibited introduction any alterations into the data afterwards. For the year 2009 the timeline was shifted to August 20.

It is equally important to pay attention to the joint letter by the RF Ministry of Finance (№06-03-06) and the Federal Treasury (№42-7.4-05.5.0-251) of May 7, 2009, which clarifies procedures of use of balances of subsidies and subventions out of the federal budget to bridge the regional budgets' temporary cash gaps in the course of a financial year. The document reads that such a use of balances of federal funds does not conflict with provisions of the federal law in the event it does not result in growth in payables by expenditure directions, which should be funded at the expense of the said target transfers.

2.3.4. The federal act "On the federal budget for 2010 and the period through 2012 with regard to earmarking interbudgetary transfers to other tiers of the budget system".

The total amount of funds planned for transferring to regional and local budgets in 2010 roughly accounts for Rb 1,129bn. In nominal terms, this is down by 12.9% vs. the amount provided for by the act on the 2009 federal budget. That said, aggregate expenditures out of the federal budget should rise insignificantly in nominal terms (by 0.42%). Consequently, the proportion of interbudgetary transfers to other tiers of the budget system in the federal budget expenditures should fall from 13.2% in 2009 to 11.4%. Given that in late 1990s the proportion of transfers from the FFSR alone would account for 14% of the federal budget expenditures, and main revenue sources now concentrate in the federal budget, the exercise of cutting back the proportion of interbudgetary transfers to other tiers of the budget system in the federal budget expenditures can be questioned. But in all likelihood the problems with funding the pension system have left no room for maneuver for the government.

It should also be noted that the interbudgetary transfers system has remained a complex and confusing one. In a developed federative state, as a rule, there exist 1-3 largest transfers from the federal budget to territorial ones and 3-15 smaller size transfers. In Russian Federation, in compliance with the act "On the federal budget for 2010 and the period through 2012", the number of various transfers is over 87 (4 ones – in sub-section on transfers, 43 – in sub-section on subsidies, including the federal target programs, 21 – in sub-section on subventions, and 19 transfers – in sub-section on other interbudgetary transfers). The question is,

whether such a system is efficient. By analogy with taxation, the number of transfers should be acceptable for their efficient administration. The volume of financing by 35 directions does not exceed Rb 1bn, which means that funds earmarked to a Subject of the Federation by a string of directions can make up dozens or hundreds of thousands of Rubles. Clearly, given the target nature of most directions (subsidies and subventions), the costs associated with evaluation of the target nature of use of the expenditures can overweigh benefits from such appropriations. It appears necessary to conduct a thorough examination of the division of powers between the federal center and regions in order to fully assign a series of powers to regions and to return a part of them to the Federation's level.

An additional way to solve the problem of existence of a great number of minor target interbudgetary transfers and the need to improve the quality of management of allocated financial resources is their consolidation into block transfers (consolidated subsidies and subventions). The bottom line is that such block transfers give a possibility to spend financial resources consolidated into an interbudgetary transfer on several directions. Meanwhile, the level of government out of whose budget such bloc transfers are earmarked can set both the formula of their allocation and conditions of their spending by each direction of financing. The level of government that receives the bloc transfer in turn can on its own select proportions of use of the earmarked finds by each direction included in the bloc transfer.

The principal vehicle of financial aid to regional governments – that is, transfers on equalization of their budget sufficiency out of the **Fund for Financial Support of Regions** – will grow by 6% (vs. the 2009 figures) and account for Rb 397bn. It should be noted that the year of 2010 should see next attempt to overcome the tendency to contraction of the proportion the Fund holds in the overall volume of interbudgetary transfers – according to the 2010 draft budget, the FFSR's proportion in interbudgetary transfers to other levels of the budget system should grow up to 35% compared with 24% in 2009. But it is worth noting a huge gap between an original version of the budget and its ultimate execution. Sectoral ministries, as a rule, succeed in lobbying for a greater amount of subsidies and other interbudgetary transfers; meanwhile, the aggravation of the situation with regional finance triggers the growth in the "balancing" transfers and budget loans (should a budget loan be disbursed for the term of 3 years under the interest of ¼ of the refinancing rate, it in many ways becomes a substitute for a "balancing" transfer); by contrast, calculated by a certain formula, the volume of FFSR remains unchanged through the end of the year. It seems to us, while considering all kinds of interbudgetary transfers, priority should be given to FFSR, as its structure matches the best international practices and its funds are allocated following relatively transparent procedures.

Since 2005 the **Fund for Compensations** has accumulated resources on financing all the legislatively set, in an explicit form, federal expenditure mandates. The draft federal budget for 2010 and though 2012 provides for some growth in the proportion of the FC in interbudgetary transfers to other tiers of the budget system (from 17.6% in 2009 to 20.7% in 2010). The surge in subventions in interbudgetary transfers is conditioned by the "rigidness" of these obligations. The federal center, as a rule, has to index the obligations by the inflation rate.

With regard to **subsidies**, the draft 2010 budget projects their Rb 50.4bn decrease in nominal terms, down to Rb 356bn (by 14.6% compared with 2009). The main 2010 expenditure avenues in this regard are:

- the state program of development of the agrarian sector and regulation of agrarian markets, raw materials and foods for 2008-2012 - 24.7% of the aggregate amount of subsidies;

- implementation of additional measures aimed to alleviate the problems on the RF Subjects' labor markets – 10.5% of the aggregate amount of subsidies;
- the federal target program "The economic and social development of the Far East and Trans-Baikal region for the period through 2013" – 10.1% of the aggregate amount of subsidies;
- financial provision of delivery of an additional medical assistance by local physicians, pediatricians, and general physicians (family doctors) – 6.1% of the aggregate amount of subsidies.

The crisis has introduced substantial changes into the list of priority directions co-financed out of the federal budget. More specifically, subsidies for modernization of the transportation system were axed dramatically (by Rb 60.6bn), albeit such cuts may not always be recognized as a justifiable move. The fact of the matter is, subsidies out of the federal budget on the road sector and the federal target program "Modernization of Russia's transport system (2002-2010)" (currently – the federal target program "Development of Russia's transport system (2010-2015") have a great social importance from the perspective of securing the country's territorial and economic space and the population's spatial mobility. The respective obligations with regard to implementation of huge road-building repair and maintenance projects are fairly large, while in most cases subfederal (regional and local) budgets cannot fund them without a federal center's contribution. Hence, it appears appropriate to provide for an increase in appropriations on road construction for the sake of creation and development of urban agglomerations. As evidenced by experiences of developed and emerging nations[1], an economic crisis is the right time for public investment in infrastructure.

Meanwhile, the volume of subsidies on support of the agrarian sector will be increased unjustifiably (by nearly Rb 21.5bn). The transfer of powers to support the agrarian sector to the regional level results in a situation when the support is rendered most intensively in regions that enjoy the greatest financial capacity to pursue such a policy, rather than in those that have the most favorable natural and climatic conditions. Earmarking resources from the federal budget for these purposes on the co-financing principles just intensifies the tendency. More specifically, it results in backing the better-off financially regions in their "trade wars" with weaker counterparts for agrarian markets. That is why efficacy of such subsidies raises serious doubts. The problem can be resolved by centralizing the subsidies at the federal level along with minimizing regional expenditures on this direction. In parallel with this, the Federation should corroborate its role in financing expenditures on social development of rural territories.

Considerable resources are earmarked on implementation of measures aimed to diminish the stretching situation on the RF Subjects' labor markets and jolt small businesses; however, efficacy of the use of such funds greatly depends on performance of the RF Subjects' agencies.

Overall, it can be noted that the federal act "On the federal budget for 2010 and for the period through 2012" has preserved a whole string of substantial challenges typical of Russia's interbudgetary relations system, namely:

1) an insufficient volume of the FFSR and an unjustifiably low share of transfers in the aggregate volume of interbudgetary transfers;

[1] For more details, see: A. Siluanov, V. Nazarov – Vzaimodeystviye federalnogo tsentra I regionov pri provedenii antikrizisnoy politiki: mezhdunarodny opyt/Voprosy ekonomiki № 9, 2009

2) a fairly big number of subventions (including minor ones in particular), which compels one to question the efficacy of the current system of division of expenditure powers between different tiers of government;
3) an excessive number of subsidies and an insufficiently transparent and efficient system of their allocation.

Table 5

Financial Aid out of the Federal Budget to Consolidated Budgets of Subjects of the Federation in 1992–2009 (as % of GDP)

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
1. Financial aid to budgets of other levels				1.8	2.3	2.5	1.6	1.18	1.43	1.79	2.2	1.94	1.7	1.65	1.52	1.79	1.89	3.04
1.1. Federal target programs as well as subsidies to RF Subjects on support of the agrarian sector, water-economic measures, support of small-sized entrepreneurship, rehabilitation of children														0.05	0.15	0.39	0.54	0.62
1.2.Fund for co-financing of social expenditures											0.15	0.11	0.04	0.12	0.11	0.10	0.09	0.12
1.3. Fund for financial support of regions, including	0	0	0.36	1.17	1.04	1.22	1.12	0.99	0.96	1.14	1.36	1.3	1.05	0.88	0.94	0.79	0.79	0.96
transfers on equalization of the budget sufficiency level	0	0	0.36	0.86	0.68	0.86	1	0.99	0.96	1.14	1.36	1.3	1.05	0.88	0.94	0.79	0.79	0.96
state support of the "Northern Supplies"									0.06	0.08	0.08	0.07	–	–	–	–	–	–
transfers at the expense of the VAT	0	0	0	0.31	0.36	0.36	0.12	–	–	–	–	–	–	–	–	–	–	–
1.4. Transfers and subventions, including:	0	0.02	0.09	0.06	0.09	0.13	0.1	0.06	0.15	0.54	0.28	0.29	0.27	0.36	0.21	0.31	0.22	0.59
transfers on support of measures on provision of balance of budgets													0.11	0.24	0.16	0.17	0.11	0.49
1.5. Resources of the Fund for reforming regional and municipal finance										0	0.01	0.01	0.01	0	0.01	0.01	0.01	0.004
1.6. Other free and non-repayable transfers (subsidies and subventions)											0.01	0.01	0.01	0.01	0.08	0.17	0.19	0.42
1.7. The regional development financing fund									0.03	0.05	0.1	0.1	0.15	0.01	0.01	0.02	0.02	–
1.8. Resources transferred by mutual settlements	0.61	1.95	2.54	0.42	0.81	0.43	0.36	0.14	0.28	0.05	0.2	0.14	0.12	0.01	0.05	0.02	–	–
1.9.Loans and budget credits less those paid off to other tiers of the public administration *	0.09	0.03	0.02	0.04	0.23	0.64	–0.03	–0.1	–0.08	0.02	0.09	–0.01	–0.02	–0.03	–0.04	–0.01	0.03	0.33
2. Fund for compensations										0.37	0.38	0.36	0.34	0.17	0.30	0.43	0.51	0.80
3. Other interbudgetary transfers, of which:								0.18	0.11	0.4	0.45	0.54	0.35	0.33	0.34	0.36	0.27	0.22
State support to the road sector**								0.18	0.11	0.27	0.27	0.31	0.22	0.13	0.15	0.17	0.08	0.07
Funds transferred to budgets of other levels of government, total	**1.49**	**2.7**	**3.4**	**1.8**	**2.3**	**2.5**	**1.6**	**1.36**	**1.54**	**2.56**	**3.03**	**2.84**	**2.39**	**2.25**	**2.17**	**2.57**	**2.67**	**4.06**

*Since 2005 – only budget loans.
**presently, most of the transfers have been included in section 1.1.
Source: the Federal Treasury, the authors' calculations.

2.4. The Russian financial market in 2008-2009: trends, crisis mitigation measures, institutional issues

2.4.1. Crisis and recovery in the Russian market

At times of crisis, stock market behaviour generally foreshadows changes in the fundamental economic indicators. This time has been no exception: the drop in the RTS market index that started in June 2008, even prior to the slump in oil prices in GDP levels, stopped abruptly in February 2009 and gave way to renewed growth of the index. Meanwhile, industrial indicators for specific sectors and product categories resumed growth only starting from April 2009[1]. By the end of 2009, the RTS index had reached 58.7% of its pre-crisis peak, while the MICEX index reached 71.2%. Based on stock price and market index dynamics, the 2008-2009 crisis has been less significant in terms of extent and duration than the 1997 – 1998 crisis (see *table 1*). Nonetheless, it is yet too early to speak about a full recovery to pre-crisis levels.

Table 1

Quantitative indicators of the 1997–1998 and 2008-2009financial crises in Russia

	1997–1998 crisis	2008–2009 crisis
1. Decrease relative to peak		
1.1. Extent of drop, %		
RTS index	–91.3	–78.2
MICEX index	–73	–68.2
1.2. Duration, months		
RTS index	14	8
MICEX index	13	7
2. Recovery time, months		
RTS index	59	11
MICEX index	8	12

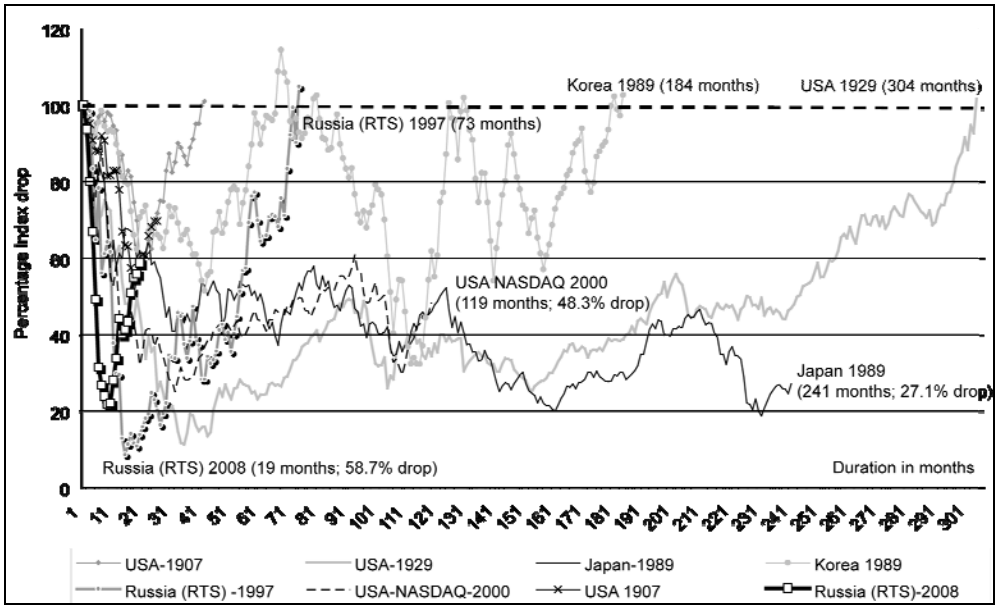
Source: RTS and MICEX data as of January 31, 2010.

The 1997-1998 crisis started in August 1997 and saw the RTS index fall for 18 months, with a total drop of 91.3%. During the current crisis, starting from June 2008, the fall in the RTS index lasted eight months and amounted to a 78.2% drop. Given the threefold devaluation of the ruble in 1998 and an oil price slump that lasted two years, it took 59 months for the RTS index to recover from the "bottom" to its pre-crisis peak. In 2009, such recovery of the RTS index took only 11 months.

Compared to the major financial crises in the past century (see *Fig. 1*), the 2008-2009 financial crisis in Russia is a clear example of a "V-shaped" crisis. In terms of the extent of the index drop, it has been less significant not only compared to the Russian 1997-1998 crisis that holds the absolute record for this indicator among the best known crises in the modern world, but also compared to the slump of the U.S. Dow Jones index during the great depression in 1929 – 1933 and to the slump of the Japanese Nikkei index in the late 1980s. The duration of the current stock market crisis in Russia that has so far lasted "only" 19 months is significantly less than the duration both of such past crises as the Russian 1997 – 1998 crisis (73

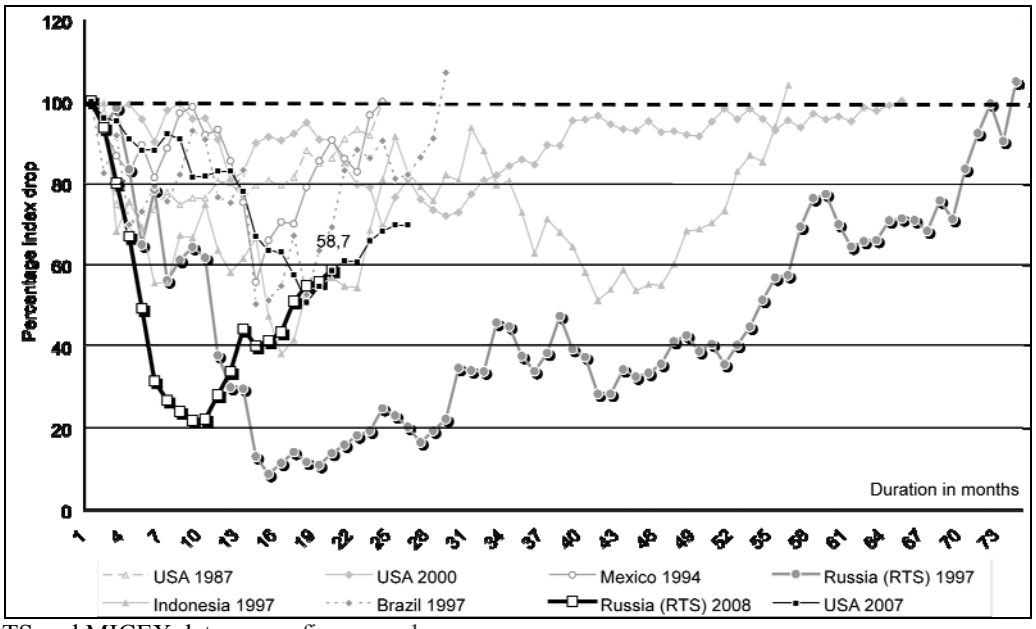
[1] *The Industry Experiences a Reluctant Recovery* by D. Butrin, Kommersant, January 25, 2010, page 2

months), the Korean 1989crisis (184 months), and the Great Depression in the U.S. (304 months) and of such continuing crises as the NASDAQ stock market crisis that has so far lasted 119 months since 2000 and the Japanese stock market crisis that began in 1989 and has so far lasted 241 months.



Source: RTS and MICEX data, www.finance.yahoo.com

Fig. 1. The extent and duration of long-term financial crises worldwide as of December 2009 (market peak = 100%)

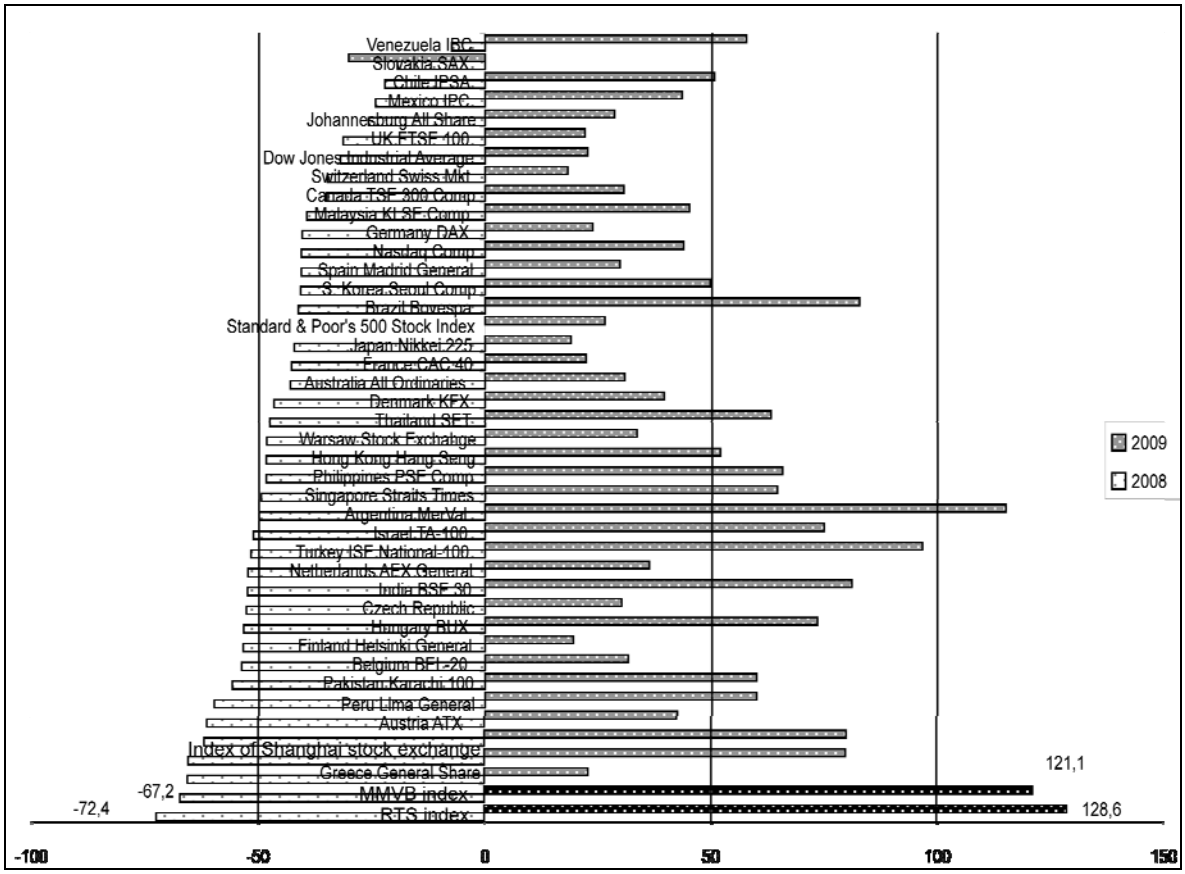


Source: RTS and MICEX data, www.finance.yahoo.com

Fig. 2. The extent and duration of short term financial crises worldwide as of December 2009 (market peak = 100%)

Seen against the most significant instances of short-term financial turmoil in the past decade, such as the "blue chip" crisis in the U.S. stock market in 1987 and 2007, the "Internet bubble" crash in 2000, the Mexican crisis in 1994, the Indonesian and Brazilian crises of 1997, the current Russian crisis is deeper than, but of medium duration compared to the above, as shown in *Fig. 2*.

The two-year crisis has confirmed the status of the Russian stock market as one of the riskiest worldwide. In 2008 the RTS and MICEX indices dropped by 72.4% and 67.2% respectively, outstripping the index drops in all other significant global stock markets. Conversely, in 2009 the Russian indices showed the highest yields, with the RTS index growing by 128.6% and the MICEX index growing by 121.1%. Such a rapid rate of recovery for Russian stock prices could hardly have been expected at the beginning of 2009 (see *Fig. 3*).

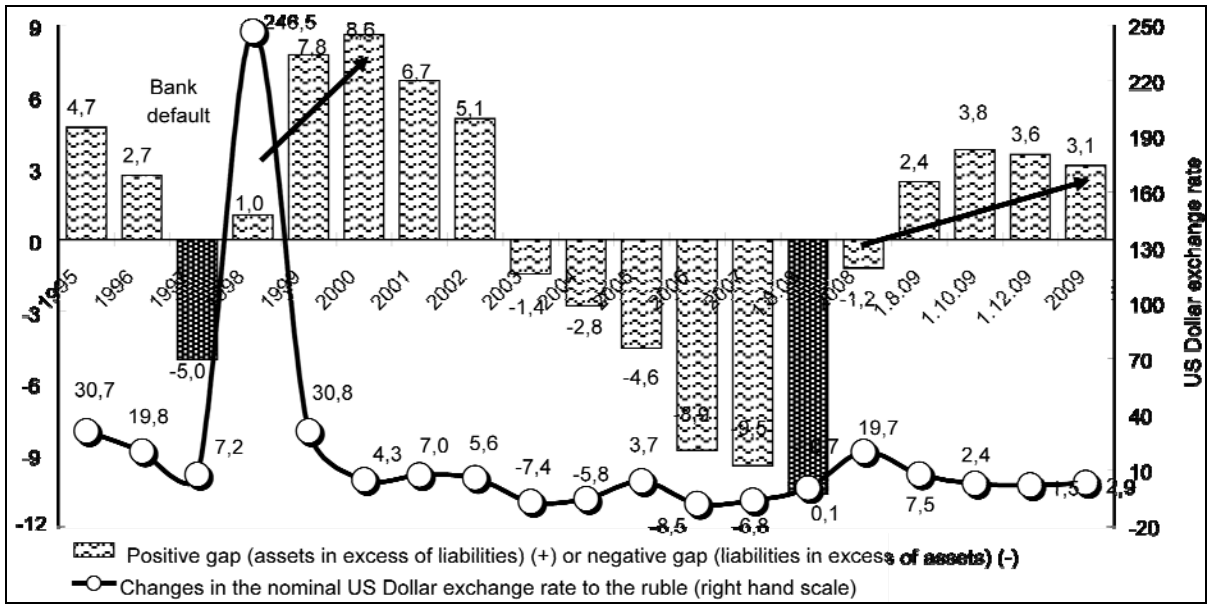


Source: RBC and the Global Stock Exchange Federation

Fig. 3. Global stock market index yields in 2008-2009 (%)

The market capitalisation of Russian companies amounted to 643 billion dollars in 2009, having grown by 62% relative to the previous year (see *Fig. 4*). Notwithstanding the 73.6% drop in market capitalisation in 2008 relative to 2007, trading volumes at Russian stock exchanges grew from 1,206 billion dollars in 2007 to 1,405 billion dollars in 2008, reflecting the large-scale sale of Russian corporate stocks in the first year of the crisis. At the same time, in the first half of the year, stock market transactions were concluded at the high pre-crisis prices. During market recovery in 2009, the growth in market capitalisation was coupled with

a significant decrease in trading volumes that fell to 900 billion dollars. The decrease in trading activity by market participants last year was due to the drop in investment volumes by portfolio investors in the Russian stock market and to the fact the stock prices for most issuers had not yet reached pre-crisis levels in 2009. The volumes of repo transactions likewise decreased due to the restrictions that were in force in the margin lending market up to the middle of June of 2009 (see below)[1].



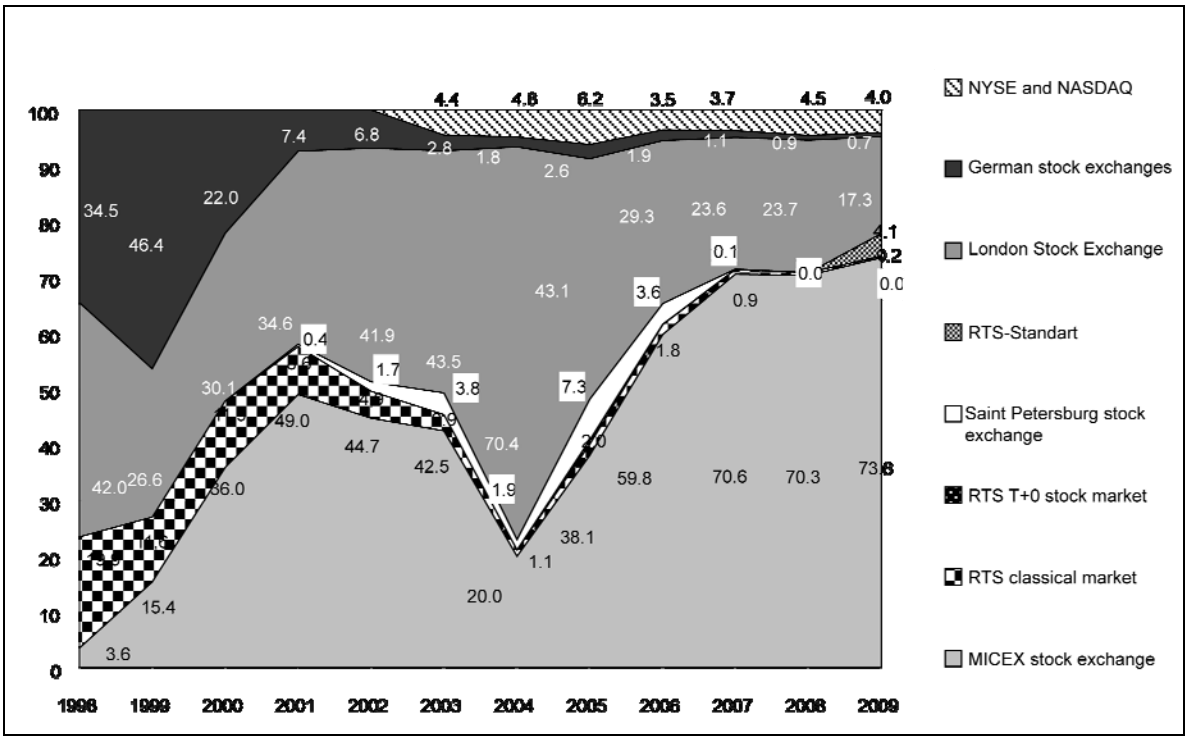
Source: RTS, S&P, IMF.

Fig. 4. Capitalisation, liquidity, and volatility of the Russian stock market

Similarly to the 1997–1998 crisis, the onset of the 2008-2009 crisis was accompanied by a significant increase in the volatility of stock yields. The standard deviation for the daily yield changes of the RTS index in 2008 amounted to 86.4% of the 1998 level, whereas in 2007 it had reached only 27.4%. In 2009, stock market volatility had decreased to 60.5% of the 1998 level. However, this is still above the risk level for 2003, the year by which the stock market had recovered from the first crisis.

In 2009, the Russian stock market was able to uphold and strengthen its position vis-a-vis its global competitors in terms of trading volume. This is evidenced by the data on the relative trading volumes for Russian corporate stocks and stock depositary receipts at national and international stock exchanges as shown in *Fig. 5*.

[1] The specifics of Russian stock market regulation determine the use of the repo transactions as the predominant instrument of margin lending to market participants.



Source: proprietary analysis based on stock exchange data

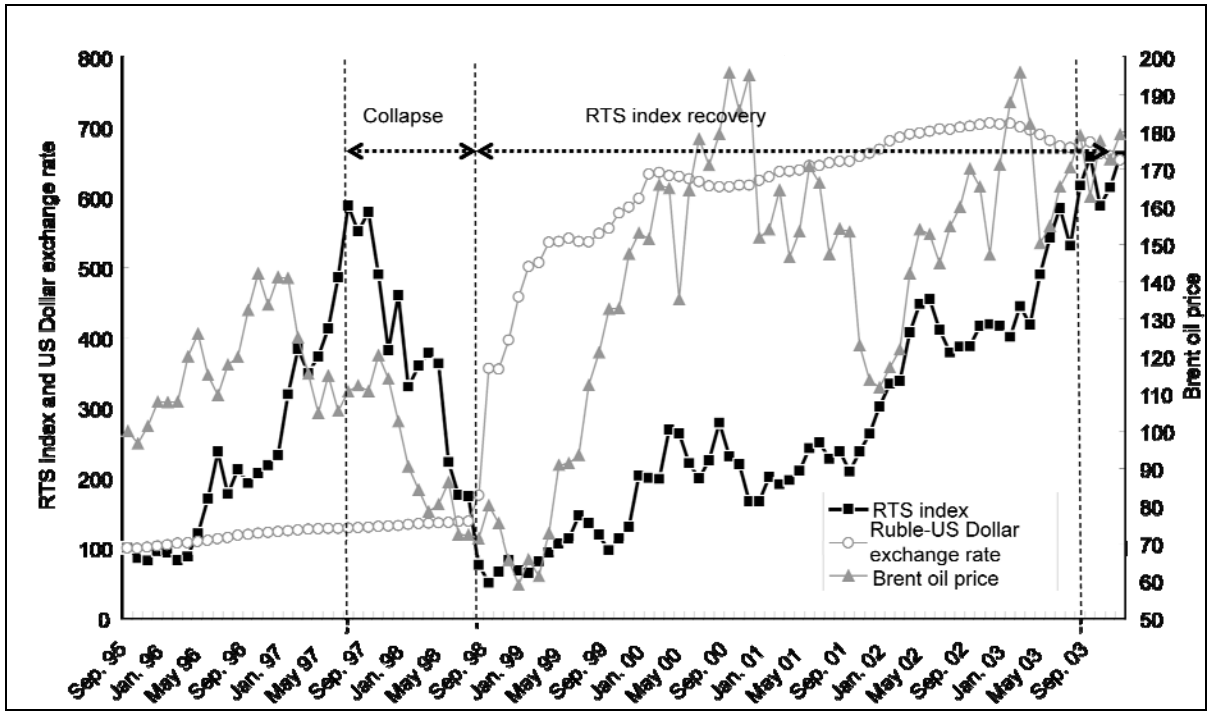
Fig. 5. Relative weight of stock exchanges in terms of Russian corporate stock trading volumes

The share of Russian stock exchanges in the total stock trading volumes had dropped to 23% in 2004, signifying a real risk of the pricing and liquidity hub for Russian corporate stocks moving outside of Russia, to the London Stock Exchange. However, this negative trend was reversed in subsequent years. Russian stock exchanges, above all MICEX, had strengthened their positions as the pricing and liquidity hubs for Russian corporate stocks. By 2009, MICEX was responsible for 73.6% of the total trading volume for Russian shares, while the Russian equity spot market was de facto based at MICEX. However, the RTS stock exchange was able to improve its competitive position with respect to the stock market in 2009 by introducing RTS-Standart(d), a new trading and settlement mechanism for stocks that allows to abandon the obsolete system of depositing securities prior to the start of trading and guarantees settlements by using a centralized clearing system. This innovation has enabled RTS to increase its share in trading Russian corporate stocks from nearly zero in 2008 to 4.3 percent in 2009.

2.4.2. Similarities and differences between the 1997–1998 and 2008–2009 crises

Assessing the effectiveness of government actions during the 2008-2009 crisis is best done by comparing the circumstances of its emergence and subsequent developments with the Russian crisis scenario of 10 years ago. The two crises had much in common in terms of their beginnings. The principal similarity is that both were caused by the cyclical nature of the Russian economy and by its strong dependence upon global raw material prices, above all oil and gas prices, as well as its dependence on the behaviour of foreign portfolio investors. This is

shown by an analysis of the scenarios of both crises in *Figs 6* and *7*. As oil prices fall, foreign investors show growing fears regarding a possible devaluation of the ruble, while the withdrawal of speculative capital in turn causes a stock market collapse. If the government is subsequently unable to manage the devaluation of the national currency, an unbalance emerges between the foreign currency assets and liabilities of banks and industrial companies with significant foreign currency borrowings, resulting in a growing threat of a banking crisis and debt defaults by real sector companies. If this is coupled with an unbalanced state budget, a default on government debt securities is also possible.



Source: RTS and IMF data.

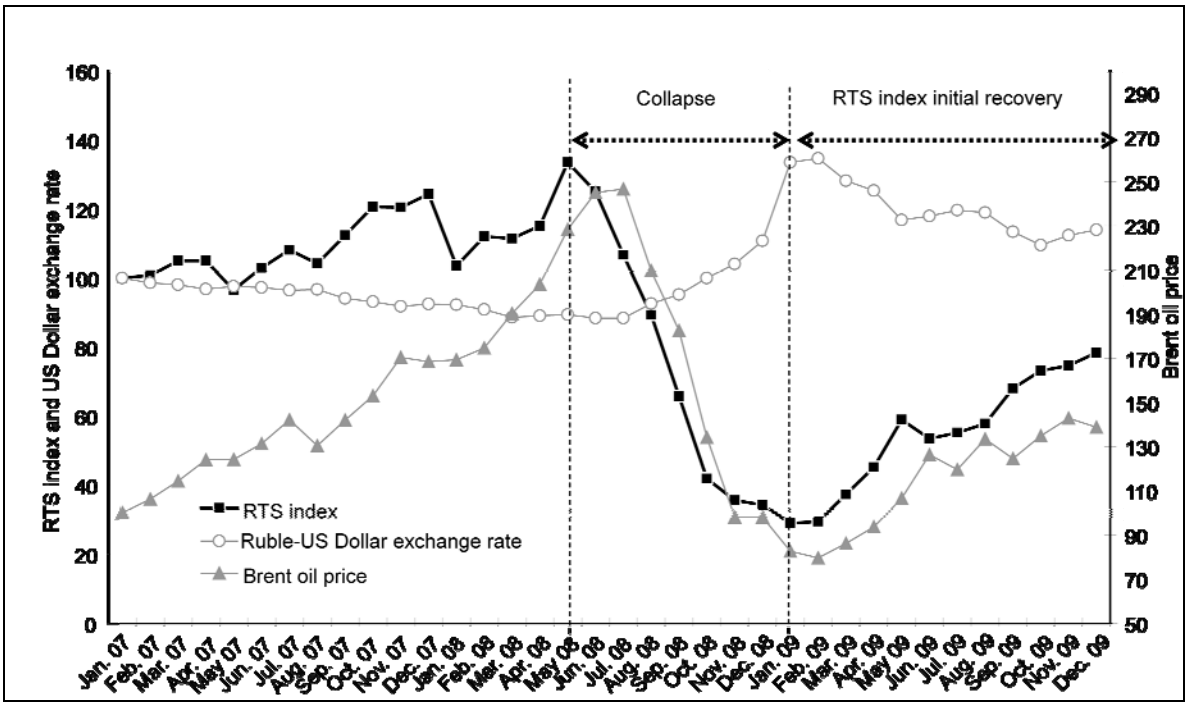
Fig. 6. Dynamics of the RTS index, Brent oil prices, and the ruble-US Dollar exchange rate (September 1995 = 100%)

RTS index and US Dollar exchange rate

The 1997-1998 crisis followed the worst-case scenario. The decrease in oil prices starting from January 1997 continued, with the Brent price falling from 23.47 dollars per barrel in December 2007 to 9.8 dollars per barrel in December 1998. The RTS index peaked at 506.45 in July 1997 before the stock market crash started in August 1997, and by January 1999 the RTS index had fallen to 55.12. The stock market collapse was caused by investor expectations regarding the increase in Russia country risk caused in turn by the dropping fuel prices and the expected devaluation of the ruble. The Russian stock market was seriously affected by the Asian stock market collapse in 1997 that had strengthened negative investor perceptions of emerging stock markets including Russia. A year after the stock market collapse, the crisis extended to the debt markets and to the banking system. In August 1998, faced with low oil prices and with the impossibility of increasing budget revenues by continuing placements of short-term government bills (GKO), the government announced a threefold devaluation of the ruble together with a default on ruble-denominated GKO securities. As the largest commer-

cial banks were unable to service their obligations to foreign and domestic creditors, the government also announced a moratorium on the fulfilment of commercial bank obligations to non-residents.

The onset of the 2008-2009 crisis followed a similar pattern (see *Fig. 7*). The factors contributing to the collapse of the Russian stock market were identical to those present in 1997 and included a drop in metal prices starting from May 2007 and in oil prices starting from July 2008, the withdrawal of foreign capital and growing risks against the background of an expected ruble devaluation. As a result, the stock market fell starting from June 2008, experiencing a real collapse in August of that year. However, on this occasion the crisis was countered by active crisis management government policies in the financial sector that were made possible by the foreign exchange reserves that had reached nearly 600 billion dollars.



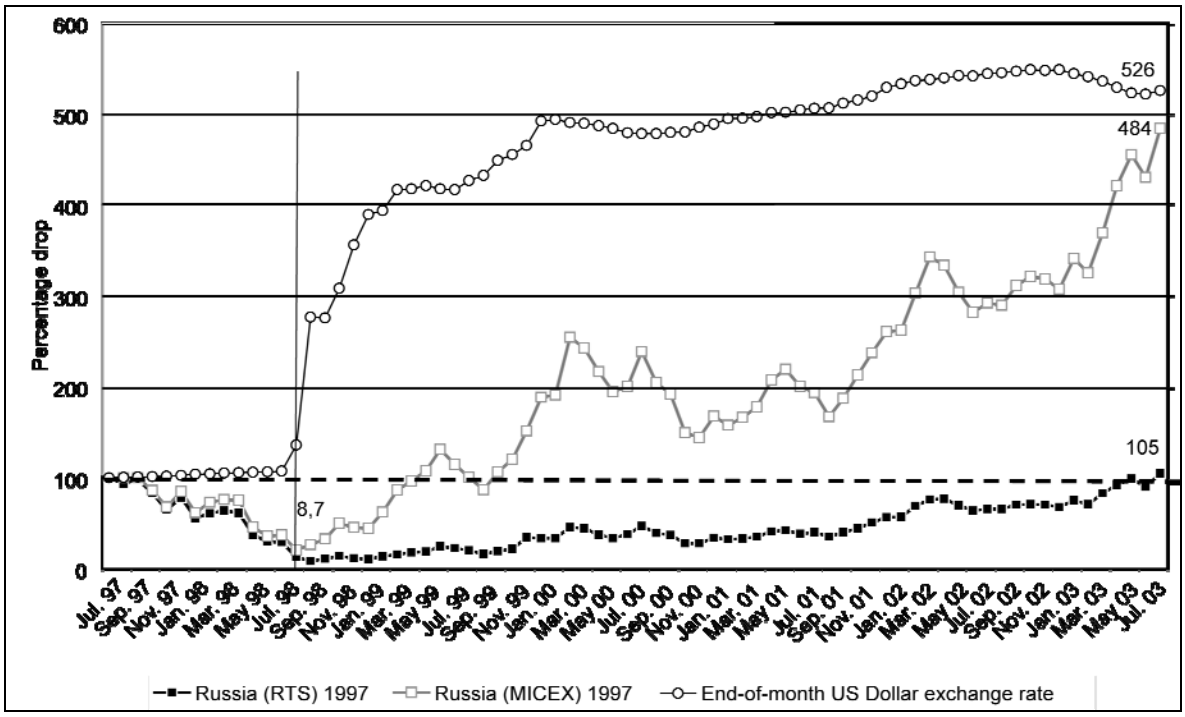
Source: RTS and IMF data.

Fig. 7. Dynamics of the RTS index, Brent oil prices, and the ruble-US Dollar exchange rate (January 2007 = 100%)

Given the decreasing raw material export revenues and the flight of short-term capital, a ruble devaluation was inevitable. However, as distinct from the events of ten years previously, the government did not delay tackling the issue until the last possible moment, initiating a devaluation starting from September 2008. Most importantly, the chosen method was of gradual rather than abrupt devaluation. This had several positive consequences in the financial sector. Banks and heavily indebted industrial companies received an opportunity to gradually restructure their foreign currency-denominated assets and borrowings from foreign creditors without resorting to a default on such borrowings. The general public was able to convert part of its ruble savings into foreign currency assets, avoiding the shock inherent in the sudden loss of savings in the national currency. However, a downside of the gradual devaluation was evident in the significant loss of foreign exchange reserves and their redistribu-

tion in the hands of a limited number of banking and industrial interests. Along with the gradual devaluation, the government made available significant debt financing to banks and to a number of key industrial enterprises, enabling them not only to avoid insolvency but also to prevent the transfer of significant equity stakes into the hands of foreign collateralised creditors. Thus the stock market collapse in 2008-early 2009 did not result in a systemic financial crisis. It should also be noted that unlike the first financial crisis where the drop in oil prices had continued for nearly two years, the 2008-2009 crisis, notwithstanding its global reach, saw oil prices dropping only slightly more than half a year, which is another reason why the duration of the current financial crisis is less than that of the 1997-1998 crisis.

Differences in the extent of the ruble devaluation during the two crises in question have resulted in the different recovery trends for the RTS and MICEX indices. MICEX stock portfolios are valued in rubles while RTS stock portfolios are valued in US Dollars, and as a result of this distinction, the MICEX index recovered faster than the RTS index notwithstanding the five-fold devaluation of the ruble[1] (see *Fig. 8*). The MICEX index had recovered to its pre-crisis peak by May 1999, a mere eight months after hitting "bottom" during the crisis, whereas the RTS index recovery took 59 months from the crisis low point.



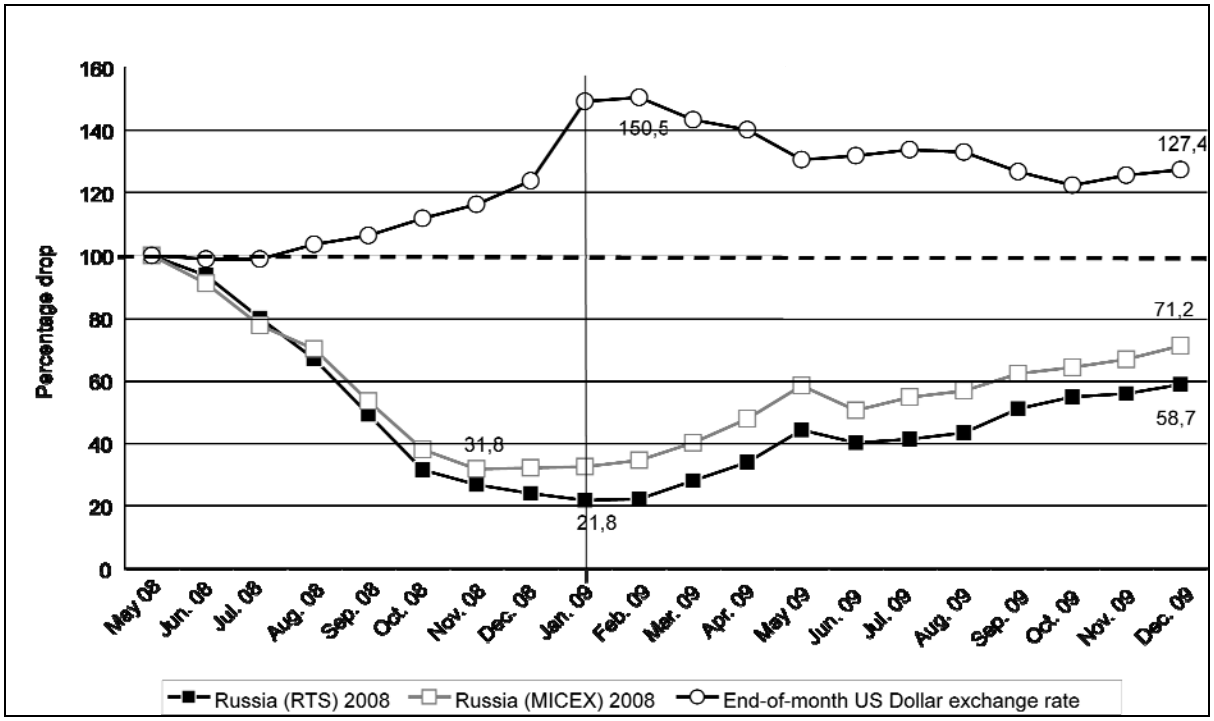
Source: RTS, MICEX Stock Exchange, the Bank of Russia.

Fig. 8. Trends in the US Dollar exchange rate, RTS index, and MICEX index during the 1997-1998 crisis (July 1997 = 100%)

The maximum extent of ruble devaluation during the 2008-2009 crisis equalled 50% (see *Fig. 9*) and was followed by the strengthening of the national currency. For this reason, the RTS and MICEX indices recovered at similar rates in the past months, with the MICEX index holding only a slight advantage in terms of recovery speed. By the end of 2009, the RTS in-

[1] From 1998 to 2003

dex had reached 58.7% of its pre-crisis peak registered in May 2008, while the MICEX index had reached 71.2% of its pre-crisis peak.



Source: RTS, MICEX Stock Exchange, the Bank of Russia.

Fig. 9. Trends in the US Dollar exchange rate, RTS index, and MICEX index during the crisis from May 2008 to December 2009 (May 2008 = 100%)

2.4.3. Government crisis mitigation support measures in the financial markets

Support to the financial system was the core element of the government crisis mitigation policies in 2008-2009. It is difficult to estimate the total amount of funding received by financial institutions due to the numerous instruments of support. Several of these instruments were based on lending principles or were offered indirectly. There is insufficient information transparency regarding the implementation of funding decisions for financial sector support. Due to these factors, the estimates of the total cost of crisis mitigation measures in the financial sector vary. On September 17, 2009, Reuters that quoted the Russian President Expert Department in stating that the total amount of financial support to companies, banks and individuals, considering the repayment of unsecured loans and the remittance of Ministry of Finance deposits, stood at RUR 7.4 trillion, or 240 billion dollars. The World Bank estimates the total amount of crisis mitigation measures financed from the state budget and aimed at supporting the Russian financial sector in 2008-2009 at RUR 1.4 trillion[1].

[1] World Bank report on the Russian economy No. 18, March 20089, page 15. Published at www.worldbank.org.ru

Government equity injections in bank capital

From the beginning of the crisis, the state demonstrated its readiness to take the most decisive measures to support the banking sector, including direct equity injections in the statutory capital of financial institutions, granting subordinated loans, as well as long-term targeted deposits. The principal instruments of such support are shown in *Table 2* and amount to a total of RUR 2.8 trillion.

Table 2

Key measures for strengthening the capital of financial institutions in 2008–2009

Measure	Amount, RUR billion
Equity injection into Vnesheconombank to support the financial system	75
Subordinated loan to Vnesheconombank to support the stock market	175
Long-term deposit for the purposes of foreign debt repayment by Russian companies and banks	1350
Funds granted to the Housing Mortgage Lending Agency to support mortgage financing	60
Funds granted to the Deposit Insurance Agency for bank restructuring	200
Long term subordinated loans to banks for improving their capital adequacy	950
Equity injection into Rosselhozbank	30
Total	**2840**

Other measures created the conditions for strengthening bank revenue bases by mobilising loan funds from the Bank of Russia, the state budget, government corporations, and private deposits. Related measures included the gradual devaluation of the ruble that enabled banks to redress the imbalance between their foreign currency denominated assets and liabilities. The decisions to lower mandatory reserve levels and the introduction of guarantees for private deposits in an amount up to RUR 700,000 at a given bank significantly contributed to improving bank stability.

Devaluation of the ruble and the currency gap in bank assets and liabilities

Foreign exchange reserves amounting to nearly RUR 600 billion at the beginning of the crisis enabled the government to prevent the spread of the crisis in the financial sector and in the lending market. Prior to the 2008-2009 crisis, similarly to the previous Russian crisis, the speculative carry trading strategies, when banks actively borrowed foreign currency funds in sophisticated international markets at low interest rates and then invested these funds in high yield ruble assets, were the main driver of bank growth. Prior to the 1998 crisis such assets were represented by short-term government bills (GKO), while prior to August 2008 they consisted of consumer loans, ruble-denominated corporate bonds, and loans to large corporates[1].

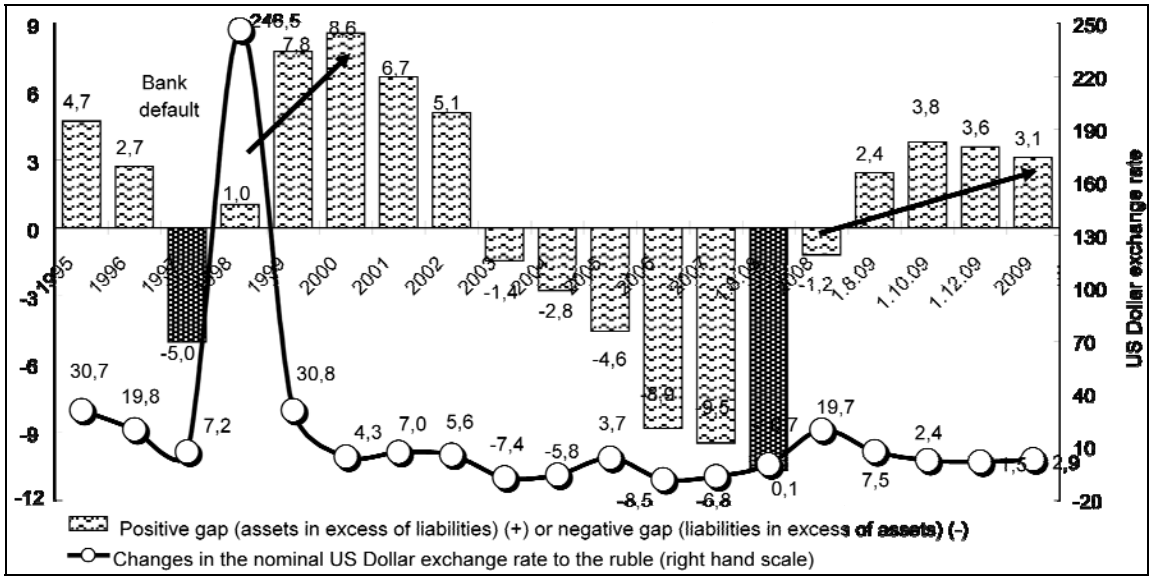
Martin Gilman, who worked as an IMF liaison with Russian authorities in the late 1990s, describes the business strategies of Russian banks on the eve of the 1998 crisis as follows: “they sought to take advantage of the exchange rate stability and make money using a seem-

[1] Carry trading strategies, their rationale and the related risks in the Russian financial markets were analysed in our earlier publications.// The Russian economy in 2008: trends and prospects, Issue No. 30, Moscow, IEPP, 2009, pages 524–534; The crisis economy in modern-day Russia: trends and prospects/ A.Abramov, E.Apevalova, E.Astafieva et al; edited by E.T. Gaidar, Moscow, Prospekt, 2010, pages 524–534.

ingly failsafe mechanism: taking cheap dollar borrowings, buying high yield government bills, buying dollars again with the ruble proceeds when the bills matured, and pocketing the difference. For more cautious non-resident investors who wanted extra insurance for their ruble-denominated investments in GKO bills, they entered into forward contracts to purchase dollars."[1]

Carry trading strategies are high-risk in nature: in case of devaluation of the national currency, the ruble-denominated assets of speculative traders immediately lose value while their foreign currency-denominated borrowings from non-residents become unserviceable. The bank is caught in the liquidity gap or becomes insolvent. According to IMF experts, the high involvement of emerging market banks in carry trading to fund the growth of consumer loans is one of the principal financial markets risks in these countries[2].

Watching the rapidly growing gaps in recent years between bank foreign currency denominated assets and their liabilities to non-residents prior to a financial crisis (see *Fig. 10*), one might wonder at the obvious disregard by the Central Bank of Russia of such core banking sector risks.



Source: Calculations based on Bank of Russia data.

Fig. 10. The positive (+) and negative (–) currency gap in bank assets and liabilities (percentage share relative to bank assets(liabilities))

The extent of bank involvement in carry trading strategies is clearly shown by the negative and positive currency gaps, i.e. the value of their foreign currency denominated assets compared to the value of non-resident claims on such banks as a percentage of total bank assets. In 1997, prior to the 1998 banking crisis, borrowings from non-residents exceeded banking assets by 5% of the total asset value of the banking system. The threefold devaluation of the ruble resulted in widespread bank insolvency. The balance was restored by bankrupting the top private Russian banks and by freezing (i.e. defaulting on) bank borrowings from non-

[1] *Гилман М.* Дефолт, которого могло не быть/ Пер. с англ. А.Багаева. М.: Время, 2009. С. 223.
[2] IMF. Global Financial Stability Report. Financial Market Turbulence: Causes, Consequences, and Policies. September 2007. P. 22–25.

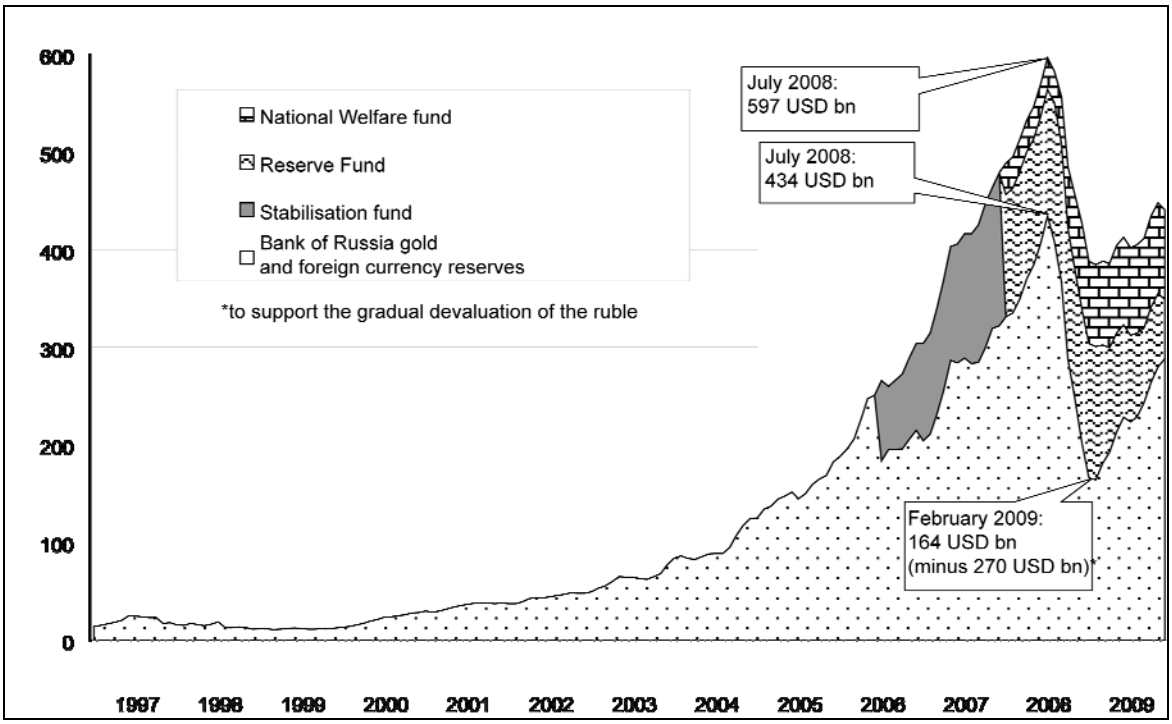
residents that the government was compelled to legalise by issuing a moratorium upon the repayment of bank obligations to non-residents. As a result, the balance between foreign currency denominated bank assets and liabilities was restored, and in 1998 the cumulative foreign currency gap in the banking system amounted to only 1% of total banking sector assets. However the international reputation of the national banking system was damaged for many years to come.

Prior to the 2008-2009 crisis, as of August 1, 2008, the currency gap between bank assets and liabilities amounted to 10.7% of the total banking sector assets, twice exceeding the level that preceded the August 1998 crisis. The period from early 2004 up through July 2008 saw the peak of carry trading strategies at Russian banks. The devaluation of the ruble starting from late 2008 that resulted to in a 50% drop in the value of the national currency (see *Fig. 9*), would have undoubtedly led to a repeat scenario of the 1998 banking system collapse if not for state support to banks. The provision of lending by the Bank of Russia and government regulators, as well as the gradual ruble devaluation policy, gave the banks the time and resources necessary to redress the balance between their foreign currency denominated assets and liabilities.

To minimize the time needed to close this currency gap, the Bank of Russia adjusted the mandatory reserve requirements for bank borrowings from non-resident banks and for other foreign currency denominated liabilities from pre crisis levels of 5.5% and 5.0% respectively of the total value of liabilities to 8.5% and 6.0% respectively for the period from September 1 to September 17, 2008[1]. Banks were compelled to partially repay foreign debts and convert ruble denominated assets into foreign currency. As a result, by the end of 2008, the currency cap that had previously amounted to RUR 2.4 trillion was largely closed, and as of January 1, 2010, the currency gap between bank assets and non-resident claims amounted to 3.1% of the total banking system assets. Our estimates put the effect of this measure on the Russian banking system at RUR 3.3 trillion (see *Table 3*).

All this was only made possible by the unprecedented government financial support to banks and key real sector companies. The scale of government support is evidenced by the decrease of Russia's foreign exchange reserves from August 2008 to February 2009, as shown in *Fig. 1*.

[1] However, starting from the second half of September 2008, these ratios began to decline to amount to only 2.5% each at the end of 2009.



Source: Bank of Russia and the Russian Ministry of Finance.

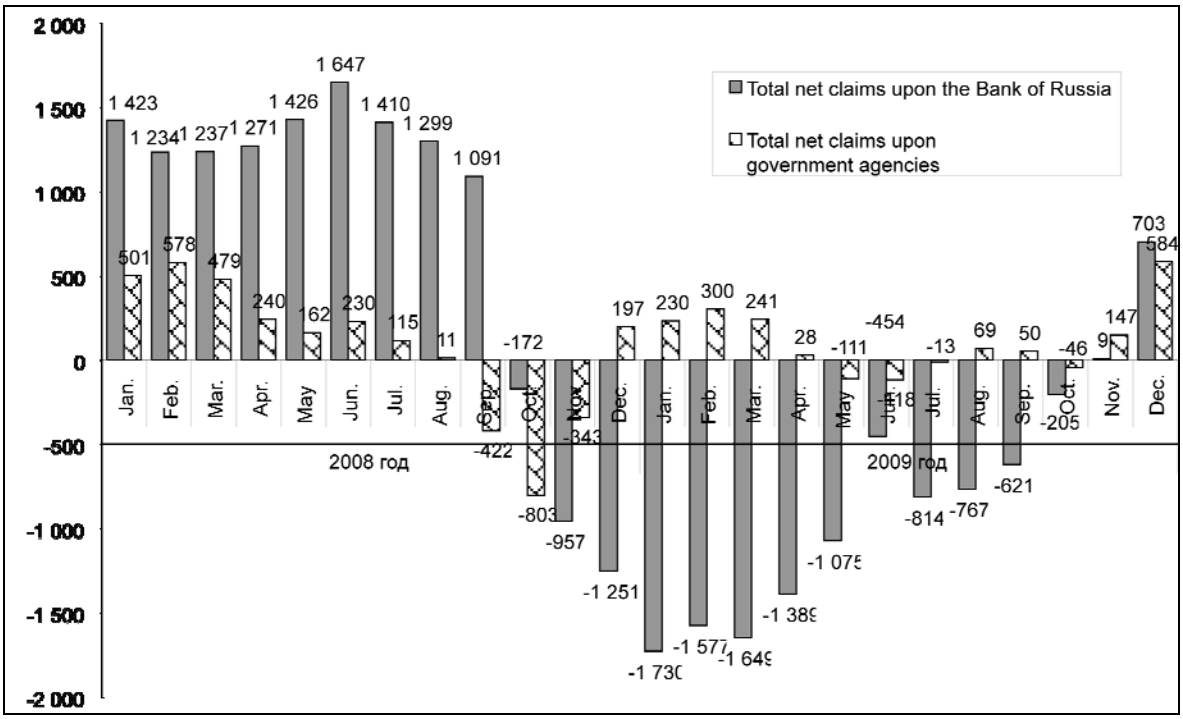
Fig. 11. Russian foreign exchange reserves (billions of dollars)

The national foreign exchange reserves consist of two parts, the Stabilisation Fund that was transformed into the Reserve Fund and the National Welfare Fund[1] in early 2008, and the Bank of Russia foreign exchange reserves. The Reserve Fund and National Welfare Fund are targeted funds for the financing of the federal budget deficit (Reserve Fund) and financing pension requirements (National Welfare Fund). *Fig. 1* shows that starting from the outset of the 2008 crisis, the portion of foreign exchange reserves administered by the Bank of Russia decreased from 434 billion dollars in July 2008 to 164 billion dollars in February 2009, i.e. by 270 billion dollars. After February 2009, as the oil prices rose, the Bank of Russia reserves were replenished. By the end of 2009, foreign exchange reserves had grown to 440.6 billion dollars, including 288.5 billion dollars of foreign exchange reserves administered by the Bank of Russia.

Lending to banks by the Bank of Russia and the government

The onset of the financial crisis and the resulting crisis of confidence signified the end of the carry trading model as a bank funding mechanism. However, from the start of the financial crisis in August and September 2008, Russian banks received massive support from the Bank of Russia and the Ministry of Finance. The carry trading funding model was replaced by a bank funding model that used borrowings from the state monetary authorities. Such support took the form of lending, whose volume can be estimated using net bank claims upon the Bank of Russia and government authorities that are shown in *Fig. 12*.

[1] These funds are known internationally as sovereign welfare funds.



Source: Bank of Russia banking sector review.

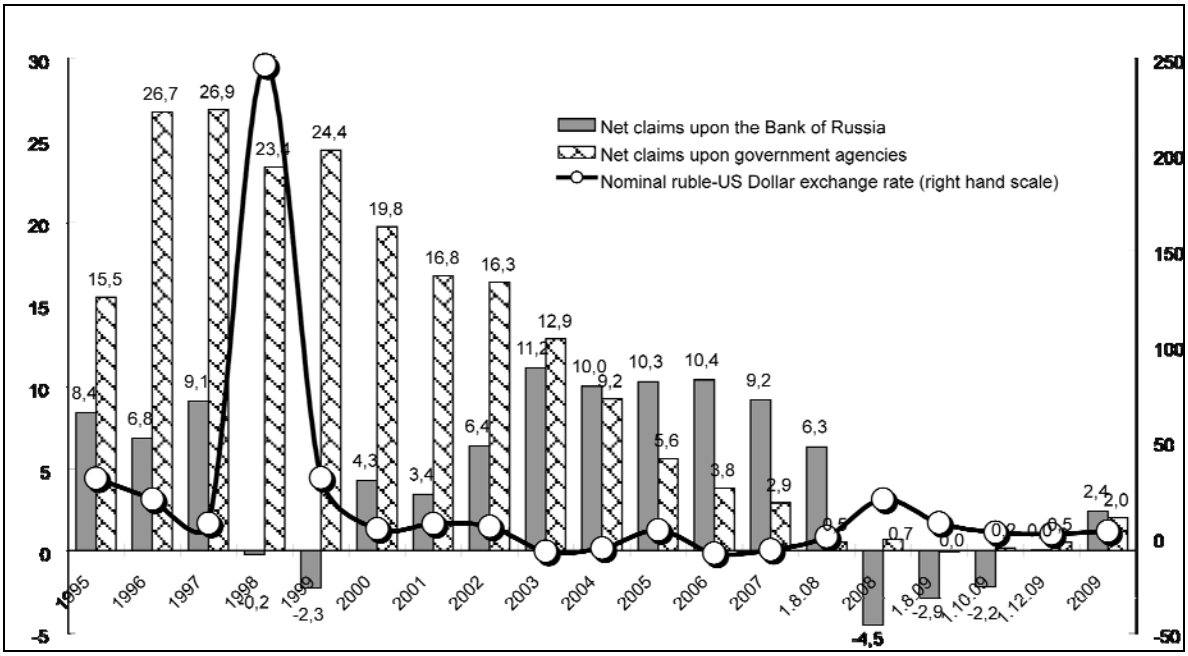
Fig. 12. Estimates of government support to banks (billion rubles)

In July 2008, net banking sector claims upon the Bank of Russia and government agencies totalled approximately 1.5 trillion rubles, i.e. until then banks had acted as creditors to the Central Bank and government authorities. The funds held by banks in deposits and correspondent bank accounts at the Central Bank of Russia and invested in Bank of Russia bonds and government securities exceeded the limited lending received from the Bank of Russia and deposits by government authorities by the above amount. The situation drastically changed starting from September 2008 when the Central Bank and government agencies became net creditors to the banking sector. At the start of the crisis, decisions were taken to lower the mandatory reserve requirements, to place the temporarily liquid funds from the state budget and government corporations in bank deposits, to promote lending to banks by the bank of Russia by way of direct repo transactions and later by way of unsecured loans and other types of lending. The principal emphasis was on lending to banks by the Bank of Russia. By November 2008, net bank borrowings from the Central Bank of Russia and government agencies amounted to 957 billion rubles, and reached 1.3 trillion rubles by December of that year. In January 2009 total net bank borrowings reached a maximum of 1.7 trillion rubles. Thus, from being net government creditors in an amount of 1.6 trillion rubles, banks became net debtors in an approximately equal amount of borrowings. Thus the total volume of government lending to banks was approximately 3 trillion rubles.

Starting from February 2009, i.e. from the beginning of Russian stock market recovery, the Ministry of Finance and the Bank of Russia implemented a policy of gradual withdrawal from the banking system. By December 2009 banks once more became net creditors to the Bank of Russia and government agencies in the respective amounts of RUR 703 billion and RUR 584 billion. While these amounts were below pre-crisis levels, they signified the end of net government lending to banks. As of January 1, 2010, total net banking sector claims upon gov-

ernment agencies had grown to 584 billion rubles from 115 billion rubles as of August 1, 2008 (see *Table 3*), i.e. by RUR 469 billion, pointing to the fact that these agencies had cut back on their lending to banks and had once more become net debtors. Within the same period, net banking sector claims upon the Bank of Russia had decreased from RUR 1,411 billion to RUR 703 billion, meaning that the cost of banking sector support by the monetary authorities by way of decreasing the amounts of bank funds used to finance the Central Bank equalled 708 billion rubles.

Fig. 13 shows the same data on net banking sector claims upon the Bank of Russia and government authorities as a percentage of total banking sector assets. It shows that the amount of government lending to banks was equal to the amounts foregone by these banks as a result of the forced abandonment of carry trading strategies. Earlier in *Fig. 10*, we could see that prior to the August 2008 crisis the amount of net lending to banks using the strategy equalled approximately 10.7% of total banking sector assets. The change in banking sector claims upon the bank of Russia from August to December 2008, was nearly identical in numeric terms, amounting to 10.8% of total banking sector assets (see *Fig. 13*).

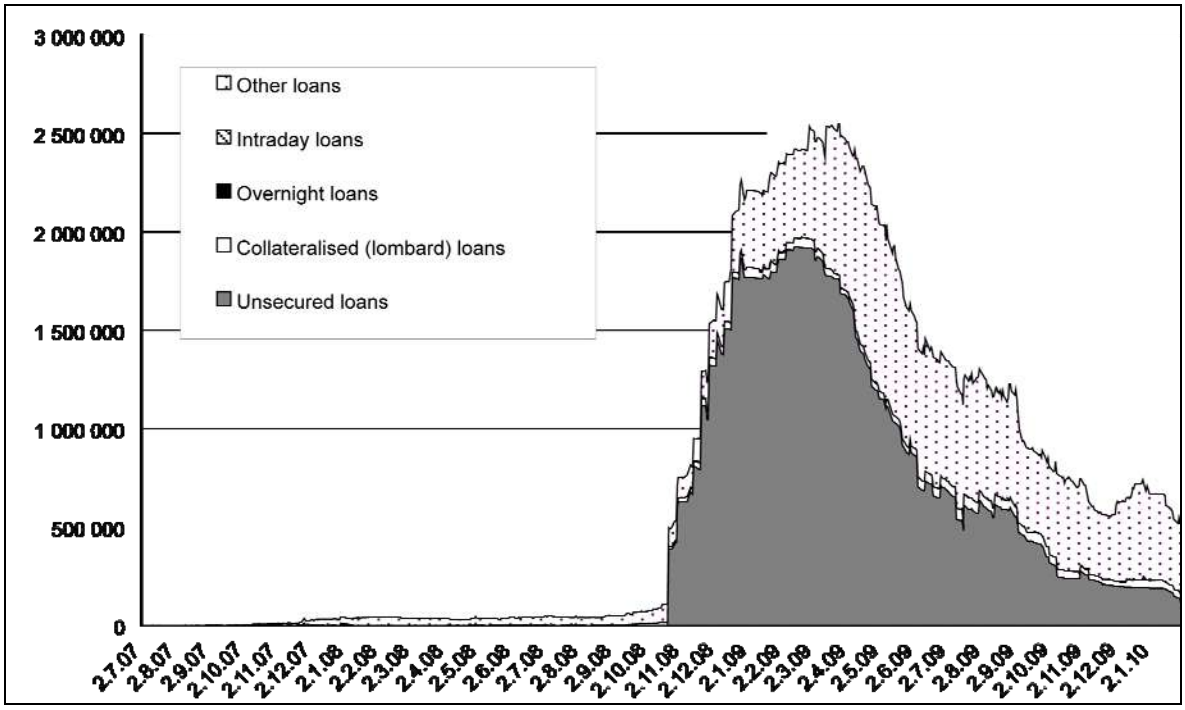


Source: Bank of Russia financial institution review.

Fig. 13. Net banking sector claims upon government authorities and the bank of Russia as a percentage of total assets (total liabilities)

Fig. 14 shows an analysis of the various forms of lending to the banking sector used by the Bank of Russia. During the crisis, unsecured loans were used as the principal instrument of support to banks starting from October 20, 2009. Such lending is not customarily used by central banks in other countries and implied a significant credit risk assumed by the Bank of Russia. Bank of Russia lending support to the banking system during the crisis did not typically link such lending to the size of bank loan portfolios, except in the case of loans collateralized by specific types of assets (see *Fig. 14*). This is the most likely reason for the limited growth of bank retail and corporate loan portfolios during the crisis, despite the substantial banking

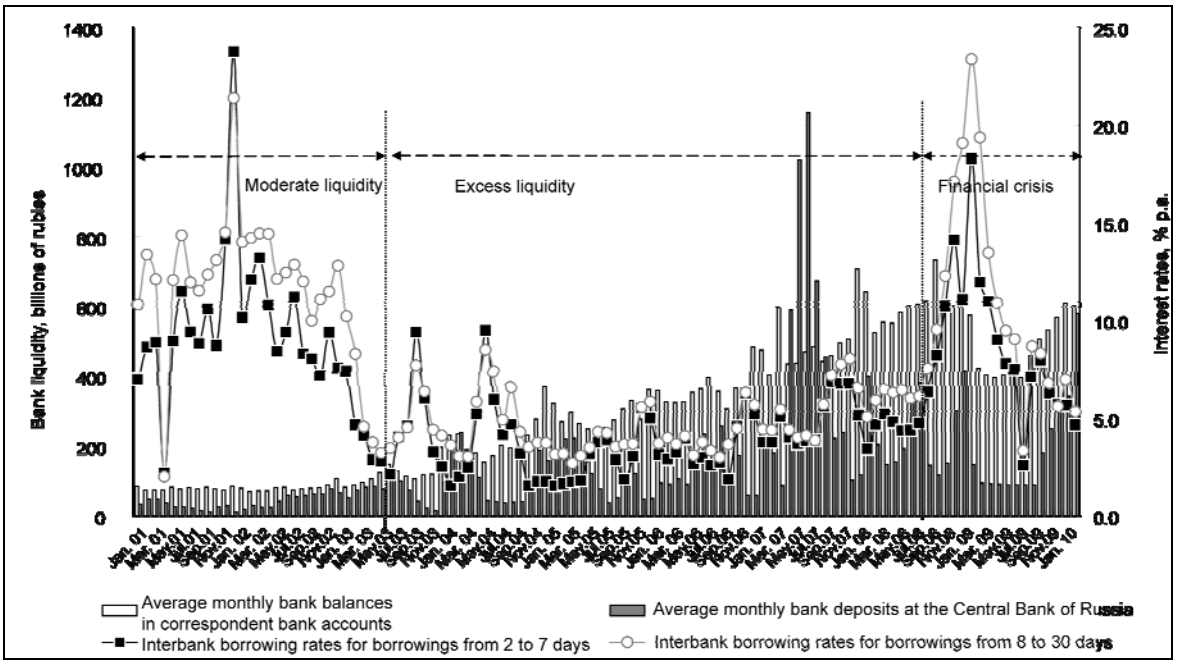
sector funding support by the Bank of Russia that had caused the latter to assume significant credit risk.



Source: Bank of Russia.
Note. The "internal lending volume" and "overnight loan exposure" amounts are close to zero and thus were excluded from the *Fig*.

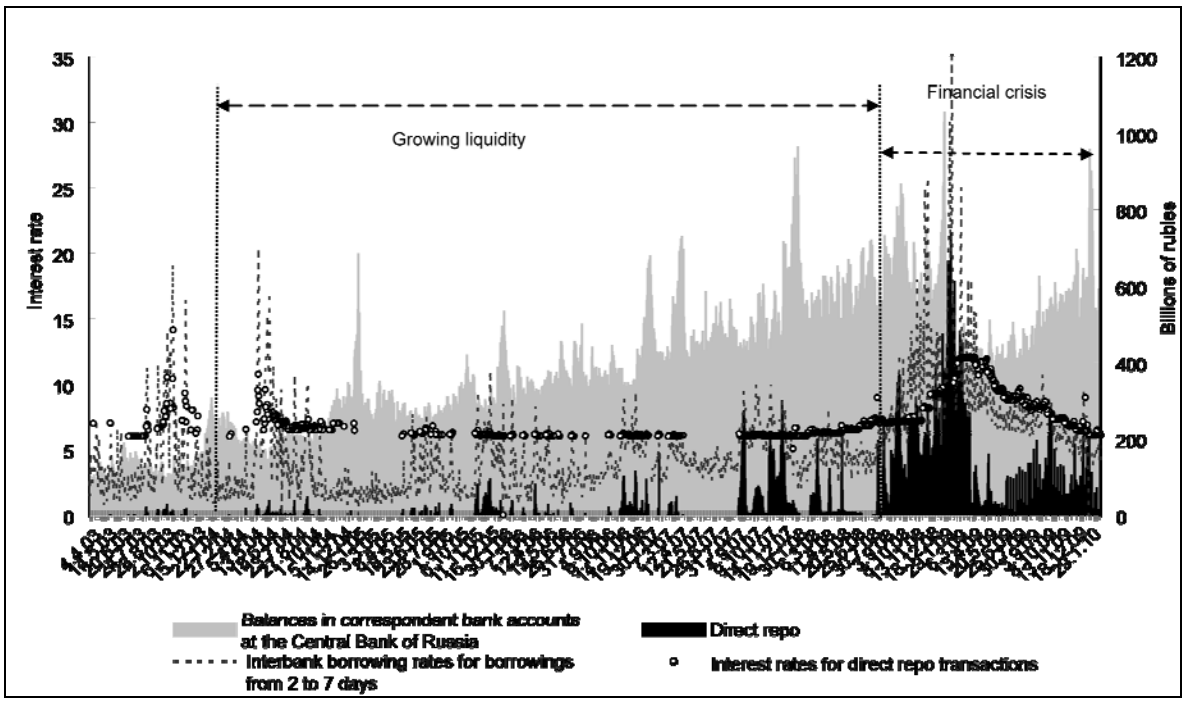
Fig. 14. Lending to the banking sector by the Bank of Russia (millions of rubles)

A more traditional instrument widely used by the Bank of Russia to enhance the stability of the banking sector during the crisis was short-term lending to banks using direct repo transactions. *Fig. 15* shows the three stages of Russian banking sector development defined by the predominant use of various funding sources to support bank liquidity. The first stage, from 2000 to 2003, was characterized by moderate liquidity and bang funding predominantly using internal sources, while interbank interest rates were relatively high. The second stage, from 2004 through July 2008, saw the peak of the carry trading strategies when banks were able to raise cheap funding abroad. The influx of cheap short-term foreign funding resulted in excess liquidity in the banking sector and low interbank borrowing rates. The third stage started from the outset of the current financial crisis (August 2008) and is characterised by the temporary cessation of carry trading strategies that in turn led to a rapid increase in interbank borrowing rates and the subsequent involvement of government agencies, whose funding temporarily substituted foreign borrowings and mitigated the situation in the interbank market.



Source: Bank of Russia.

Fig. 15. Monthly bank liquidity indicators and interbank borrowing rates, 2001 – January 2010



Source: Bank of Russia.

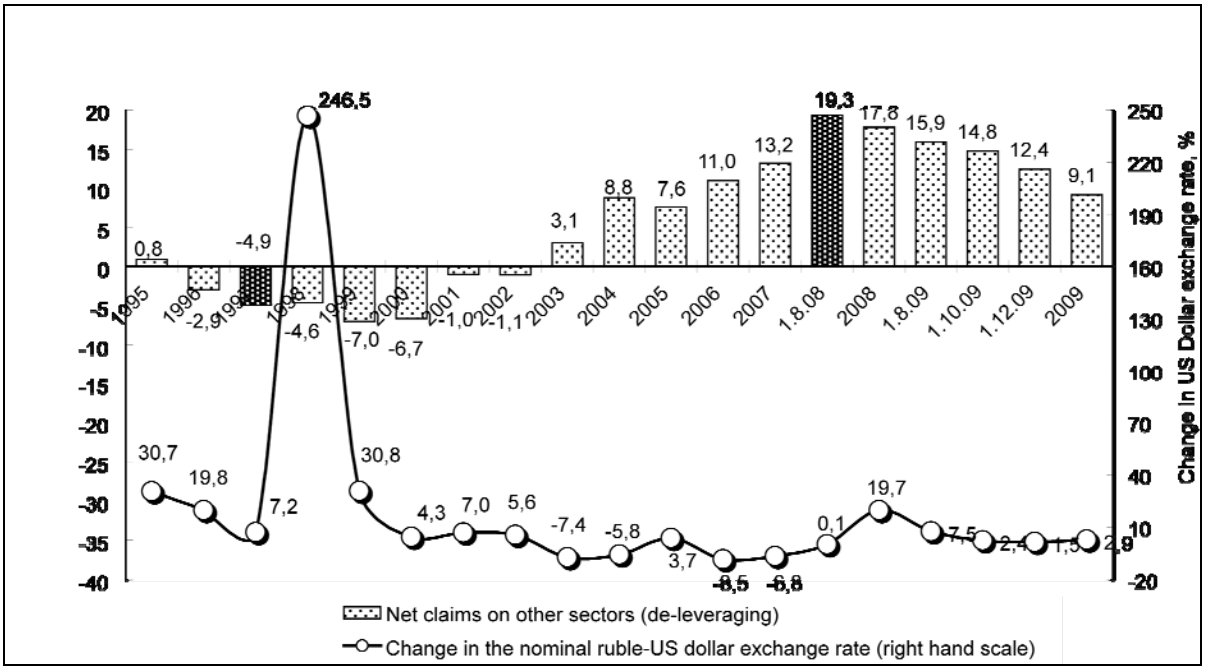
Fig. 16. The use of direct repo transactions to regulate banking sector liquidity in 2003-January 2010

*Fig. 16 s*hows the relationship between interbank borrowing rates and the use of the direct repo mechanism. At the time of growing liquidity, the bank of Russia used direct repo transactions only occasionally and on a limited scale. From the outset of the financial crisis, they were more widely used to stabilize the interbank lending market. Such transactions were concluded regularly in a daily basis, and their volumes had increased significantly from pre-crisis levels.

Growth of bank deposits and bank de-leveraging

Among the most effective crisis mitigation measures aimed at supporting the banking sector was the state undertaking to increase the amount of full guarantees for retail bank deposits from RUR 400,000 to RUR 700,000 for aggregate deposits by an individual at a single bank. Set against the flight of individual investors from high-risk assets such as corporate stocks, investment fund shares, and junk bonds, this ensured significant growth of retail bank deposits at a time of crisis. From August 1, 2008 to January 1, 2010, retail bank deposits grew from RUR 5,850 billion to RUR 7,485 billion, which resulted in an increase in the banking sector revenue base of RUR 1,635 billion (see *Table 3*).

The decrease in bank loan portfolios and the growth in retail deposits during the crisis resulted in a de-leveraging of the banking system (see *Fig. 17*), i.e. the decrease in the ratio of net banking sector claims upon retail and corporate borrowers relative to total banking sector assets, from 19.3% as of August 1, 2008, immediately prior to the crisis, to 9.1% as of January 1, 2010. Besides the decrease in loan portfolios, this ratio was also influenced by the limited availability of cheap foreign funding for banks.



Source: Bank of Russia.

Fig. 17. The ratio of bank loans to bank deposits as an indication of de-leveraging (percentage to total banking sector assets (liabilities))

Summary estimates of crisis mitigation support measures

The principal instruments of funding support to banks, as shown in *Table 3*, consisted of rebalancing bank assets and liabilities denominated in foreign currency, decreasing net banking sector claims upon the Bank of Russia, increasing bank capital by means of government and private owner equity injections, and increasing retail and corporate deposits. As of the end of 2009, the total amount of such support can be estimated at more than RUR 7 trillion. These measures have helped maintain the stability of the banking sector, however, they did not result in its increased efficiency or in the growth of bank loan portfolios during the crisis.

Table 3

Quantitative estimates of the effect of banking sector support measures, billions of rubles

	August 1, 2008	January 1, 2010	Cost	Effect
Net claims upon non-residents	–2377	905	3282	Rebalancing foreign currency-denominated assets and liabilities by way of a gradual devaluation of the ruble
Net claims upon the state	115	584	–469	Mobilizing funds for financing the government
Net claims upon the Bank of Russia	1411	703	708	Increasing bank liquidity by the Bank of Russia
Bank equity	3116	4120	1004	Increasing bank capitalization
Retail deposits	5850	7485	1635	Increasing deposit insurance to RUR700,000
Corporate deposits	4465	5467	1001	Increasing bank funding, including by way of state-owned company deposits
Total			**7161**	

Thus the main positive outcome of government crisis mitigation policies in 2008-2009 was the preservation of the banking sector. This had involved unprecedented measures, both in terms of scale and range of application in the Russian market, to ensure banking sector stability. The principal related issue is that, despite being able to maintain stability due to these measures, the banking system has remained inefficient and incapable of tackling the issues of large scale economic modernization, same as prior to the crisis. In terms of banking sector efficiency, in 2009 Russia ranked last among 55 countries whose financial market competitiveness was estimated by the World Economic Forum[1].

2.4.4. Measuring the effectiveness of crisis mitigation measures in the stock market

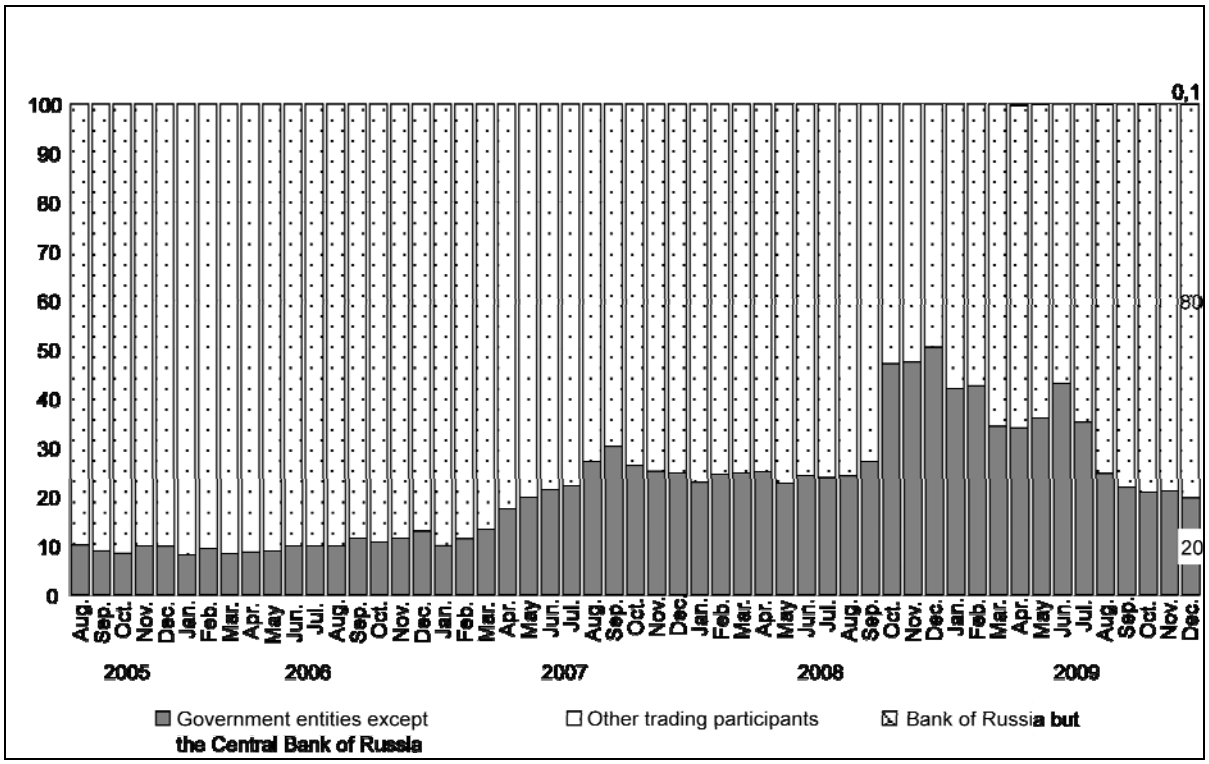
During the crisis, government support to the stock market involved the use of two principal channels, the subordinated loan of RUR 175 billion at 7% p.a. to Vnesheconombank from the National Welfare Fund for the purpose of supporting the Russian stock market, and a set of measures to support the ruble-denominated corporate bond market as an alternative to bank lending.

Vnesheconombank support to the stock market

Vnesheconombank received the subordinated loan at a 7% interest rate in October 2008 for the purposes of supporting the stock market and repaid it on December 15, 2009. The impact

[1] World Economic Forum. The Financial Development Report. 2009, page 210. Published at www.weforum.org.

of this loan on the trading activities of government banks and related entities is shown in *Fig. 18*. From October 2008 through July 2009, the share of government entities in the total trading volume at MICEX increased from the pre-crisis level of 25% to 34-50%, which suggests that this period witnessed active government interventions in the stock market. At the same time, from August to December 2009, the level of government trading at the stock exchange remained at pre-crisis levels, which raises doubts as to whether the stocks purchased using government funding were indeed sold on the 175 billion ruble loan was repaid by Vnesheconombank[1]. It is likely that Vnesheconombank used other sources to repay the loan to the Ministry of Finance.



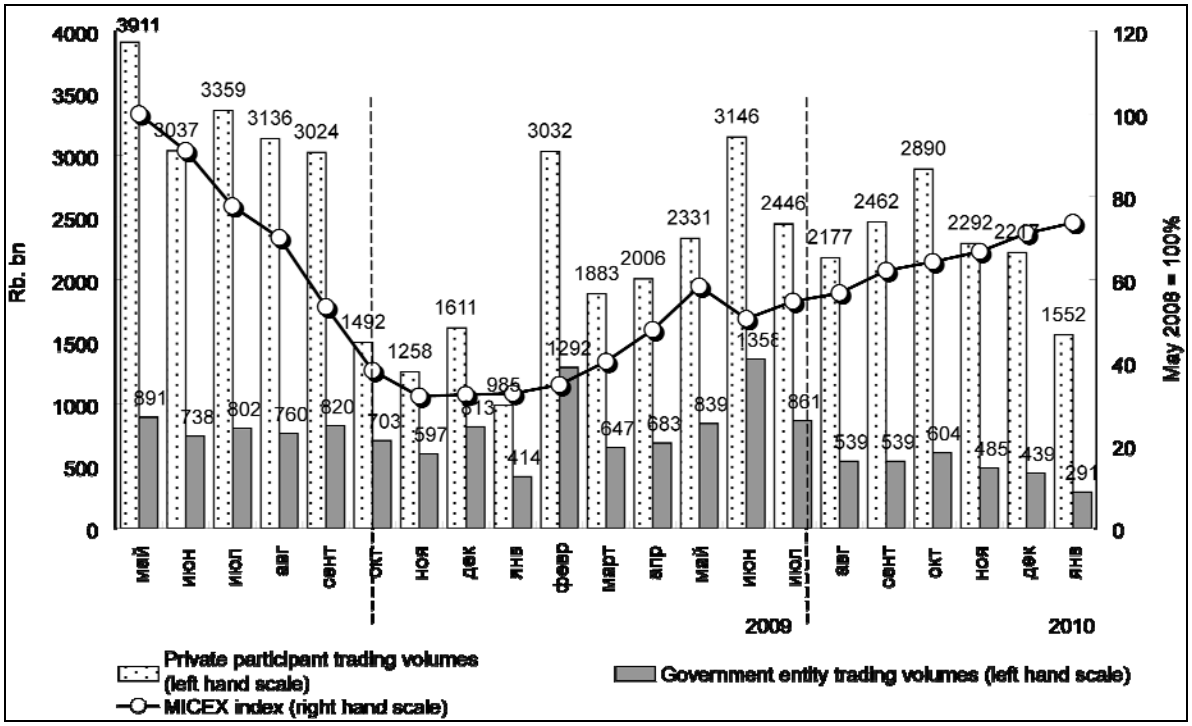
Note. Bank of Russia figures are close to zero and are not visible given the scale of the *Fig.*
Source: proprietary calculations using MICEX data.

Fig. 18. The share of private and state brokers in MICEDX trading volumes (%)[2]

The impact of using government funds upon the stock prices of Russian issuers is shown in *Fig. 19* that follows the MICEX index from its peak as of May 2008 to January 2010, juxtaposed against MICEX stock market trading volumes, shown separately for private trading participants and government entities. The drop in the MICEX index from June 2008 to January 2009 was largely caused by the decrease in the activity of private investors. Despite the increase in the share of government entities in stock market trading volumes from October 2008 to July 2009, such volumes remained at pre-crisis levels in terms of absolute numbers.

[1] The President of Vnesheconombank, V. Dmitriev, made the relevant statement during the Vesti news broadcast on December 21, 2009.
[2] Vnesheconombank, Vneshtorgbank, VTB Capital, VTB 24, Gazprombank, Sberbank, KIT Finance, Sviazbank and Bank of Moscow.

Similarly, the recovery in the MICEX index starting from February 2009 is more likely to have been due to the growth in private trading volumes than to government entity trading. It is possible that government support to the stock market using financial interventions has smoothed the market drop, but it is unlikely to have had any influence on the trend per se. Market recovery was mostly due to private investors.



Source: proprietary calculations using MICEX data.

Fig. 19. Index trends in trading volumes for public and private MICEX market participants from May 2008 to January 2010.

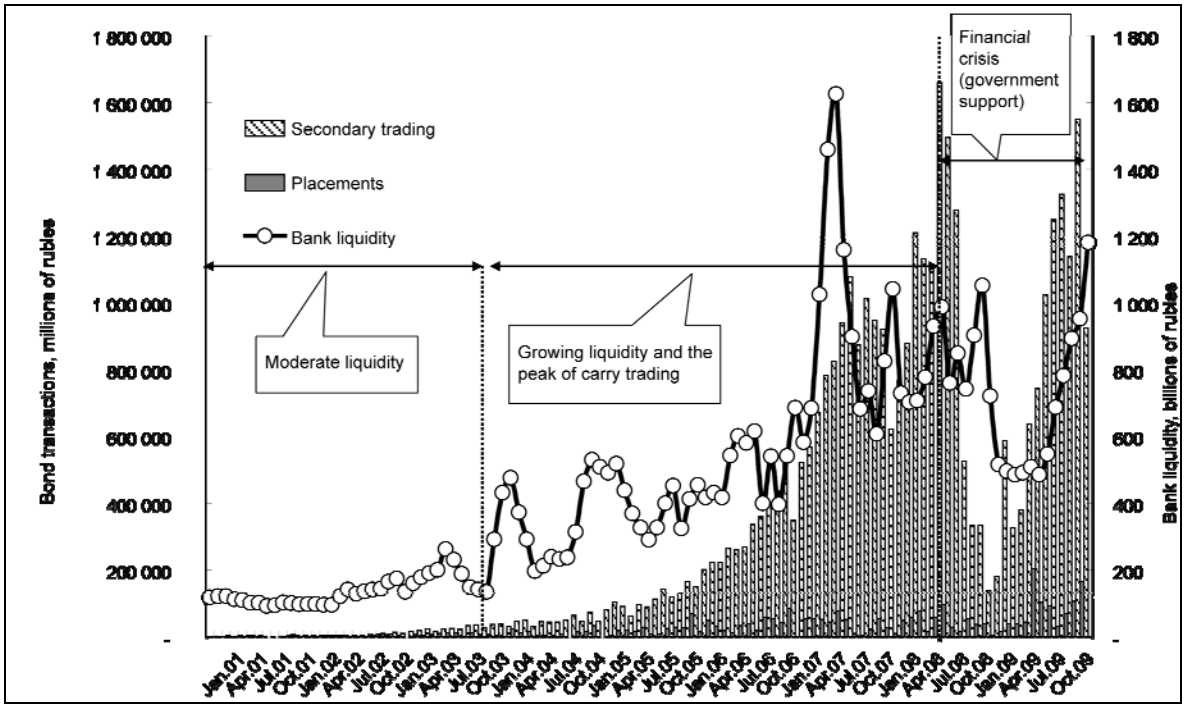
If the stock market is viewed as a zero sum game in terms of average yields for market participants whereby the profit made by certain investors signifies losses for other investors, it follows that the high yields from the equity investments made by Vnesheconombank using a fixed interest rate subordinated loan (where the bank estimates its profits from the transaction at 60% according to the analysis it published in late 2009), amount to a deduction from the profits of other investors that sold their stocks to it at the "bottom" of the market. In this case it is more appropriate to speak about a profitable "margin" transaction by government-owned bank using a loan granted on highly favourable terms (maturity and interest rate) than to claim effective government support to the stock market and to investors.

Government support measures for the ruble-denominated bond market

Fig. 20 shows monthly data on the issuance and secondary market trading volumes for ruble-denominated corporate boards at MICEX from 2001 to January 2010. The *Fig*. also shows data for bank liquidity measured by correspondent bank account and deposit balances for commercial bank deposits at the Bank of Russia. It can be seen from the *Fig*. but that the start of the financial crisis in August 2008 led to a significant decrease in bank liquidity, in stock

exchange trading volumes, and in corporate bond placement volumes. The stock market crisis that started in May 2008 and was exacerbated by investor panic and the global markets following the Lehman Brothers investment bank bankruptcy announcement in September 2008 then threatened to spread to the ruble-denominated bond market. In September 2008 MICEX experienced a temporary crisis due to the lack of a risk management system for repo transactions that led to a default on such transactions by several key market participants. However, the timely intervention by the Bank of Russia, an improvement of settlement procedures, and the restructuring of insolvent banks have resulted in the avoidance of a systemic crisis in the bond market.

The decrease in trading volumes in the Russian corporate bond market continued until February 2009. The market experienced massive defaults on offers, coupon payments, and principal repayments by second tier issuers. However, starting from February 2009, secondary market trading volumes started an unexpectedly rapid recovery, and starting from June, high-volume corporate bond issues resumed. As a result, for 2009 as a whole, the volume of corporate bond placements in the domestic Russian market totalled 917 billion rubles compared to 398 billion rubles in 2008 and 457 billion rubles and 2007. Secondary market trading volumes for bonds in 2009 amounted to 9282 billion rubles, which is somewhat below the respective figures of 11349 billion rubles in 2008 and 9489 billion rubles in 2007.

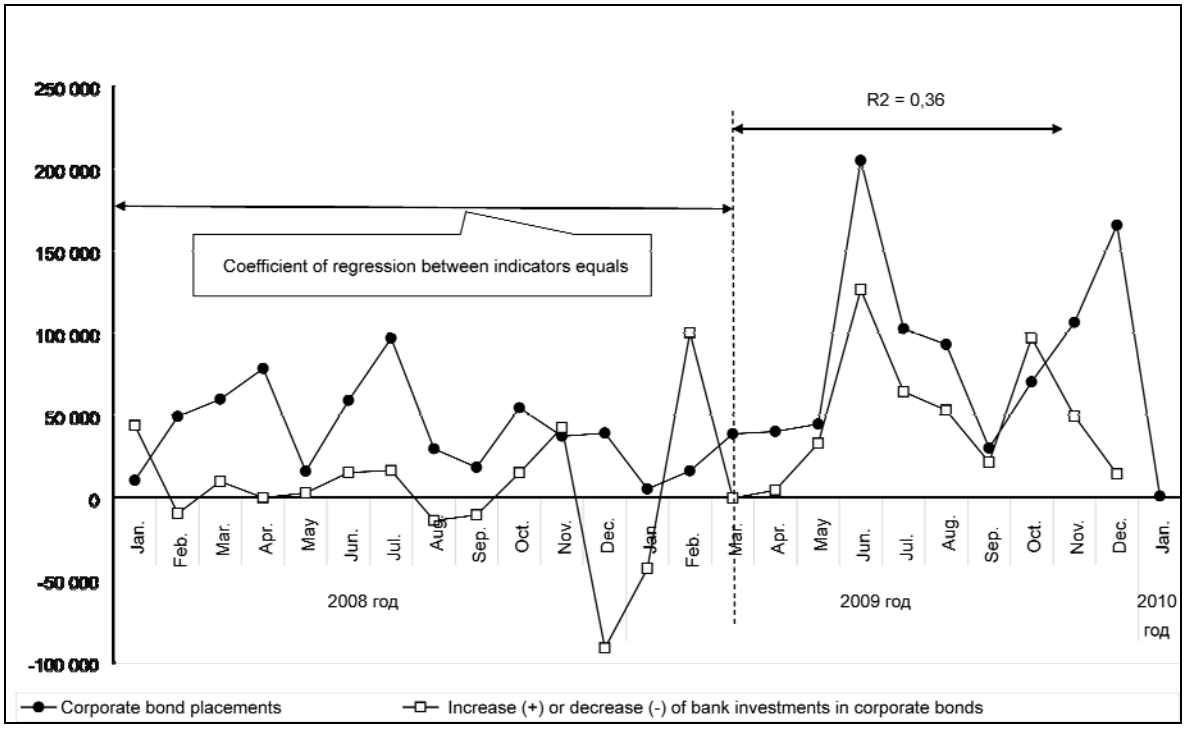


Source: Bank of Russia, MICEX stock exchange.

Fig. 20. Corporate bond trading and bank liquidity in 2001- January 2010

The recovery in the corporate bond market in 2009 even in the absence of carry trading strategies that had been continuously used since 2004 was made possible due to the use of Central Bank resources and liquid funds within the state budget to maintain liquidity in the banking system. *Fig. 21* shows that starting from February-March 2009, banks became the principal buyers of ruble denominated bond placements. Prior to the start of the financial cri-

sis there was no clear link between the growth in bank portfolios of corporate bonds and the placements of such bonds, with an R2 regression ratio of zero. However, in March – December 2009, the ratio increased to 0.4, pointing to correlation between the two sets of data[1].



Source: Bank of Russia, MICEX stock exchange.

Fig. 21. Correlation between corporate bond placement volumes and bank investment in such placements (millions of rubles)

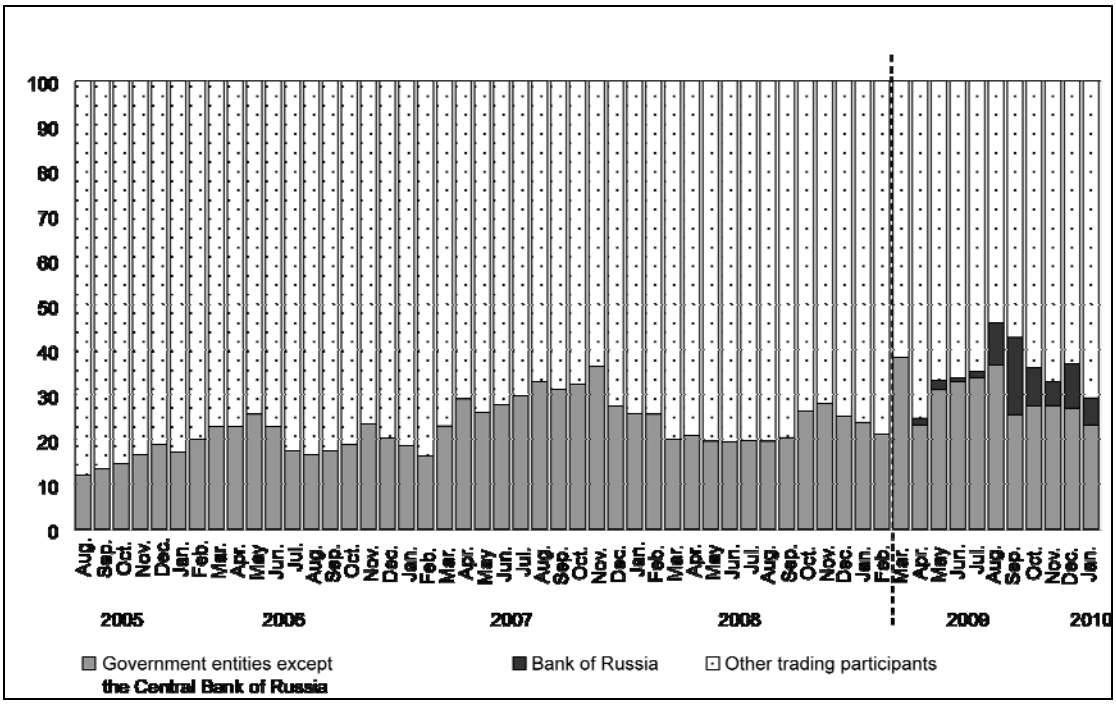
The reason for bank preference for purchasing corporate bonds rather than increasing loan portfolios given sufficient banking sector liquidity in 2009 is that unlike lending, corporate bonds are liquid instruments. Their liquidity was supported by the government both directly, with the Bank of Russia using direct repo transactions with government bonds to lend to the banking system and indirectly, by shoring up the liquidity of state banks that traditionally acted as creditors in the market of interbank borrowings collateralised by such bonds. By repeatedly using the bonds as collateral for repo transactions, banks are able to use 1:1 or 1:2 leverage, i.e. raise 1-2 rubles of funding in the form of loans collateralized by bonds for each ruble invested in underlying bonds.

Fig. 22 shows the percentage share of various trading participant groups (private financial companies, government entities[2], and the Bank of Russia) in the MICEX market trading volumes for corporate bonds for all types of transactions, including open market transactions, over the counter transactions, and repo transactions. The share of government entities in corporate bond trading significantly grew starting from March 2009, while the Bank of Russia

[1] From March to November this ratio equaled 0.7. It was only in November and December 2009 that other players, most likely pension system funds managed by Vnesheconombank, increased their participation in corporate bond placement activities.

[2] Government entities are listed in the footnote to *Fig 18*.

joined the market in April as a major and liquidity provider by means of repo transactions and other transactions.[1] From April 2009 until January 2000, the share of the Bank of Russia in corporate bond trading volumes at MICEX ranged from 0.7% to 17.3%.

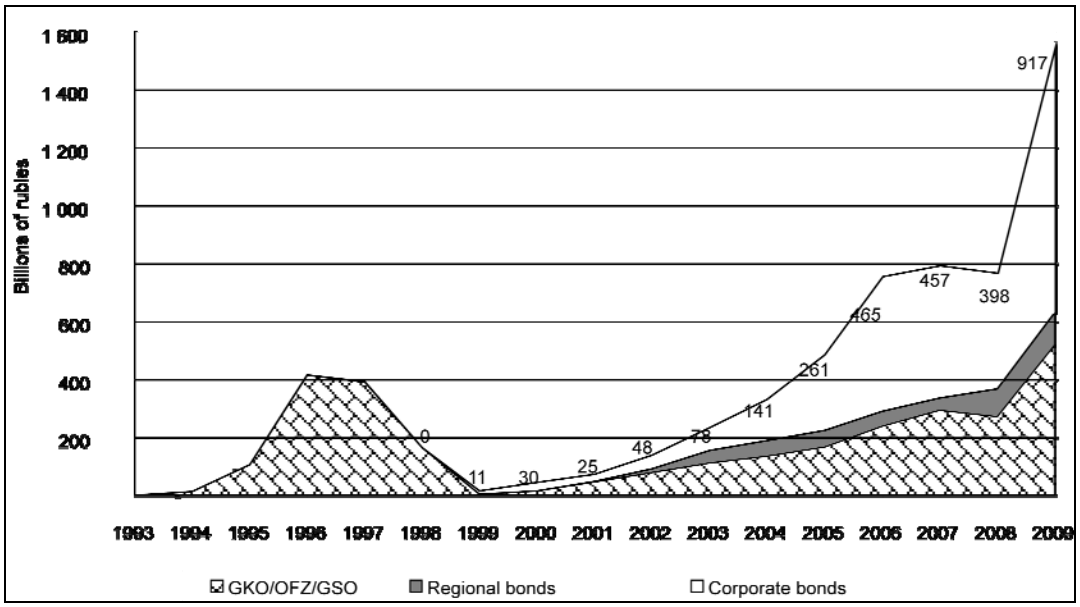


Source: MICEX stock exchange.

Fig. 22. The share of private and public entities in MICEX corporate bond trading volumes (%)

Fig. 23 shows an analysis of placement volumes not only for corporate bonds but also for ruble-denominated bonds issued by regional and federal governments. The placement volumes for federal and regional bonds in 2009 were considerably lower than corporate bond issues; however, these volumes set a record for the 2000s. Issues of Federal Borrowing Bonds (OFZ) and State Savings Bonds (GSO) increased from RUR 294 billion in 2007 and RUR 271 billion in 2008 to RUR 519 billion in 2009. The reasons for the increase in federal bond issues that was concentrated in the second half of 2009 are linked to the active policy measures by the Ministry of Finance aimed at mopping up excess liquidity in the banking sector that had increased due to the stalled growth of loan portfolios, including doing so by offering higher yields for such bonds compared to previous years. Regional bond placements grew from RUR 42 billion in 2007 and RUR 97 billion in 2008 to RUR 112 billion in 2009. The increased attractiveness of regional bonds for investors in 2009 was due to government support measures, similarly to corporate bonds.

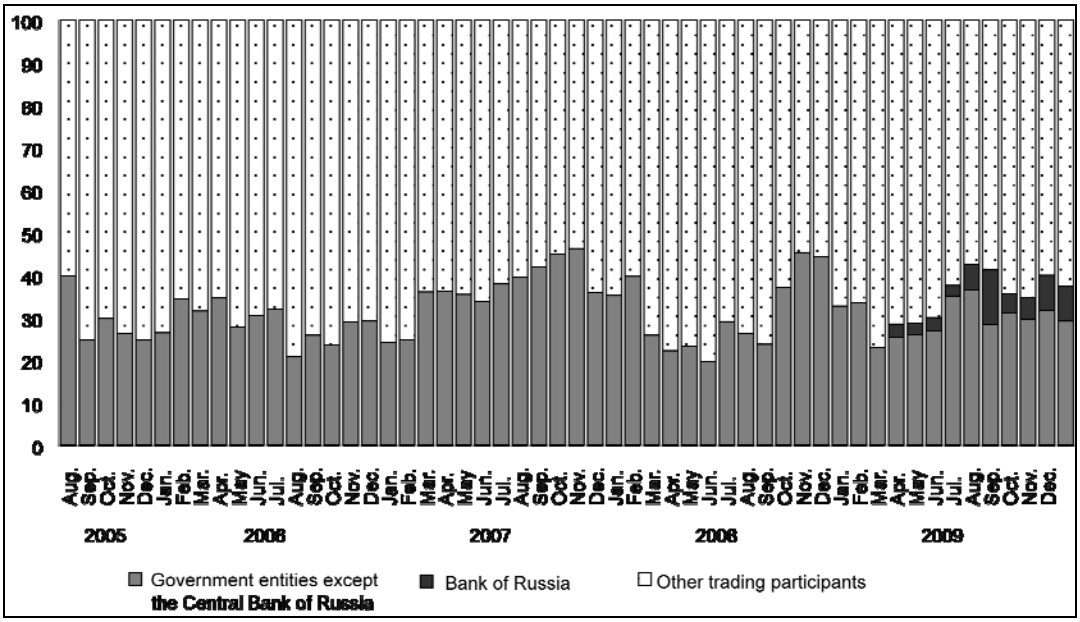
[1] The data on trading activity by the Bank of Russia shown in *Fig. 22*, exclude over-the-counter direct repo transactions by the Bank of Russia with corporate bonds.



Source: RTS trading system, IMF.

Fig. 23. Ruble-denominated bond placement volumes

Fig. 24 shows the share of government entities and the Bank of Russia in market trading volumes for regional bonds. Although the market share of government entities from the Bank of Russia was relatively unchanged from August 2008 to January 2010, it is obvious that a preservation of the share at level approximately 40% of the total volume of regional bond transactions was an important factor in supporting this bond market segment.



Source: MICEX stock exchange.

Fig. 24. The share of private and public entities in MICEX regional bond trading volumes, %

An effective mechanism of supporting the ruble-denominated corporate and regional bond market in 2009 was provided by the adoption of legislative amendments concerning the pension system that allowed to invest a proportion of pension system savings in non-government bonds. The Federal Law No 182-ФЗ, On Amendments to the Federal Law on Non-government Pension Funds and the Federal Law On Investing the Funds for Financing the Savings Portion of Labour Pensions in Russia both came into effect on July 18, 2009. According to the provisions of these laws, the state management company, whose duties are carried out by Vnesheconombank, is now able to invest the public pension savings into a broader investment portfolio that includes corporate bonds by Russian issuers, government guaranteed bank deposits denominated in rubles or foreign currency, mortgage securities, and bonds issued by international financial institutions. As of October 2009, data about the structure of the Vnesheconombank investment portfolio published at the Russian pension fund web site, showed that the portfolio did not contain corporate bonds. However, it is likely that the presence of the savings portion of the pension system in the non-government bond market increased in late 2009 – early 2010[1].

On the supply side, the growth in the ruble-denominated corporate bond market was driven by major state-owned companies. This was largely due to changes in the securities market legislation that facilitated the issue of traded bonds by using a simplified procedure for registering securities issues at stock exchanges instead of the Russian Federal Financial Markets Service. To promote greater stability in the corporate bond market, the allowed maturity for traded bonds was extended from one to three years. Bond issues were permitted not only for open joint stock companies but also for other business entities and state corporations.

Table 4 shows corporate bond placement data by issuer. Widespread defaults resulted in the bond market being effectively closed to second tier issuers. Principal corporate bond issuers in 2009 included natural monopolies (Russian Railways, Transneft, Gazprom), state corporations, Vnesheconombank, Atomenergoprom, and major private and state owned companies (LUKoil, AFK Sistema, VTB, Gazpromneft, MTS, the Novolipetsk Steel Mill, Severstal, MMK, etc). For many of these, the domestic bond market became a temporary substitute of foreign borrowings made difficult by the crisis of confidence in this market segment.

The crisis mitigation measures planned by the Russian government for 2009 envisaged the development of a mechanism of government guarantees for so-called infrastructure bonds to support the implementation of large scale development projects. However, the mechanism of such guarantees was not developed and consequently, no such bond guarantees were granted by the Ministry of Finance. It is most likely that the major companies and corporations sought to meet their domestic funding needs by way of issuing corporate bonds by reaching working agreements with state owned banks at top management level.

[1] According to media reports, the initial placement of corporate bonds in 2010, i.e. the 23rd tranche of the Russian Railways bonds with a total value of RUR 15 billion and maturing in 15 years, the largest purchaser that bought RUR 1 billion worth of bonds was believed by trading participants to be Vnesheconombank using pension savings funds. A. Mazunin, Bonds significantly in debt// Kommersant, February 5, 2010, page 10.

Table 4

Key ruble-denominated corporate bond issuers in 2009

	Issuer	Placement volume, millions of rubles	Market share, %
1	Russian Railways (RZhD)	145	15,8
2	Transneft	135	14,7
3	Vnesheconombank	60	6,6
4	LUKoil	50	5,5
5	Atomenergoprom	50	5,5
6	Bashneft	50	5,5
7	AFK Sistema	39	4,3
8	MTS	30	3,3
9	Housing Mortgage Lending Agency	28	3,1
10	VTB (VTB 24)	23	2,5
11	Sibmetinvest	20	2,2
12	Gazpromneft	18	2,0
13	VTB Leasing Finance	15	1,6
14	Mechel	15	1,6
15	MMK	15	1,6
16	Gazprom	15	1,6
17	Novolipetsk Steel Mill	15	1,6
18	Severstal	15	1,6
19	NIA VTB 001	14	1,6
20	Petrokommerz Bank	11	1,2
21	MBRR	10	1,1
22	Rosbank	10	1,1
23	Rosselhozbank	10	1,1
24	Vimpelkom Invest	10	1,1
25	Other issuers	113	12,3
	Total	**916**	**100**

Source: www.cBonds.ru, MICEX stock exchange.

Crisis mitigation measures taken by the Russian Federal Financial Markets Service to minimise stock markets risks

The current financial crisis gave rise to a number of innovations in the area of government stock market regulation. Due to the increased market volatility, the Federal Financial Markets Service imposed a ban on brokers for entering into unsecured (short sale) transactions on September 18, 2008. The ban was lifted on September 26, 2008 but was then reinstated on September 30 and remained in force until June 15, 2009.

Starting from September 25, 2008 the Federal Financial Markets Service limited the use of debt leverage for margin transactions[1] by brokerage clients. Prior to this restriction, brokers

[1] Margin transactions are securities purchase transactions by brokerage clients using borrowed funds. Unlike short sale transactions that are used to derive short term profits in a falling market, margin trading strategies are generally used in a growing stock market to derive incremental profits from using debt leverage.

were able to lend funds to their clients in an amount equal to the amount invested by such clients (1:1 leverage). Qualified investors, i.e. liquid and experienced brokerage customers, were able to borrow up to three times the amount of their investment from brokers. The above sanction by the regulatory body limited debt leverage for margin transactions for all types of investors to a ratio of 1:1. The right to use 1:3 leverage for qualified investors was reinstated with a number of additional restrictions starting from June 15, 2009.

The regulatory rationale behind the measures to ban short sales and limit margin trading was apparently to prevent speculative traders from exacerbating the market slump by short sales (where market participants sell securities borrowed from a broker using falling market expectations), as well as to limit the risk of a new market bubble and to protect the investors using margin trading strategies from significant losses. The introduction of such restrictions requires the effective and constant monitoring of all broker operations by the Federal Financial Markets Service, which is still missing[1]. Despite sanctions imposed on two major brokerage companies, Brokercreditservice and Finam that breached the short sales ban while it was in effect, and despite their managers and owners having their market participant qualifications annulled, there can be no certainty that all other market participants followed these regulations. These restrictions on the debt leverage that could be made available to brokerage clients could also be legally sidestepped.

The question remains as to the appropriateness and effectiveness of these measures in the stock market. The restriction on margin trading had little sense in a falling market, as such strategies are only profitable for investors in growing markets. Therefore, the 1:1 leverage restriction for margin trading for all market participants did not hinder the operations of most participants and may have aided certain less experienced investors in avoiding losses. During the acute phase of the crisis up to February 2009, as well as later, most market participants avoided margin transactions of their own account due to fears of a crisis relapse. This in turn significantly affected broker revenues that are mostly made up of interest income on margin loans to clients. A. Shemetov, Director General of ATON, one of the leading brokerages, whereas 60-70% of pre-crisis broker revenues derived from margin lending, and the rest was made up of brokerage commissions, during the acute phase of the crisis the situation was reversed, with brokerage commissions accounting for 60% of revenues. [2]

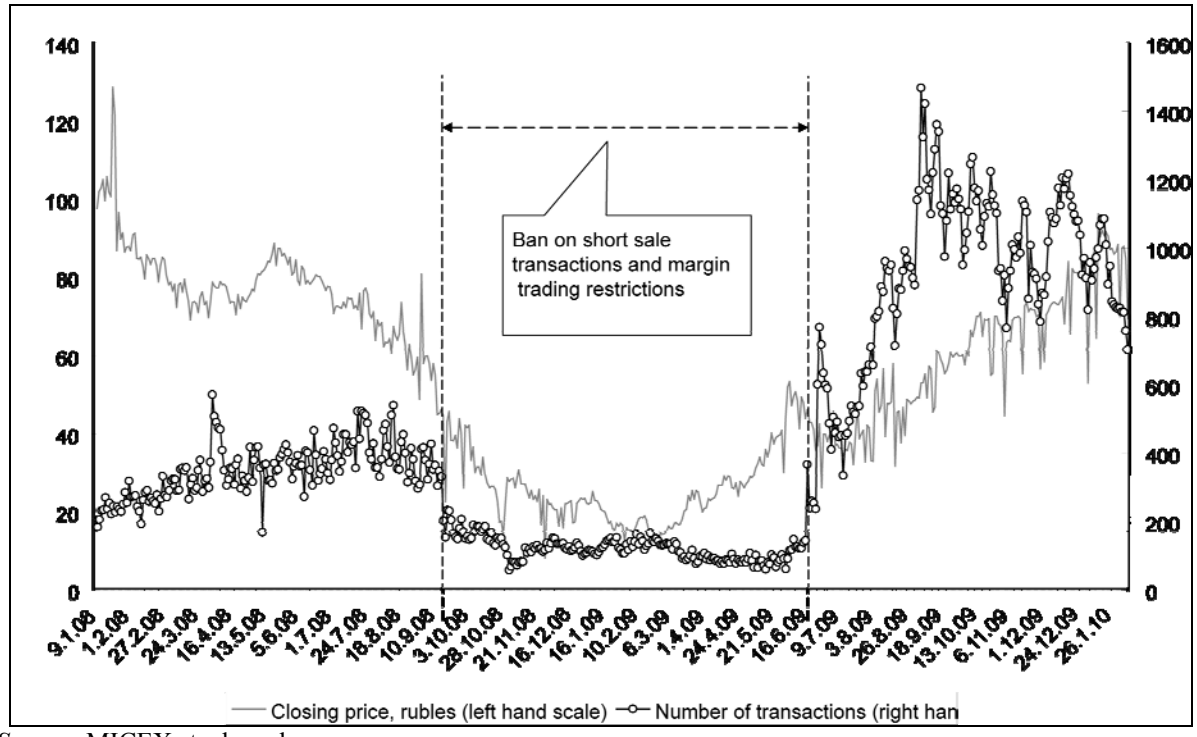
Indirect confirmation of general market participant compliance with margin lending restrictions starting from mid-September 2008 until the middle of June 2009 is provided by the date are shown in *Fig. 25* regarding the number of repo transactions involving Sberbank ordinary shares that are the most liquid traded instrument at the MICEX stock exchange. Repo transactions involving shares are a popular instrument used by brokers at MICEX to raise

[1] The authors of the Report on the results of the 2008 study of the effectiveness of the legislative and regulatory framework for financial market and securities market operations with a view to stabilising the financial system, carried out at the Federal Financial Markets Service and the Ministry of Finance (upon request) by the Audit Chamber of the Russian federation, "there is no analysis being systematically carried out with regards to monitoring and evaluating the stock market situation by government agencies, while the stock market activities of large financial institutions are not being monitored or analyzed, which leads to the absence of comprehensive and accurate information concerning the situation in the Russian stock market for the Russian government and top officials. Audit Chamber Bulletin, No. 1, 2010, page 100. Published at http://www.ach.gov.ru/userfiles/bulletins/05-buleten_doc_files-fl-1855.pdf

[2] V. Kudinov, Short sales transactions are coming back, Vedomosti, June 15, 2009.

funding in the financial markets for further on-lending to fund margin transactions by their clients.

By way of evaluating the impact of regulatory measures on trading activity for the most liquid MICEX traded stocks as exemplified by Sberbank shares that were the most actively traded blue chip stock at MICEX in 2009, *Fig. 25* shows that while the restrictions on margin lending remained in effect from September 16, 2008 to June 15, 2009, the number of repo transactions in the stock market was significantly lower than in other periods.



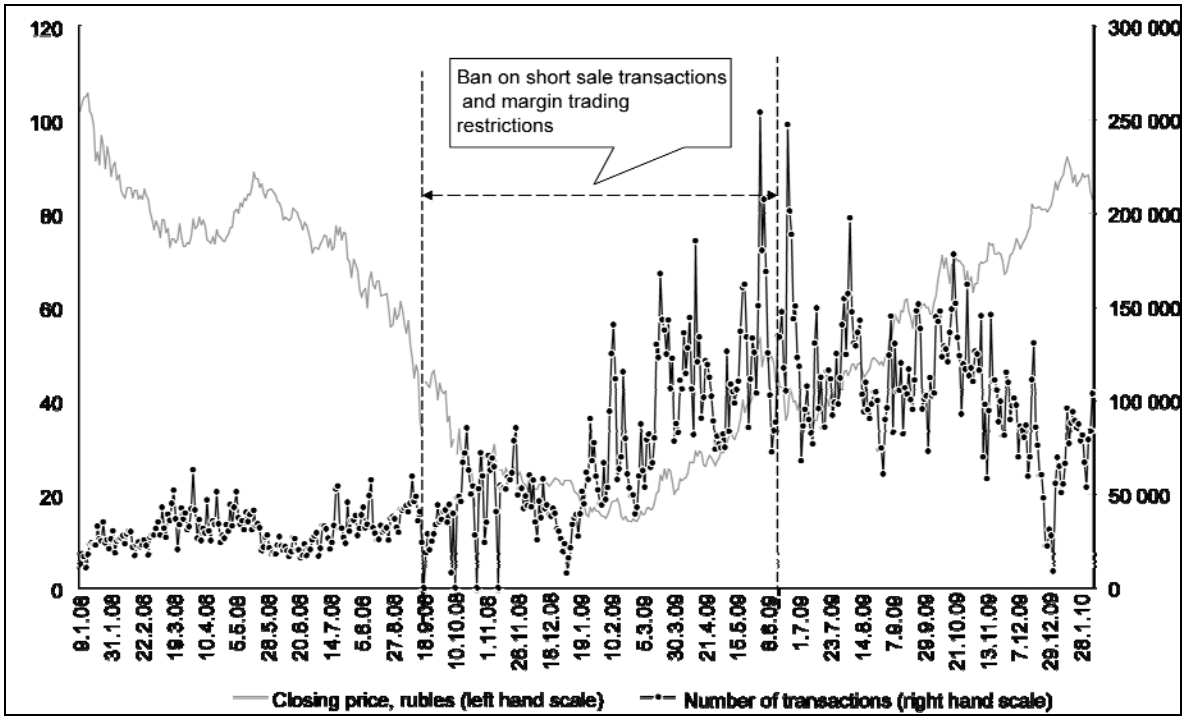
Source: MICEX stock exchange.

Fig. 25. Repo transactions with Sberbank ordinary shares

The issue of appropriateness of the short sale transaction ban is less clear. Unlike margin trading, interest in which naturally dropped in the falling market, short sale transactions were in demand by market participants at that time. Short sale transactions and are investors to derive profits from a falling market. Playing on falling market expectations entails natural limitations for investors in terms of managing risks, which limits their potential of further exacerbating the market drop. For this reason, regulator fears that such trading strategies could seriously affect the extent of the Russian stock market downfall have questionable grounds. The above downfall was primarily caused by the flight of short-term foreign investors from the Russian market that was not affected by the restrictions imposed by the Federal Financial Markets Service.

The economic expediency of short sale transactions set against a weak regulatory background led to frequent breaches of such restrictions, as evidenced by the sanctions imposed on the top managers of two major brokerages mentioned above. Such breaches are also indirectly evidenced by the number of market transactions involving Sberbank shares at MICEX prior to the introduction of the ban on short sale transactions, during its validity, and following its lift-

ing (*Fig. 26*). The imposition of the ban on short sale transactions in mid-September 2008 had no impact on the number of transactions with the most liquid securities. Moreover, that number grew steadily up through the middle of June 2009 when the ban was lifted. In all likelihood, market participants found other legal means of enabling their clients to enter into short sale transactions.



Source: MICEX Stock Exchange.

Fig. 26. Market transactions with Sberbank ordinary shares

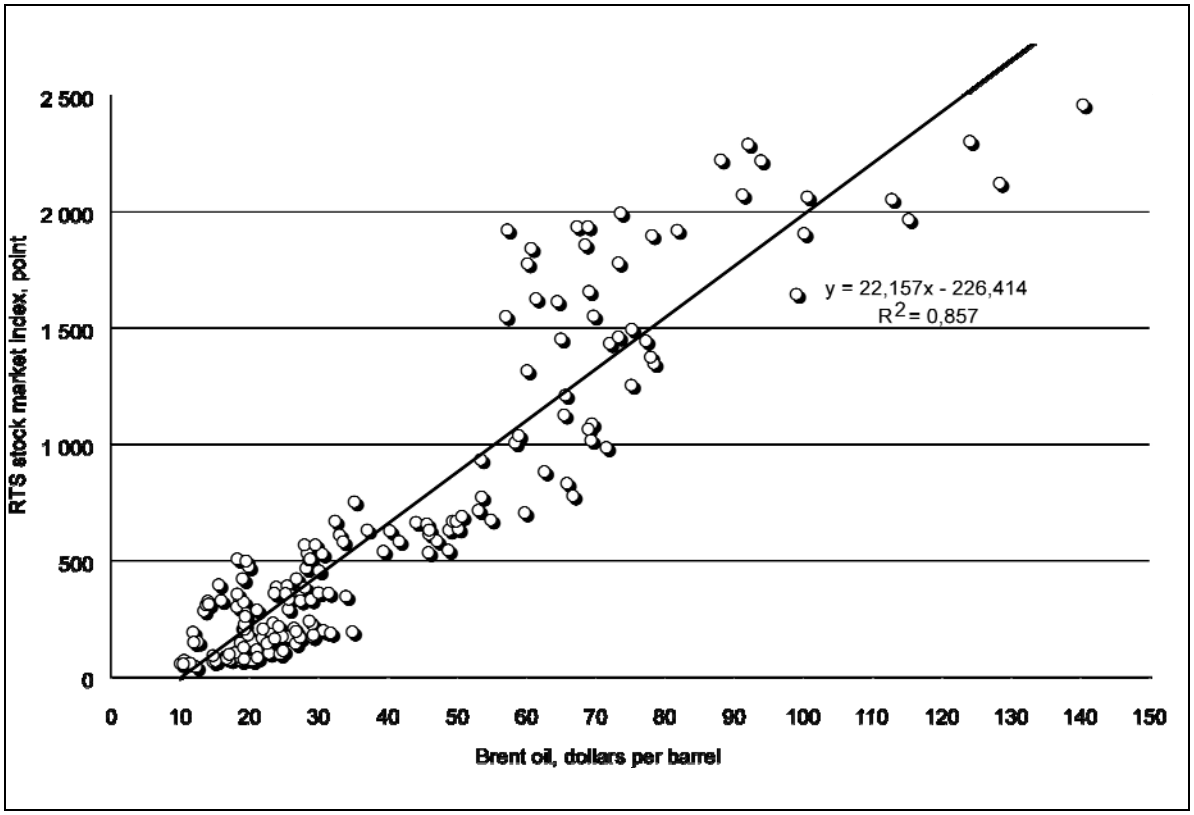
2.4.5. Principal financial market risks

Based on the outcome of the 2008-2009 crisis so far, principal financial market risks are to do with the excessive dependence of the economy and stock market on oil prices; the growth of new market bubbles in the stock market and ruble-denominated bond market due to excess liquidity, fast rates of growth for foreign borrowings by banks and real sector companies, risks of foreign capital flight, devaluation of the ruble, growth of forward market trading volumes given insufficient transaction coverage, growing risks in the repo market, and the low capacity of the financial services market that stands in the way of increasing the capitalisation of financial intermediaries.

Dependence of the stock market on oil prices

Similarly to the economy as a whole, the Russian stock market is highly dependent on oil prices. This is clearly shown in *Fig. 27* that traces the correlation (R2 regression ratio) between absolute monthly RTS index values and Brent oil prices throughout the existence of this stock market index and up to December 2009. The R2 ratio between these sets of data equals 0.86, which points to a close correlation between these parameters. Given the low di-

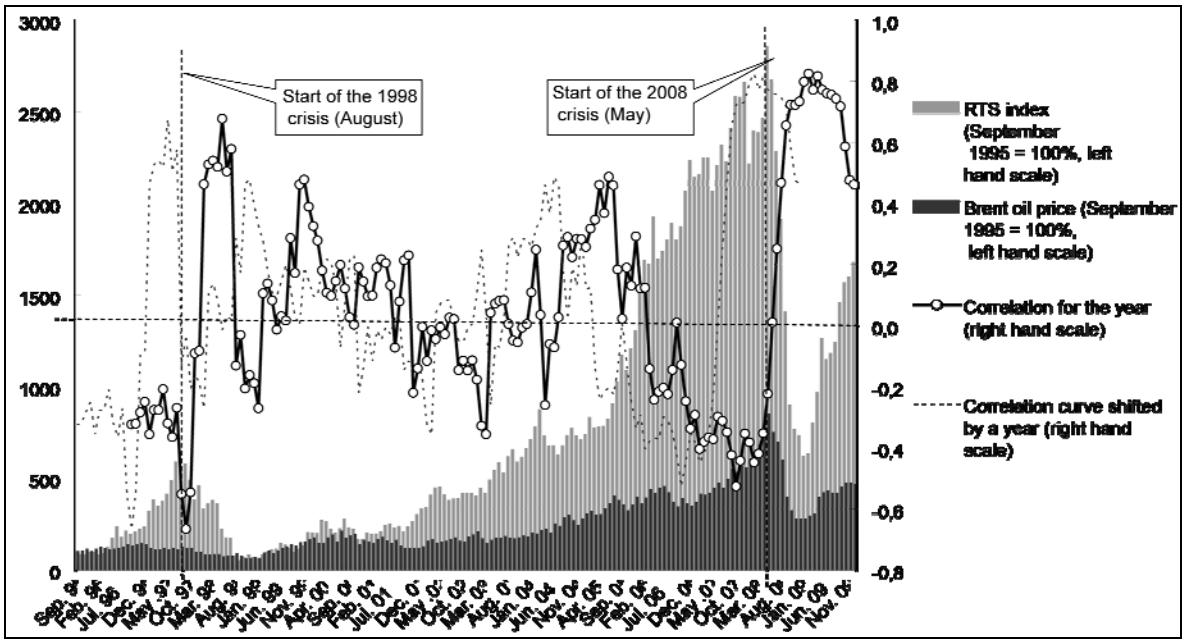
versification in the economy, the oil price plays a key role in determining the prices of Russian blue chip stocks and thus the value of portfolios underlying stock market indices.



Source: calculations based on IMF IFS and the RTS trading system

Fig. 27. Correlation between the RTS stock market index and Brent oil price from September 1995 to December 2009

The link between oil prices and stock market indices is also evidenced by data in *Fig. 28* that shows the changes in the correlation coefficient between the relative monthly changes in the RTS index and Brent oil prices in a 12-month period. The sliding correlation curve is characterized by the 12-month delay in showing the strengthening or weakening of the link between the two indicators. However, superimposing various data on the data sets in *Fig. 28* shows additional relationships. Immediately preceding the peak index values prior to the 1997-1998 and 2007-2008 financial crises, the correlation coefficient fell sharply, to reach -0.67 in September 2007 and -0.53 in October 2007. After reaching bottom in October 2007, the correlation coefficient rose abruptly to reach near-maximum levels (approaching 1). Thus with the onset of a crisis, stock market indices and oil prices move simultaneously and in the same direction. The correlation ratio then decreases several months later as the stock market recovers.



Source: calculation using IMF IFS and RTS trading system data.

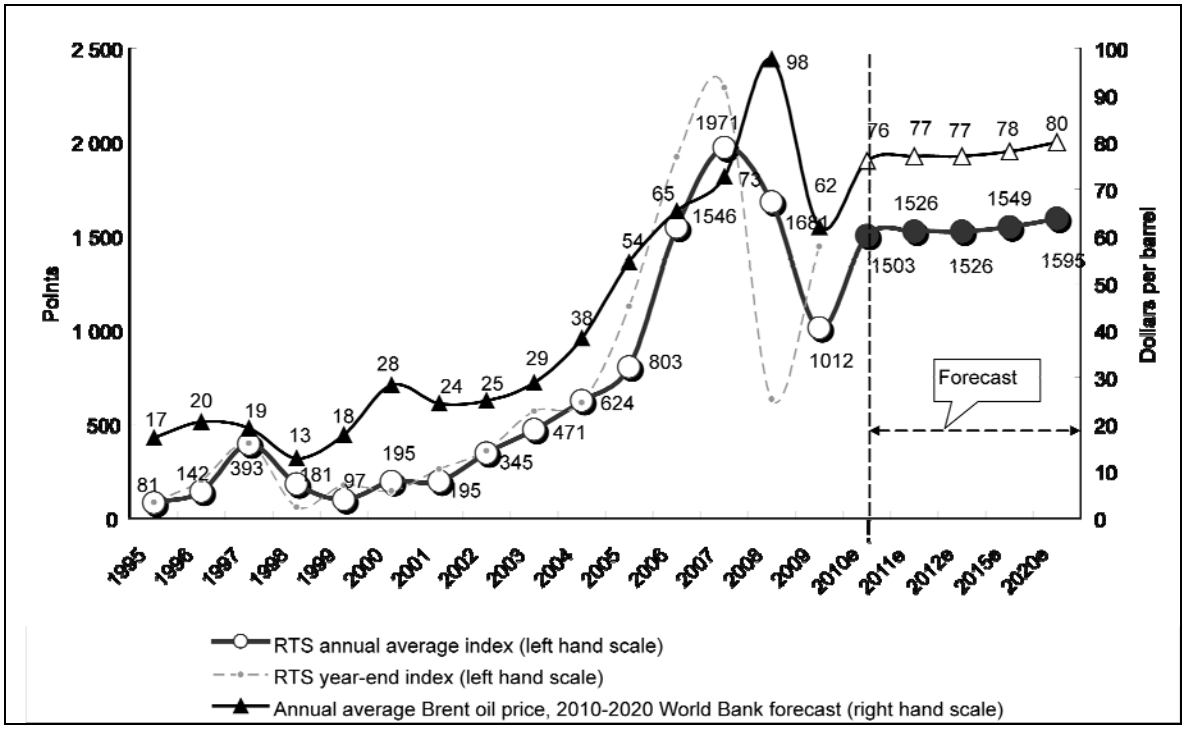
Fig. 28. Correlation between RTS stock market index changes and Brent oil price changes from September 1995 to December 2009

The above cyclical fluctuations of the sliding correlation curve are due to economic reasons. RTS index values are largely determined by the oil price. Furthermore, the Russian market is highly sensitive to the behavior of short-term foreign investors. The onset of a financial crisis is generally preceded by euphoria on the part of such speculative investors. Several years of Russian stock market growth fueled by oil prices tend to lead to the mass influx of foreign portfolio investments (see *Fig. 34* below for more details), which in turn leads to rapid growth in stock prices and high yields that attract yet more investors. Stock market growth accelerates regardless of oil price dynamics. In this case the sliding correlation curve moves into the negative zone. The market per se lacks the prudence to stop the growth euphoria, and a strong external impulse is needed to stop the investor rally, which is effectively provided by the oil price shock. Faced with falling oil prices, foreign investors become aware of the Russian economy and the stability of the national currency are anchored on energy sector export revenues. Speculative capital flees the country, and the close relationship between oil prices and the RTS stock market index is restored until the next instance of foreign portfolio investor euphoria.

The current level of Russian stock market dependence on oil prices is one of the principal risk factors for investors. Estimates by international financial institutions, in particular the World Bank and the IMF, shown in *Fig. 29*, do not foresee significant growth in oil prices similar to that seen in the 2000s. World Bank data estimate oil prices at 76 dollars per barrel in 2010, 77 dollars per barrel in 2011-2012, 78 dollars per barrel in 2015, and 80 dollars per barrel in 2020. Based on the regression equation describing the relationship between the RTS

index and annual oil prices, it is possible to determine the average annual values of the RTS index for the coming decade. [1]

In this case, average annual values of the RTS index (see *Fig. 1*) shall remain at their present level of 1,500-1,600 points for several years, which means that, unless the Russian economy undergoes modernisation and becomes more diversified, the internal stock market will stagnate for 10 years, which does not rule out high volatility. In this case, the recovery of the RTS index, unlike the present "V-shaped" scenario, can take place under an "L-shaped" scenario lasting several years, similar to that for the DJIA index following the Great Depression, the Japanese Nikkei 225 index after its collapse in 1989, or the NASDAQ index after the Internet bubble crash in the early 2000s.



Source: calculations based on price change forecasts for goods published at the World Bank web site www.worldbank.org, and RTS trading system data.

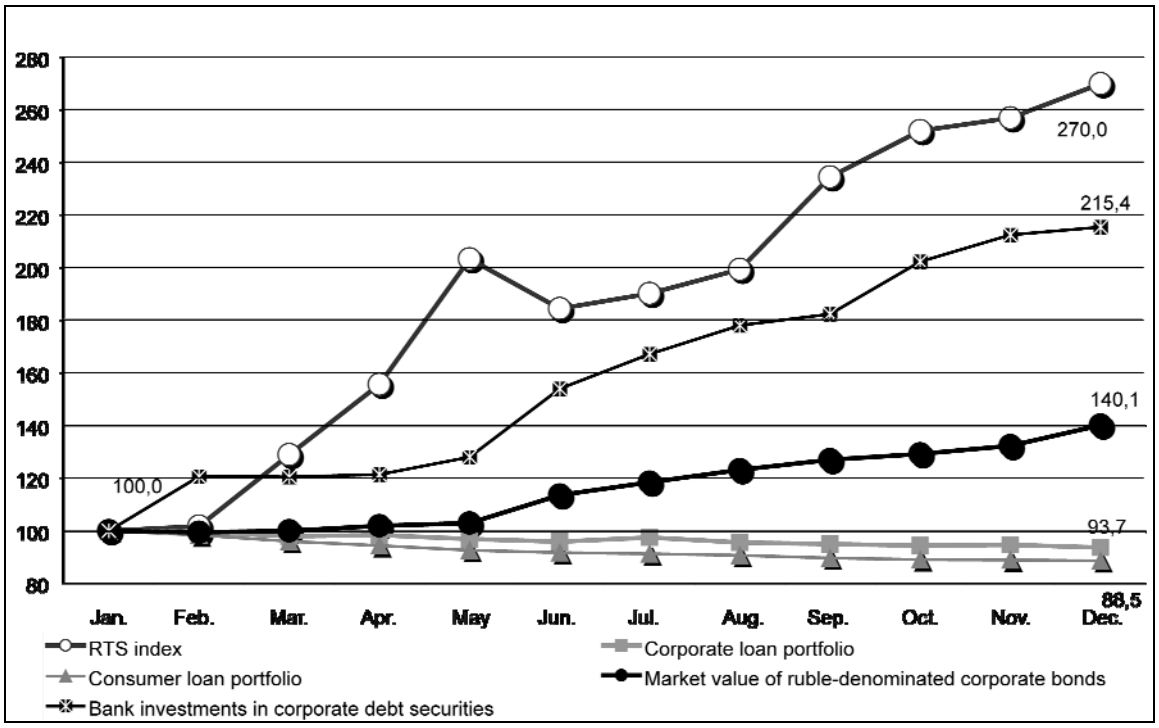
Fig. 29. RTS index forecast up to 2020 based on World Bank oil price forecast

Emergence of new market bubbles in the stock market and ruble-denominated bond markets due to excess liquidity in Russia and globally

Another risk in the Russian stock market that may lead to the emergence of new market bubbles in the stock market and ruble-denominated bond markets despite the expected oil price stagnation forecast by international financial institution experts is represented by the excess liquidity accumulated in financial markets. The principal reasons for its accumulation in the domestic market include the funds injected into the banking system by government crisis mitigation policies have not yet been channelled into lending, as well as the renewal of foreign funding for domestic stock market operations using carry trading strategies.

[1] Provided that the Russian economy does not become more structurally diversified the relationship between oil prices and the indices remains unchanged

Fig. 30 shows the growth rates for equity market capitalisation and corporate bond market value indicators compared with the trends in bank loan portfolios. From January to December 2009, the RTS index grew by 170.0% and the aggregate market value for ruble-denominated corporate bonds increased by 40.1%. At the same time, bank corporate loan portfolios decreased by 6.3% over the same period and consumer loan portfolios decreased by 11.5% while bank investments in corporate bonds grew by 115.4%.



Source: calculations based on Bank of Russia and RTS trading system data

Fig. 30. Trends in the RTS index, loan portfolios, and the corporate bond market in 2009 (January 2009 = 100%)

According to Goldman Sachs analysts, Russia belongs to a small group of countries that tightened rather than relaxed their monetary and lending policies as a response to a financial crisis. [1] There was a certain logic behind the decision, since the government feared widespread payment defaults. At the peak of the crisis, from December 1, 2008, to April 23, 2009, the Bank of Russia established a base refinancing rate of 13%, one of the highest among G20 countries, that de facto put a stop to bank loan refinancing. Only starting from April 2009, the Bank of Russia began gradually lowering the rate to its current level of 8.75%. The high refinancing rate was meant to deter banks from the temptation of using government funding to finance ex-ante doubtful loans. In our opinion, this measure served more as protection against fraud than as a barrier to real lending, since even if the rate had remained low throughout the crisis, high demand for funding from responsible entrepreneurs would have been unlikely due to their uncertainty regarding the return on future investment projects. For this reason the ma-

[1] D. Butrin, Russian monetary policy does not follow BRIC standards //Kommersant, February 9, 2009, page 2.

jority of countries, with the exception of China, experienced similar lack of loan portfolio growth despite their refinancing rates being close to zero.

The greatest challenge faced by the Bank of Russia after the crisis is to convince entrepreneurs of the need for increased borrowings and of the likelihood of investing borrowed funds in effective investment projects[1].

If entrepreneur expectations remain unchanged and demand for borrowed funds is not restored, the banking system will continue accumulating excess liquidity that may channelled into the stock and corporate bond markets. Moreover, as the markets for foreign borrowings recover, banks and foreign hedge funds may revert to the use of carry trading strategies to raise funds for investments in ruble-denominated bonds. According to IMF experts, the involvement of emerging market banks in carry trading to fund consumer lending is one of the principal financial market risks in these countries. [2].

Unlike banking sector loan portfolios, bank investments in corporate bonds have experienced rapid growth. In our opinion, this is due not only to the greater liquidity of bonds compared to loans but also to a number of negative factors, such as less stringent material and moral liability standards for bond market operators compared to lenders, as well as the lack of professionalism among bank staff. Corporate lending requires thorough knowledge of the current financial condition and business prospects of the lenders on the part of bankers. In this case, there exists responsibility personal for the bank specialists who carry out borrower due diligence and approve lending decisions. In the case of bonds, the process is simplified. Bank employees do not need to perform in-depth financial analysis of issuers. Under the provisions of the securities market legislation, bond issuers are required to disclose all relevant information to all potential investors. This largely absolves bankers of the responsibility for the accuracy and completeness of the relevant information considered in investment decisions. Meanwhile, many issuers default on their bonds, and many investors incur losses, during crises. The responsibility of specific financiers within issuer companies defaulting on bonds and of bank employees who took investment decisions with respect to such bonds is diluted among many people. The greater the number of people involved, the more difficult it is to establish individual material and moral liability. This issue that became evident during the past crisis is no less significant than the «too big to fail» issue with respect to avoiding the bankruptcy of the largest banks that attract retail deposits.

Ruble devaluation risk

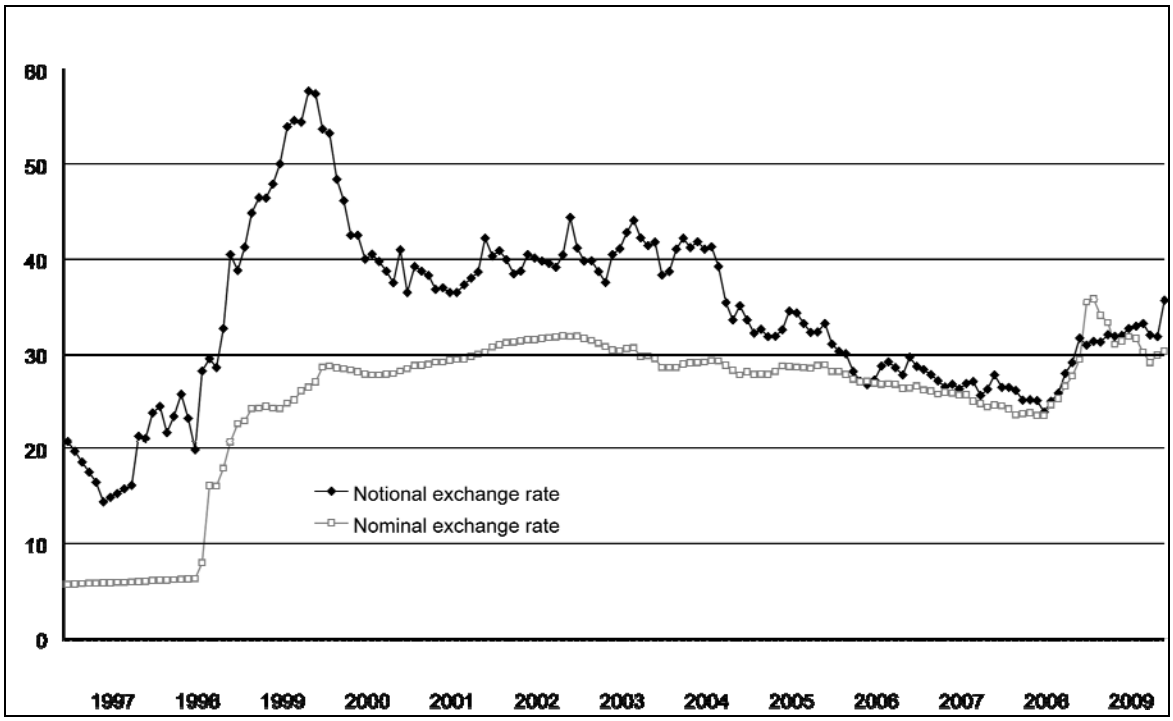
The devaluation of the ruble is a continuing risk in the Russian financial market. The data shown in *Fig. 31* lead to the assumption that for the past several years, monetary authorities in Russia have followed an informal rule that the nominal exchange rate of the ruble to the US Dollar be in line with its notional exchange rate estimated by dividing the M2 money supply aggregate by the amount of foreign exchange reserves [3]. This rule in essence is reminiscent of

[1] The Governor of the Bank of Russia stated in his speech to bank representatives on February 4, 2010, that given the recent trends for increasing stability of the national currency, its moderate volatility and the growth of the M2 money supply aggregate in the economy, bank loan portfolios are expected to grow by 20% in 2010. Moreover, "a lending rally is expected by the end of the year that may even need to be curtailed in the interests of combating inflation". S. Dementieva, Russia's glorious rally// Kommersant, February 5, 2010, page 1

[2] IMF. Global Financial Stability Report. Financial Market Turbulence: Causes, Consequences, and Policies. September 2007 P. 22–25.

[3] The author has not encountered admissions by officials with regards to following this rule.

the "foreign exchange reserve standard" whereby the ruble money supply must be backed by a certain amount of gold and foreign exchange reserves. In cases when the public initiates large-scale purchases of US Dollars, the exchange rate in rubles is in line with the coverage of the ruble money supply by such gold and foreign exchange reserves; thus in these situations, an increase in the notional dollar exchange rate is an early indication of an impending ruble devaluation.



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

Fig. 31. Relationship between the nominal and notional (calculated) US Dollar exchange rates

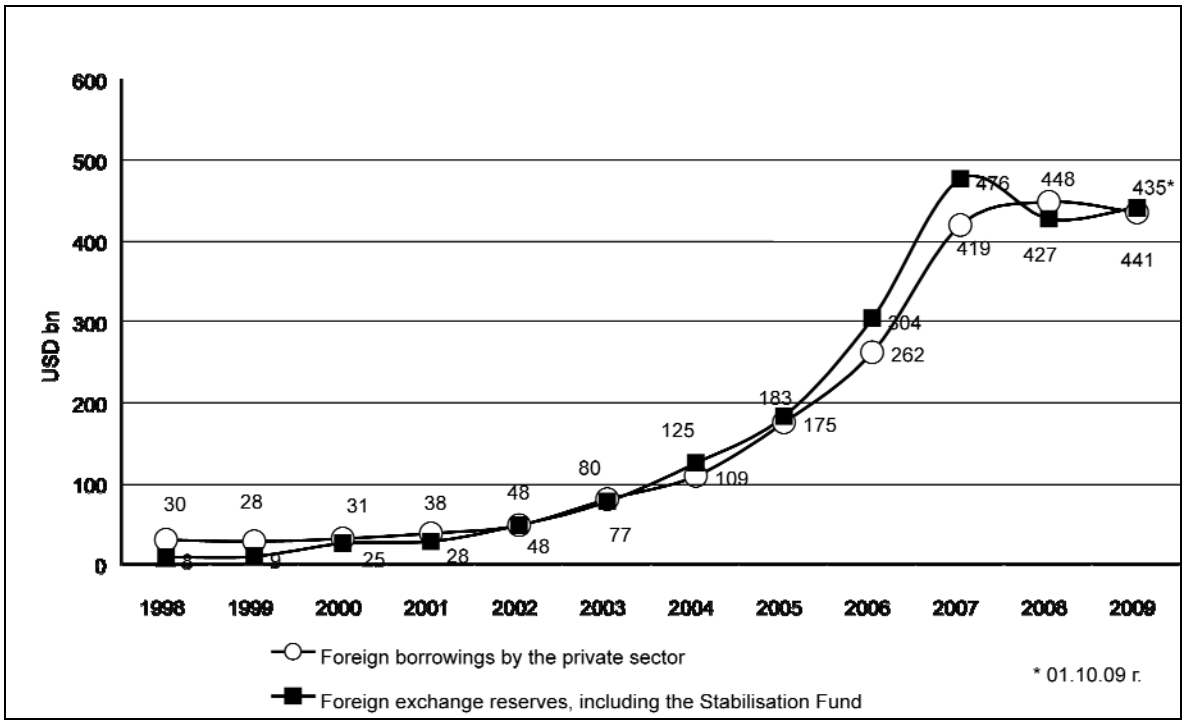
In late 2009 the growth rate of the notional dollar exchange rate significantly exceeded that of the nominal exchange rate, with the former rate reaching 35.6 rubles in December 2009 versus the official nominal exchange rate of 30.24 rubles. This was due to the faster growth rate of the M2 money supply indicator, especially in December 2009 due to increased pension payments, the customary year-end completion of construction projects and payments for government contracts, the attempts of entities financed from the state budget to fully utilise their annual budget allocations, and year-end bonus payments at private companies. These factors jointly contributed to the significant growth of ruble cash in public hands and on bank deposits. The likelihood of increased state spending from the Reserve Fund as a way of financing pension payments, the expected increasing monetisation of the GDP, the slower growth of oil prices, all point to the growth rate of the notional dollar exchange rate continuing to outstrip the growth rate of the actual nominal rate, which in turn translates into a higher ratio between the ruble money supply and the foreign exchange reserves and will push government in the direction of further devaluation of the ruble.

In addition, the policy of weakening the ruble exchange rate is advantageous for the state from the point of view of fostering the growth of value-added sectors of the economy and re-

stricting the influx of speculative foreign capital. For these reasons the gradual devaluation of the ruble in the post-crisis period is considered highly probable.

Risk of excessive foreign borrowings by banks and real sector companies

The foreign indebtedness of the private sector is practically equal to Russia's total foreign exchange reserves (see *Fig. 32*) and remains a significant risk for the national financial system. The fact that the amounts of foreign exchange reserves and foreign corporate borrowings have practically coincided throughout the 2000s points to a relationship between these categories. On the one hand, the concentration of a portion of value added created by business in foreign exchange reserves creates a necessary safety cushion for the financial system and checks the excessive strengthening of the ruble. On the other hand, the removal of such funds from business revenues in the global economic context has a negative impact on and creates complications for sustaining and fostering the national businesses that generate such revenues. To keep their operations at a sustainable level, entrepreneurs need to compensate for the deductions channelled into the national foreign exchange reserves by obtaining foreign borrowings. Therefore, despite the crisis and government pressure to decrease the foreign borrowings by large state-owned companies, it has so far been impossible to bring about a significant reduction in foreign borrowing volumes.

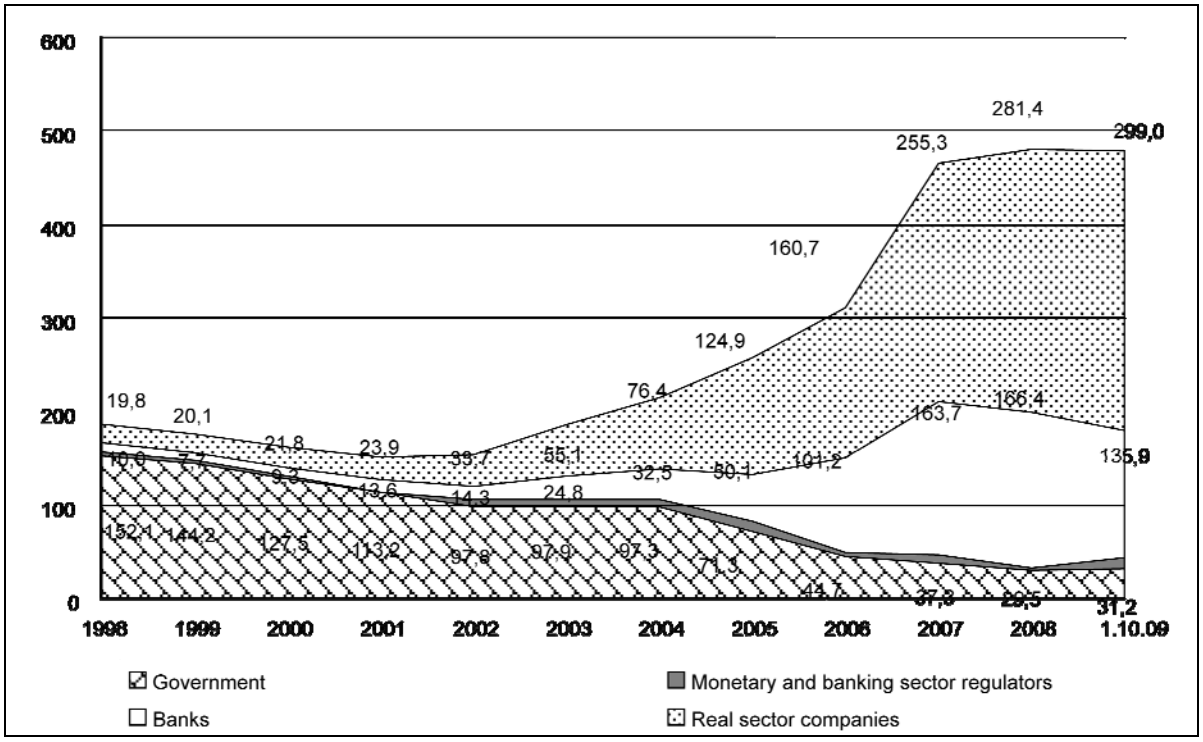


Source: balance of payments data.

Fig. 32. Growth in private sector borrowings and state reserves

Fig. 33 shows separate data for foreign borrowings by banks and corporates. As of September 2009, foreign borrowings by banks decreased from US$166.4 billion to US$135.9 billion, while corporate foreign debt increased from US$281.4 billion to US$299.0 billion. As shown previously in *Fig. 10* and *Table 3*, the decrease in foreign bank borrowings was only

made possible by substantial lending to the banking sector by the Bank of Russia, the Ministry of Finance, and Vnesheconombank, and by the gradual devaluation of the ruble. In other words, foreign bank debt was partially repaid and replaced by borrowings ultimately derived from the foreign exchange reserves. Unfortunately, it is unlikely that the Russian financial sector will be able to raise of cheap funding in volumes sufficient for its development from the state or from retail deposits. The principal hopes of private banks in this regard are for the resumption of carry trading, which will in turn translate into renewed growth of foreign borrowings by the banking sector.



Source: balance of payments data

Fig. 33. Foreign debt of the Russian Federation, 1999-2009 (January through September 2009), billions of dollars

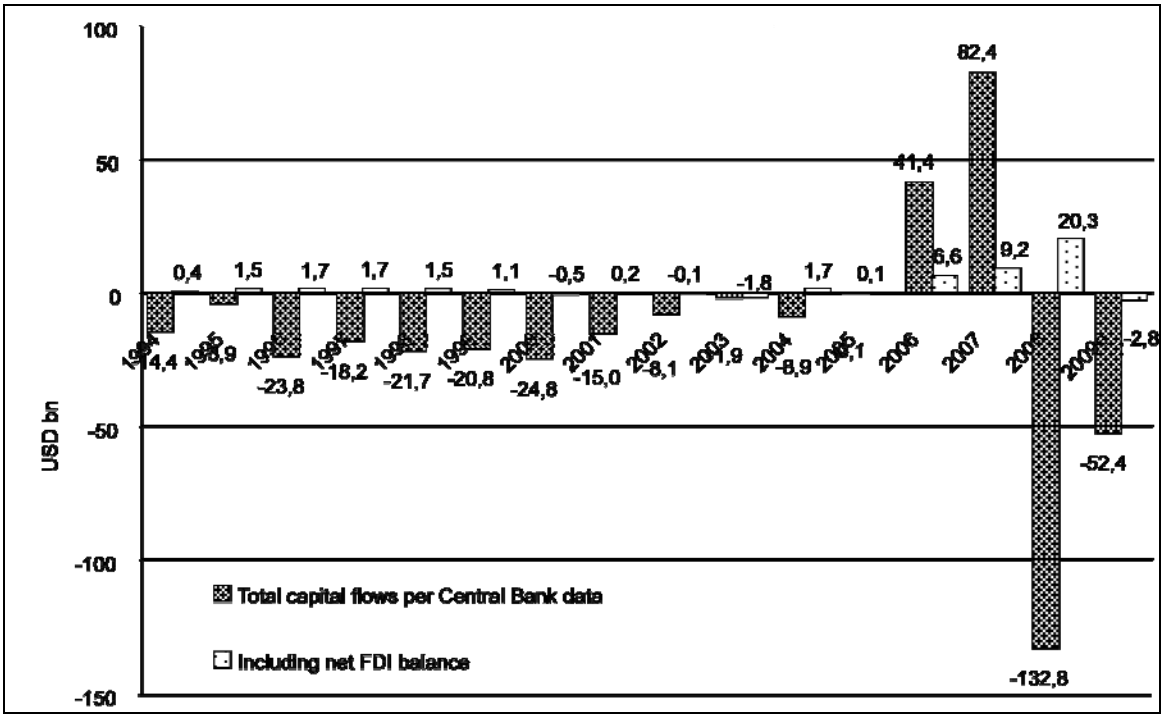
The principal risks related to the increase in corporate foreign borrowings are related less to the short-term debt service in the next 1-2 years and more to the long-term perspective. If the assumption that the national foreign exchange reserves are the "reverse side of the coin" of foreign private sector borrowings is true, it means that in the medium term, banks and corporates will be unable service their foreign debt independently, without recourse to foreign exchange reserves. Meanwhile, channelling reserve funds for these purposes can significantly weaken the ruble and cause other problems in the financial system.

Risk of foreign capital flight

The Russian financial market is still highly dependent on short-term foreign capital movements. Capital flight may be triggered by expectations regarding devaluation of the ruble, weak macroeconomic indicators, the decrease in national foreign currency revenues due to

lower prices for raw material exports, and budget and monetary policy restrictions in international financial markets.

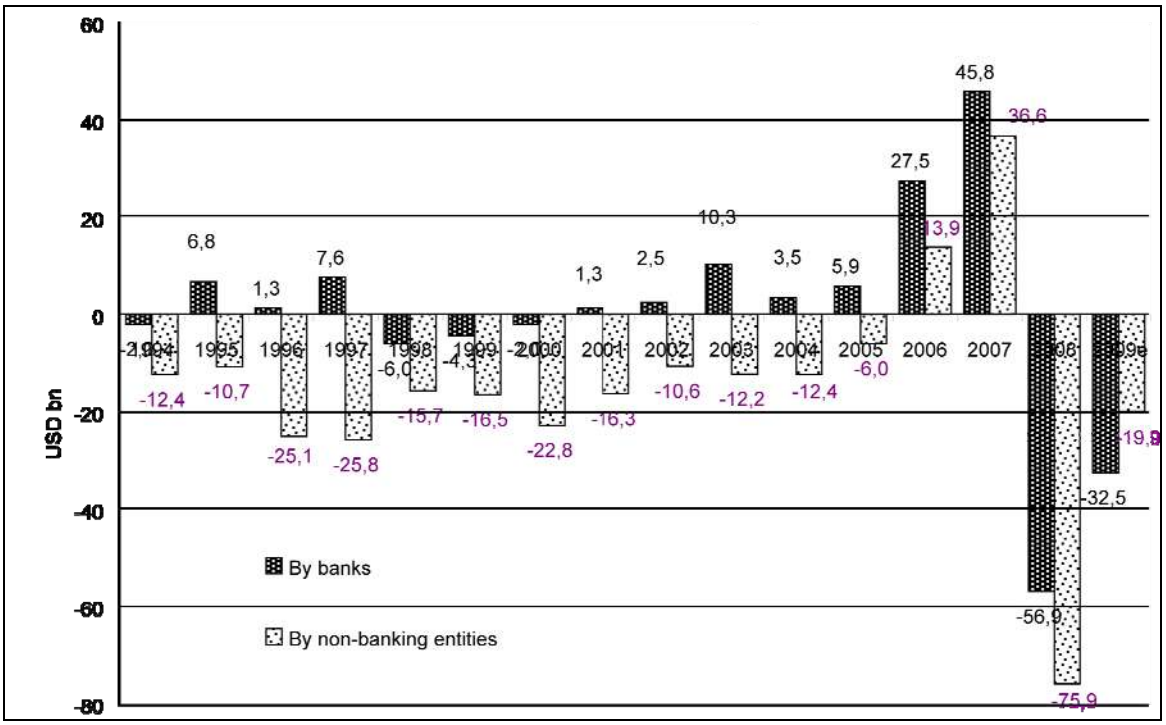
As shown in *Fig. 34*, capital flight from Russia in 2008 amounted to US$132.8 billion. Since the foreign direct investment (FDI) balance was positive at US$20.3 billion, the actual amount of short-term investments withdrawn from Russia stood at US$153.1 billion. The Bank of Russia estimates capital flight from Russia at US$52.4 billion in 2009, including US$2.8 billion in FDI.



Source: Bank of Russia.

Fig. 34. Capital inflows and outflows: total flows and FDI flows

Considering that servicing the needs of short-term foreign investments is an integral component of Russian bank carry trading strategies, it is unlikely that such investments will disappear or will be significantly reduced in the near future. *Fig. 35* shows that in 2009, banks channelled the bulk of the outflow of short-term investment amounts. This in turn means that the Russian stock market will continue to remain highly volatile. A more complex challenge for the Russian economy and financial sector is the attraction of foreign direct investments and of portfolio investors by conservative foreign investors (mutual funds, pension funds, insurance companies, investment funds, etc.)



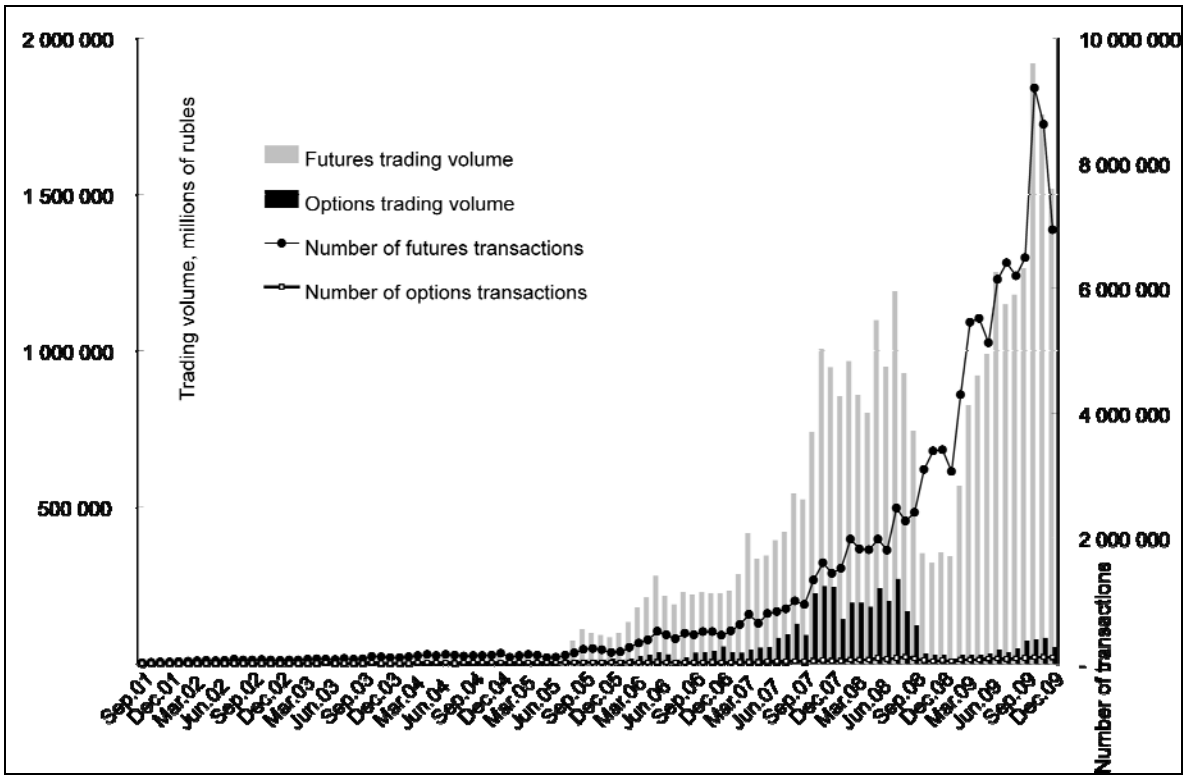
Source: Bank of Russia.

Fig. 35. Capital inflows (+)/outflows (–) by market segment

Attracting FDI and the funds of large instituttional investors requires diligent efforts in improving the institutional environment and business climate and in modernising the economy. Russian banks and private equity funds could be of great help in this undertaking; however, at present that are not in a position to adequately tackle these challenges (see Section 8 for more details).

Risk in the Russian forward market

As shown in *Fig. 36*, similarly to the stock market (see *Fig. 9*) and the ruble-denominated corporate bond market (see *Fig. 20*), the Russian forward market that is primarily concentrated in the RTS trading system has seen a drop in aggregate traded value from August 2008 to February 2009, but has started a fast recovery beginning from March 2009. Moreover, the crisis had virtually no impact on the number of futures and options transactions and the temporary drop in aggregate value was due purely to the decrease in the value of underlying assets. The forward market plays an increasingly important role in the overall context of financial markets, not only allowing to broaden the range of assets traded but also offering market participants an opportunity ho hedge risks related to the decrease in the market value of underlying assets.

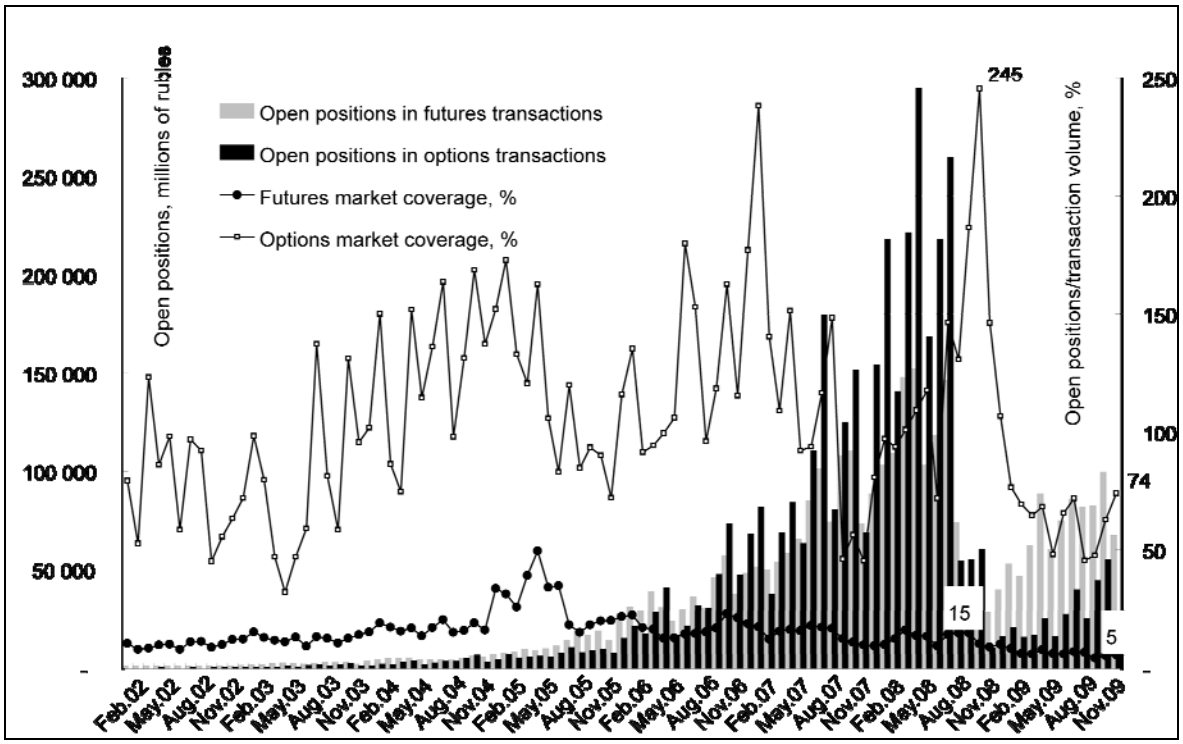


Source: RTS trading system.

Fig. 36. Trading volumes and number of transactions at the RTS forward market from Septemeb 1, 2001, to December 31, 2009

However, we see a cause for concern in the development of the forward market as evidenced by the decrease in coverage of futures and options contracts, as shown in *Fig. 37* that contains data on open positions in the futures and options markets, as well as data on transaction coverage in each market segment that is calculated as the ratio of average monthly open position volumes by the average monthly trading volume for the respective forward contracts. The recovery in forward market trading volumes starting from March 2009 was accompanied by a decrease in coverage levels for futures transactions from 10% of the trading volumes in December 2008 to 5% in December 2009, while the options market saw a decrease from 146% to 74% over the same period.

The rapid development of the financial crisis in the stock market starting from August 2008 also brought about a crisis in the repo markets when several major market participants were unable to service their repayment obligations. It was only possible to avoid a system-wide default by involving the Bank of Russia in the settlement process that helped solve the problem of mutual defaults. The crisis was caused by the lack of a guarantee mechanism for the execution of the second stage of repo transactions, i.e. the repayment of funds by the debtor, for repo transactions concluded at MICEX. The financial community in general derived appropriate lessons from this experience; MICEX announced the prospective creation of a transaction execution guarantee system for repo transactions and the transition to a system of transaction settlements using a single clearing agent.



Source: RTS trading system

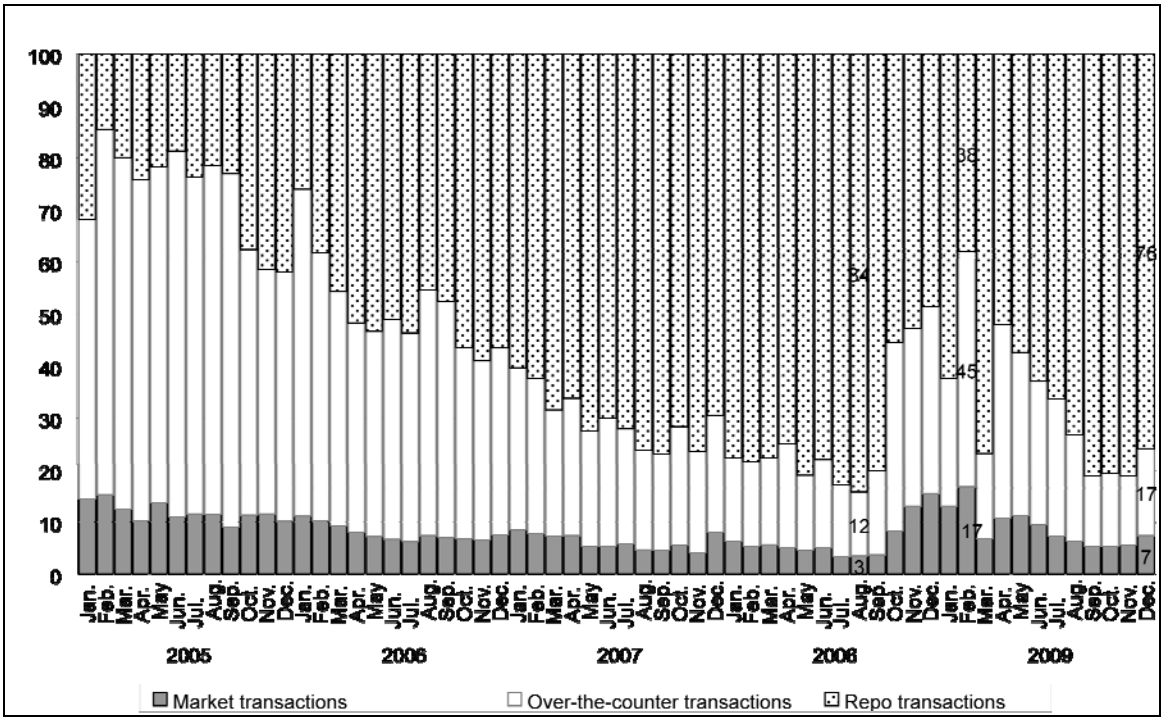
Fig. 37. Open positions and transaction coverage in the RTS forward market from February 1, to December 31, 2000

Risk in repo transactions

However, improving the settlement and guarantee systems for repo transactions leaves open the issue of the risks related to excessive development of this market segment. *Fig. 38* shows the structure of stock exchange transactions with corporate bonds at MICEX. From early 2005 to August 2008, the share of repo transactions grew rapidly, reaching 84% of the stock exchange trading volume. The crisis in the repo market in September 2008 – February 2009 resulted in a significant decrease of this share, however, it started growing again as the market recovered to reach 76% in December 2009. The share of market transactions is only 7%.

The fast growth rates for repo transactions have an economic basis as these transactions are an important instrument of refinancing the banking system by the Bank of Russia and by commercial banks with excess liquidity. However, as previously noted in the comments to *Fig. 21*, banks tend to use this refinancing mechanism rather aggressively, increasing their investments in bonds in a pyramid scheme fashion by continuously entering into repo transactions. Thus investments in long-term bonds are frequently funded by short-term borrowings. The increasingly narrowing segment of market transactions with bonds does not allow for the determination of their real market value. For this reason, repo transactions use highly conditional methods of bond valuation. All this increases the systemic risks of investments in ruble-denominated bonds that can result in a system-wide default in case of a sudden default by one or a group of major issuers that may be impossible to manage even for a specialized clearing

agent. It may be advisable for the Bank of Russia to consider developing other methods of refinancing the banking system alongside the repo market.

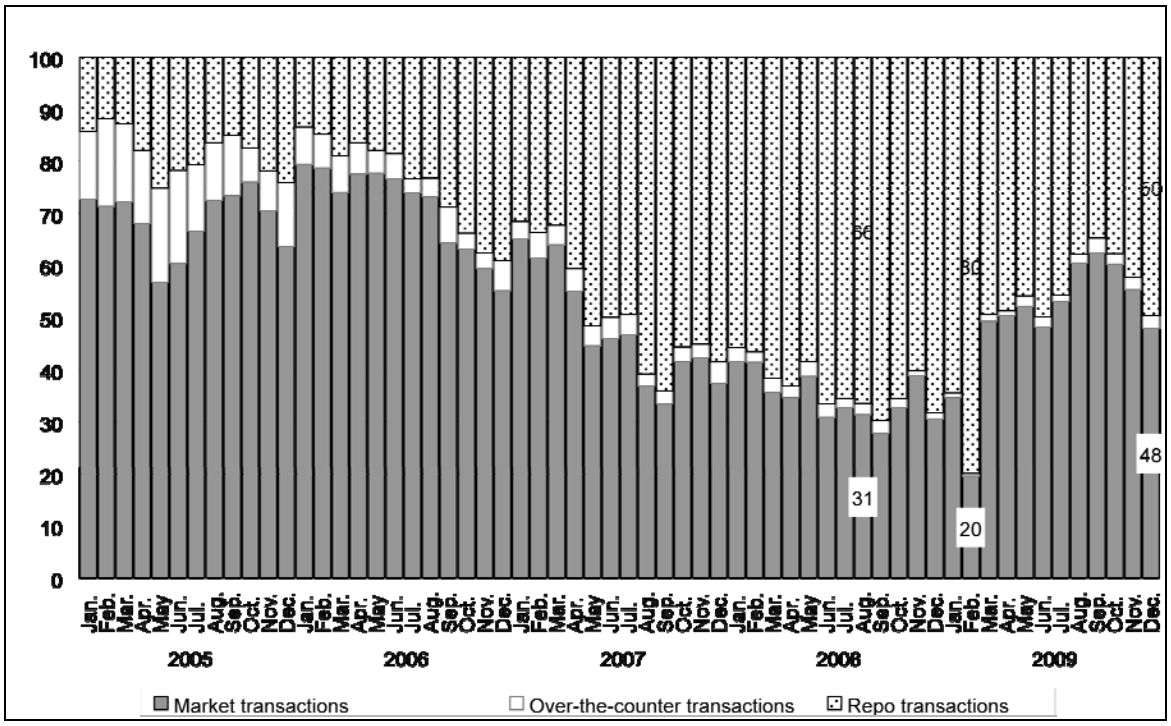


Source: RTS trading system.

Fig. 38. The structure of corporate bond transactions at MICEX (%)

Fig. 39 shows data on the evolution of the structure of equity transactions at MICEX. These also showed a clear trend towards the growing share of repo transactions in 2005-2009 that was briefly interrupted in early 2009 but appeared to have resumed by the end of the year[1]. The nature of equity repo transactions is significantly different from that of the similar market segment for ruble-denominated bonds. Equity repo transactions are predominantly used by brokerage companies to raise funds for subsequent margin lending to their clients. The share of repo transactions in the equity market fluctuates between 50% and 66% of the market stock trading volume. In our opinion these levels do not yet represent substantial grounds for risk fears. However, is this share grows, market participants and regulators may need to jointly consider ways of decreasing the dependence of broker margin lending funds on short term borrowings.

[1] The figure for February 2009 is distorted by the inclusion in the overall trading volume of 16 transactions with ordinary shares of Gazprom in the total amount of RUR 1,620,880 million rubles that were erroneously executed by a trader on February 2, 2009, as equity repo transactions and were later ruled invalid following a ruling of the MICEX arbitration committee on February 18, 2009.



Source: RTS trading system

Fig. 39. The structure of equity transactions at MICEX (%)

Low capacity of the domestic financial services market

For Russian financial intermediaries to be competitive and to be able to provide financial services at a global level, it is necessary for their capitalization, i.e. their net asset value, to approach that of similar international entities. Thus, as of February 8, 2010, the capitalization of nonbank financial holdings in the USA specializing in the provisional Financial Services to the general public, such as Charles Schwab Corp. (SCHW), TD Ameritrade (AMTD) и E*Trade Financial Corp. (ETFC), amounted respectively to US$21 billion, US$10 billion, and US$2.8 billion. The major investment fund managers have the following market values: Prudential Financial Inc. (PRU) that of US$22.5 billion, BlackRock Inc. (BLK) of US$39.4 billion, Invesco Ltd. (IVZ) of US$8.0 billion, Janus Capital (JNS) of US$2.18 billion. American bank holdings that function primarily as investment banks, such as Goldman Sachs Group Inc. (GS) and Morgan Stanley (MS), have a capitalization of US$83.7 billion and US$37.1 billion respectively. The market value of US universal banking holdings was US$129 billion for Bank of America Corp. (BAC) and US$91.7 billion for Citigroup Inc. (C).

The majority of Russian Financial intermediaries, except select major banks whose shares are traded at MICEX and RTS, are not publicly traded and do not publish Consolidated Financial accounts. In the apparent understanding that the provision of competitive financial services in the domestic market is impossible without radically changing the operations of brokers, investment banks, managing companies, and other intermediaries, the Russian Federal Financial Markets Service adopted a decision in 2009 to significantly raise the minimum capital requirements for professional securities market participants. A directive by the Russian Federal Financial Markets Service, No. 09-29/пз-н dated July 30, 2009, On amendments

to the capital adequacy ratios for professional securities market participants, investment fund managing companies, Mutual Investment funds, and private pension funds that were previously established by the Federal Financial markets service directive No. 07-50/ПЗ-Н dated April 24, 2007, the minimum capital adequacy requirements were raised from RUR 5 million to RUR 35 million starting from July 1, 2010 and to RUR 50 million starting from July 1, 2011 for brokerages; from RUR 10 million to RUR 35 million and RUR 50 million respectively for dealers and securities trust managers, and from RUR 60 million to RUR 80 million starting from July 1, 2011 for collective investment vehicle managing companies.

However, in our opinion, these measures will be inadequate to solve the problems of low capitalization and of the ensuing low efficiency of Russian financial intermediaries. Developing this business segment is seriously hindered by the low capacity of the financial service market in Russia. In other words, the measures taken by the authorities in the areas of pension reform, social support to the public, developing the financial market, etc., will not translate into significant growth in the assets brought by domestic investors to the stock market either at present or in the short term perspective.

Within the subject study of nonbank financial intermediary economics that was taught at the Higher School Of Economics state university in 2009, we sought to estimate the capacity of the Russian financial market in 2009-2014.[1] Using various sources and interviews with experts, asset values were estimated for the assets held by various categories of individual and institutional investors in brokerage accounts or transferred into trust management, including investments in mutual funds. The size of the market for investment services was also estimated for the placements of various securities and for conducting merger and acquisition transactions. This was followed by estimating the annual revenues of financial intermediaries from offering these non-banking financial services, which finally enabled the potential business valuation of investment banks, brokerages, and trust managers using a discounted cash flow model. Our estimates show that the business value for financial services providers in Russia is approximately US$6 billion for intermediaries servicing retail investors and US$13 billion for intermediaries servicing issuers and institutional investors, totalling US$19 billion. Approximately half of the total capitalisation is taken up by non-resident institutions or their Russian subsidiaries that successfully compete with Russian institutions in servicing high net worth individuals with net asset values in excess of US$1 million and in the investment banking services market for foreign bond placements by Russian corporates, equity IPOs and SPOs, and mergers and acquisitions.

Thus the total business value for Russian investment banks, brokerages, and trust managers is approximately US$10 billion, which prevents the appearance in this market of institutions that could effectively compete with foreign financial institutions. Despite the superficially favorable indicators of market trading volumes, of the capitalization of Russian companies, of IPO and merger and acquisition transaction volumes, the competitiveness of Russian providers of nonbank financial services is questionable not only at present but also in the near future. This per se carries greater risks for investors, issuers, and the economy as a whole. Addressing this challenge will require government authorities and private businesses to make breakthroughs in the areas of strategic management, innovation, incorporating Russian financial institutions into global value chains in international financial markets, and taking deci-

[1]For more details, see the study results published in the NAUFOR bulletin, No.3 (March) 2010.

sions that can have a real impact on significantly increasing the capacity of the domestic financial market.

Despite the gradual recovery in the stock market, unprecedented liquidity indicators and ruble-denominated bond placement volumes in 2009, the inherent risks of the Russian financial market remain, and the market remains vulnerable to both external shocks and internal risk factors.

2.4.6. The prospects of resuming carry trading operations

The Russian stock market has two principal external growth drivers: oil prices (see *Fig. 28*) and short-term foreign capital (see *Fig. 34*). As shown previously (see *Fig. 29*), there are fundamental grounds to believe that the oil prices will not grow significantly in the next 10 years. In this case, stock prices will come under increasing pressure from movements in foreign portfolio investments and thus will be increasingly influenced by carry trading strategies.[1]

Prior to the crisis, such strategies were a principle growth driver for the banking sector, giving banks cheap funds for onlending and investing in fixed income instruments. The scale of their use is evidenced in *Fig. 10* that shows the currency gap between bank assets and liabilities denominated in foreign currency. During the crisis, borrowings from non-residents were replaced by borrowings from the state. However, the Bank of Russia and the Ministry of Finance consistently withdrew from the banking sector in late 2009, once again transitioning from net creditors to net debtors of the banking system (see *Fig. 12*). Despite the growth of bank deposits, one must bear in mind that such funding is expensive for banks and its use for lending results in a low net interest income margin of 3-5%. For this reason, it is highly likely that the use of carry trading in banking will resume in the post crisis period.

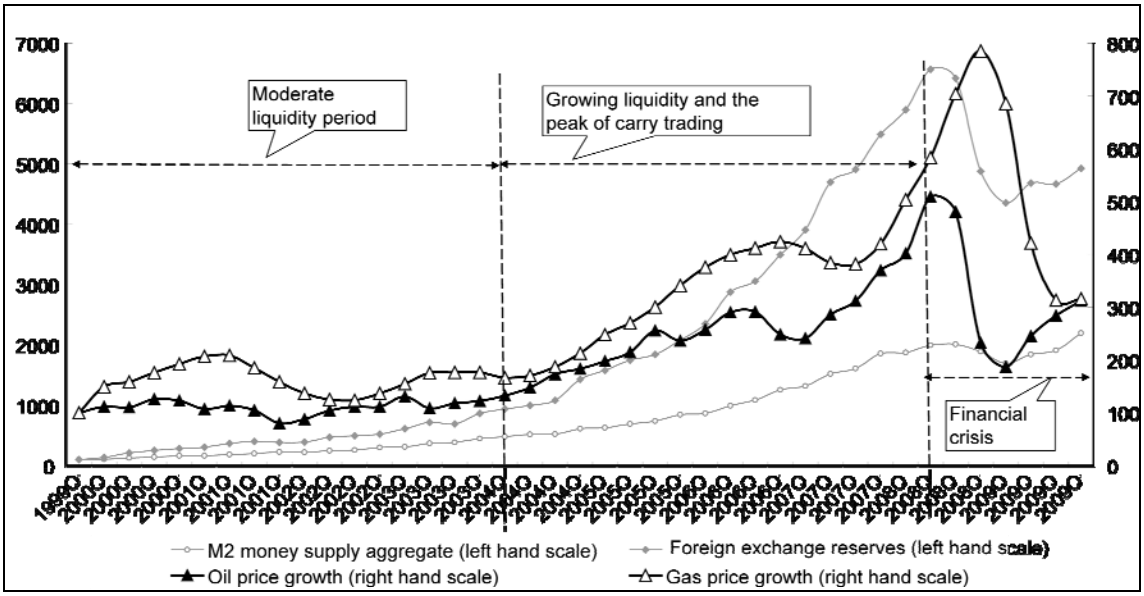
Moreover, banks remain as the principal investors in the ruble-denominated bond market. As shown in *Fig. 20*, the rapid growth of transaction volumes in the ruble-denominated corporate bond market from early 2004 to July 2008 was made possible predominantly by the use of carry trading strategies by Russian banks and foreign hedge funds. It is difficult to derive a quantitative estimate of the share of this strategy in the total funding sources for investments in ruble-denominated bonds. For example, Greenwich Associates estimates that hedge funds accounted for 45% of the trading volumes for emerging markets issuer bonds in 2006.[2]

At the start of the global financial crisis, mutual mistrust by banks led to the failure of carry trading strategies. To answer the question regarding the timing of its resumption, one must look into the preconditions for its existence. There are three such prerequisites: a drop in the value of the borrowing currency, low interest rates in the country of borrowing, and the existence of a liquid and relatively stable foreign exchange market and of financial assets denominated in national currencies. *Fig. 40* shows data for the evolution of oil and gas prices, as well as for the growth of the M2 money supply indicator and of foreign exchange reserves. These data show that in 2009 the market reached its bottom for all of the above indicators, which was followed by their resumed growth. This provides reasons to believe that Russia's

[1] The essence of the strategy is straightforward: attracting funds in foreign borrowings in the currency of countries with low interest rates (borrowing currency) for the purpose of this subsequent investment in the financial instruments of countries with relatively the high national currency interest rates (investment currency).

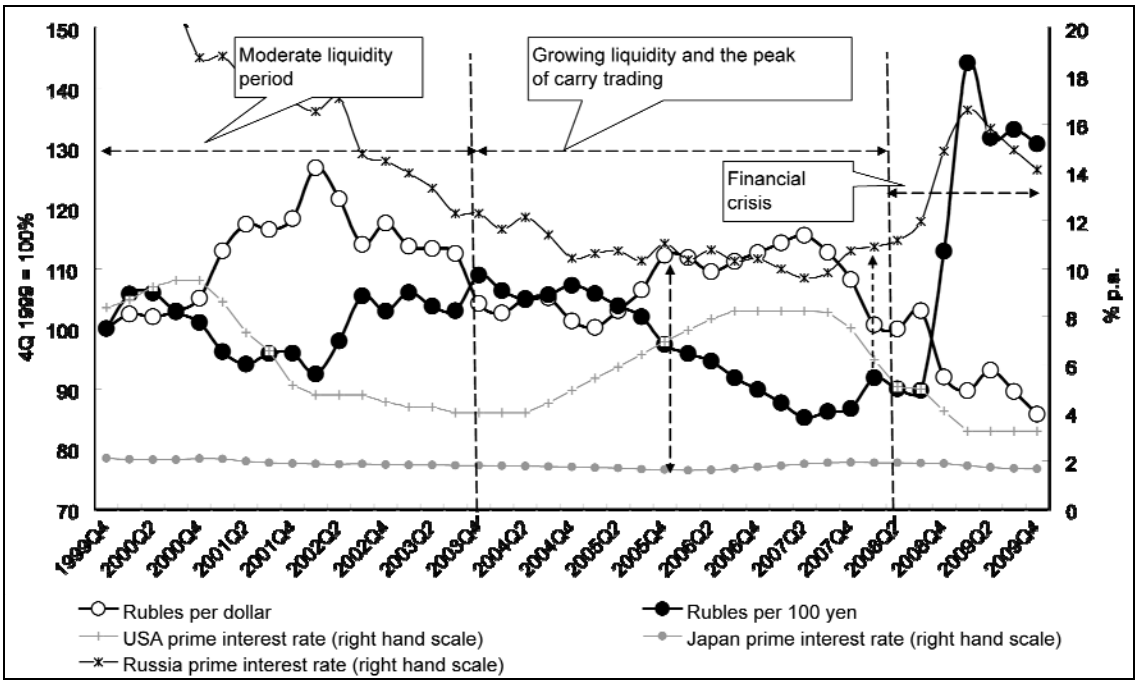
[2] Key findings have been published in The Wall Street Journal on August 30, 2007. See also OECD Financial Markets Trends. Volume 2007/1. No.92, page 42.

financial condition shall remain stable in the short to medium term, which will have a favorable effect on all the preconditions for the resumption of carry trading.



Source: calculations based on data from the IMF Financial Statistics Database.

Fig. 40. Growth of energy prices and of excess liquidity in Russia (4Q 1999 = 100%)



Source: calculations based on data from the IMF Financial Statistics Database.

Fig. 41. Preconditions for carry trading in Russia

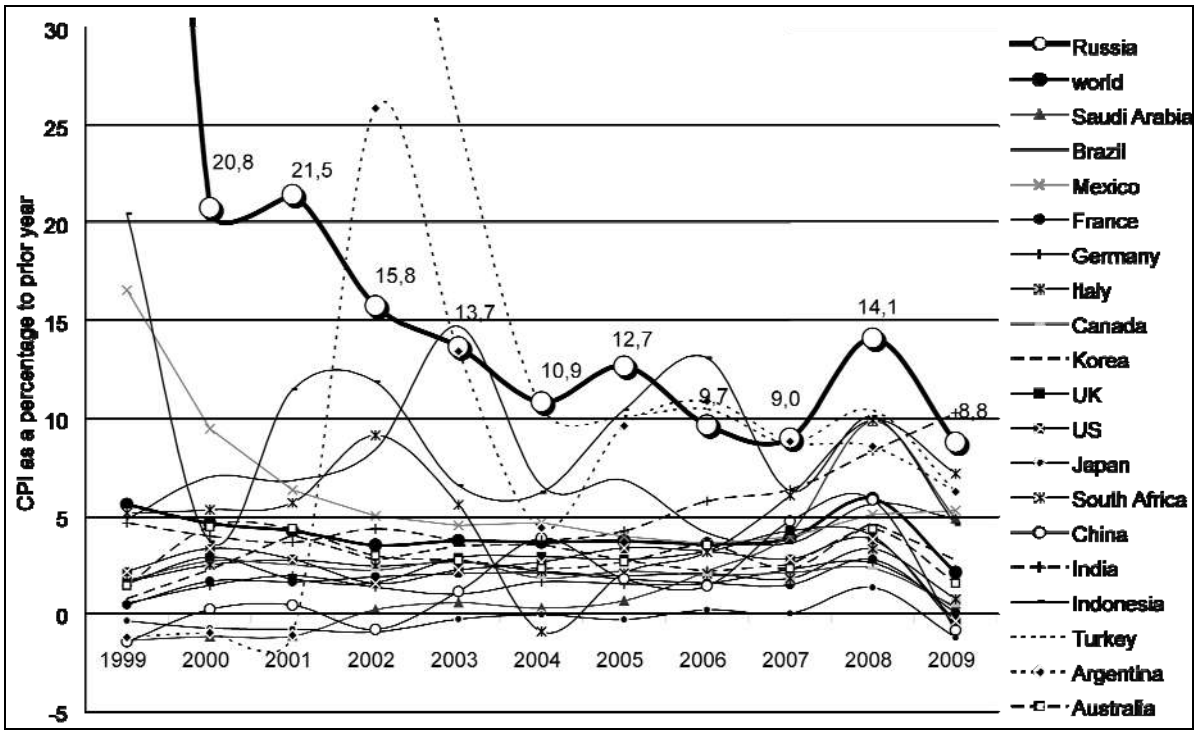
The prerequisites for a renewal of carry trading from the point of view of exchange rate policies and the cost of funding are analysed in *Fig. 41*. Despite the current strengthening of the ruble exchange rate to the yen and the dollar, the instability of the ruble significantly increased during the financial crisis. The ruble was devalued relative to the dollar and, to an even greater extent, relative to the yen. This instability of the ruble continues to be an obstacle to carry trading. Moreover, as was shown in *Fig. 31*, the so-called notional ruble exchange rate grew much faster than the nominal exchange rate in December 2009 due to the significant growth in the M2 indicator set against a decrease in the foreign exchange reserves which, in our opinion, is indirect evidence of the expected devaluation of the ruble.

As regards the difference between the interest rates in Russia, Japan, and the USA (see *Fig. 41*), it remains significant despite the fact that Russia in 2009 kept inflation at a moderate level of 8.8% and continued lowering the refinancing rate. This means that the second precondition for carry trading is being met. The same can be said of the third precondition, i.e. the existence of a liquid and relatively stable foreign exchange market and of financial assets denominated in national currencies.

Thus the majority of the preconditions for the renewal of carry trading in Russia are being met. However, such a renewal remains limited by the relative instability of the ruble. Another important obstacle to carry trading activities is the remaining lack of confidence in the global financial markets.

Their risks of carry trading for Russia are several. First, such strategies leave few stimuli for the financiers to make riskier and often less profitable investments in the real sector. It is much easier and more profitable to raise short term funds than to take upon oneself the risks of economic modernization. Second, such strategies imply a huge inherent risk for the banking system, ultimately leading, as has already been seen prior to both financial crises, to a currency gap between bank assets and liabilities denominated in foreign currency that entailed a bank liquidity crisis. Third, carry trading needs to the emergence of bubbles in the ruble-denominated corporate bond market and leads to "overheating" in the consumer lending segment. Fourth, this strategy leads to the "securitization" of financial relationships that transforms banks from "smart lenders" and investors in the bond market into "lending factories" where lender due diligence is performed by computers instead of people. The banking sector loses credit appraisal skills that require high professional qualifications of staff and an in-depth knowledge of the borrowers' business. As a result, the bank's potential for aiding economic modernization is lost. Finally, carry trading undermines the domestic savings system, making investments in ruble denominated bonds unprofitable for the borrowers that use ruble funding (general public, mutual investment funds, private pension funds, insurance companies, etc), due to the fact that such investments often have negative real rates of return.

The state must decisively oppose carry trading. The greatest effect in this respect can be achieved by measures to curtail inflation. The higher the domestic inflation, the higher the spread between domestic ruble borrowing rates and the cost of raising funding abroad, the more effective carry trading strategies are for speculators. *Fig. 42* shows data on inflation levels in Russia compared to other G20 countries. It is obvious that, despite inflation being lowered from 14.1% in 2008 to 8.8% in 2009, its level remains practically the highest among G20 countries. This in turn points to the need to combat inflation and, above all, to combat the factors contributing to its domestic growth as one of the key priorities for the government and for the Bank of Russia.



Source: IMF data and national statistics.

Fig. 42. Inflation in G20 countries in 1999–2009

2.4.7. Attracting conservative institutional investors

The Russian stock market remains unattractive for the most highly capitalized and conservative investors, above all for foreign pension funds. In order to understand the reasons for this, we can use the experience of the largest U.S. pension fund, the California Public Employees' Retirement System (CalPERS), with reserves of approximately US$200 billion. For many years until 2007, CalPERS rated emerging markets as potential investment targets for its assets. The CalPERS methodology was publicly disclosed and based on studies by authoritative agencies such as Freedom House, the World Economic Forum, Oxford Analytica, The Heritage Foundation, Wall Street Journal and many other research bodies.

The CalPERS methodology involved an assessment of emerging markets investment attractiveness based on two groups of indicators, country risks and the inherent risks of specific financial markets.

Country risks were evaluated by CalPERS according to the following criteria:

- Political stability, i.e. the state of civil liberties, the extent of independence of the judicial system, and political risk;
- Information transparency, including freedom of the press, disclosure of information on the monetary policy and budget, quality of stock exchange listings, and the effectiveness of application of International Financial Reporting Standards (IFRS)
- The compliance of labor legislation with the international standards that regulate labour relations, such as the ratification of the ILO convention, the compliance of labour legislation with ILO standards, the effectiveness of law enforcement..

In other words, evaluating country risks entailed an assessment of the investment climate and investment institutions as the foundation for financial markets.

The second group of indicators entailed the assessment of quantitative and qualitative parameters of emerging capital markets, including the following indicators:

- Stock market liquidity and volatility, the assessment of market capitalisation and its growth rates, the ratio of monthly trading volumes to market capitalisation, the growth in the number of listed companies, stock market volatility and the risk/return ratio;
- assessing the effectiveness of banking supervision and legal practices in the stock market, the degree of protection of creditor and shareholder rights;
- Assessing the degree of openness of the economy to foreign investment, bank and financial institution regulatory regimes, restrictions on the purchase of securities;
- Assessing the effectiveness of the stock market settlement mechanisms and the levels of transaction costs, predominantly tax expenses, related to securities market transactions and to the remittance of profits to beneficiary owners.

The maximum score for any market equals 3. Countries that scored 2 and above were included in the list of markets approved for investing CalPERS assets. Otherwise a country market was considered off limits for investment by CalPERS.

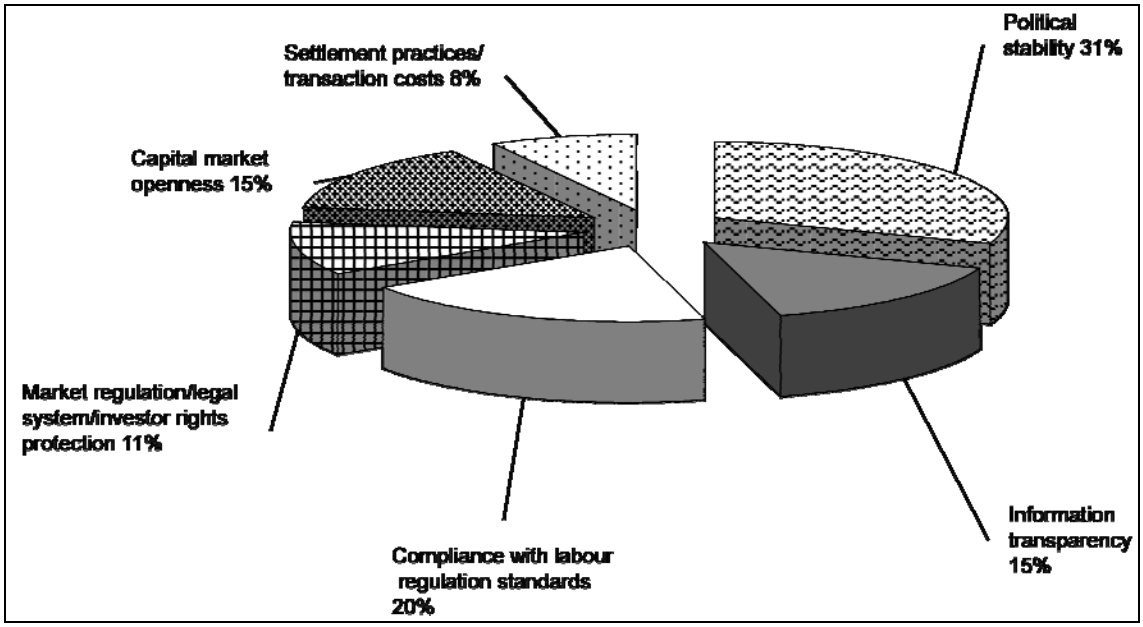
In 2007 CalPERS modified its decision taking methodology with regard to investments in emerging markets. Portfolio managers were given the right to independently choose emerging markets companies as investment targets taking into account the inherent risks of different countries and stock markets. However, even given the changes in the investment decision process in 2007-2009, CalPERS never invested in Russian securities. This means that the de facto approach taken by this fund to analyzing the Russian stock market has remained unchanged and is still relevant for understanding the deficiencies of this market from the point of view of conservative foreign investments.

In 2007, the Russian stock market received the CalPERS score of 1.91, i.e. below the investment threshold score of 2, which precluded CalPERS from investing in this market. *Fig. 43* analyses the principal obstacles that prevented the Russian market from obtaining the maximum score according to CalPERS methodology.

Country risk factors, including political stability, information transparency, and compliance of the labor laws with international standards together accounted for 66% of the missing score for Russia. Political stability in the country received a score of one out of three. The principal reasons for such scores are the low assessment of civil liberties, of the independence of the judiciary system, and the degree of protection of ownership rights, as well as political system stability. The level of information transparency in Russia received a score of two, sufficient for the market to be designated as an investment target. Within this category, the higher scores for information disclosure concerning monetary policy, the budgetary system, and stock market listing were counterbalanced by low scores for freedom of the press in the effectiveness of applying IFRS (IAS or US GAAP). The degree of compliance of labour laws with ILO standards received a score of 1.7 out of three.

Against this background of conservative assessment of the effectiveness of institutional factors, the quantitative and qualitative characteristics of the Russian stock market appear quite adequate. However, Russia still failed to reach the threshold score of two by 34% for this indicator. The quality of market regulation of the banking sector and stock markets received the average rating of two; a higher score was made impossible by the insufficient effectiveness of banking supervision and legal practices in the stock market, as well as deficien-

cies in the protection of creditor rights. Capital market openness received a low score of 1.7 Dees the entry barriers for banks and insurance companies.



Source: www.calpers.ca.gov

Fig. 43. Obstacles that prevented the Russian market from obtaining the maximum score according to CalPERS methodology (USA) in 2007

The Russian market received a relatively high score of 2.3 for settlement efficiency and the level of transaction costs. Settlement efficiency and the securities market in particular received the top score of 3.0, even despite the absence of a central depository and of a system of settlement guarantees without the ex ante securities deposits.

Changes in the Russian economy and political system in 2008-2009, even apart from the crisis, exacerbated the situation in the areas where Russia had received the lowest CalPERS scores. This is evidenced by *Table 5* that shows the scores for the relevant areas assigned by the agencies whose ratings were used by CalPERS, or, if firsthand information was not available, alternative assessments by authoritative agencies, over the past three years.

Table 5

Changes in the problem areas of Russian economic and political life as seen by conservative foreign investors, 2007–2009

	CalPERS scores							Subsequent scores			
	Information source	Weight, %	2003	2004	2005	2006	2007	Information source	2007	2008	2009
1. Political stability		16,7	1,0	1,0	1,0	1,0	1,0				
• Civil liberties	Freedom House		1,0	1,0	1,0	1,0	1,0	Freedom House***	5,0	5,0	5,0
• Independence of the judicial system and legal protection	Global Competitiveness Report		1,0	1,0	1,0	1,0	1,3	Global Competitiveness Report*	106	109	116
2. Transparency (openness)		16,7	1,0	3,0	2,0	2,0	2,0				
• Freedom of the press	Freedom House		2,0	2,0	1,0	1,0	1,0	Freedom House	75	78	80

	CalPERS scores							Subsequent scores			
	Information source	Weight, %	2003	2004	2005	2006	2007	Information source	2007	2008	2009
• Transparency of monetary and fiscal information	Oxford Analytica		1,0	2,0	2,0	2,0	2,0	Global Competitiveness Report*	118	119	114
• Compliance with IFRS	eStandards Forum				2,0	1,5	1,5	Global Competitiveness Report*	95	108	119
3. Compliance of labor laws with international standards	Verite	16,7	1,0	1,0	1,0	1,7	1,7	Global Competitiveness Report*	33	27	43
4. Investor rights protection	Разное	12,5	2,0	2,0	2,0	2,0	2,0	Global Competitiveness Report*	45	67	71
5. Openness of capital markets	The Heritage Foundation's Index of Economic Freedom	12,5	1,0	1,0	1,0	1,3	1,7	The Heritage Foundation's Index of Economic Freedom **	49,8	50,8	50,3
• Trade barriers	The Heritage Foundation's Index of Economic Freedom		1,0	2,0	2,0	1,5	2,5	The Heritage Foundation's Index of Economic Freedom **	44,2	60,8	68,4
• Foreign investment	The Heritage Foundation's Index of Economic Freedom		2,0	2,0	1,0	1,5	1,5	The Heritage Foundation's Index of Economic Freedom **	30,0	30,0	25,0
• Banking and finance	The Heritage Foundation's Index of Economic Freedom		1,0	1,0	1,0	1,5	1,5	The Heritage Foundation's Index of Economic Freedom **	40,0	40,0	40,0
• Stock market openness ****	S&P Global Stock Markets Factbook		2,0	2,0	2,0	2,0	2,0	Global Competitiveness Report*	129	127	120

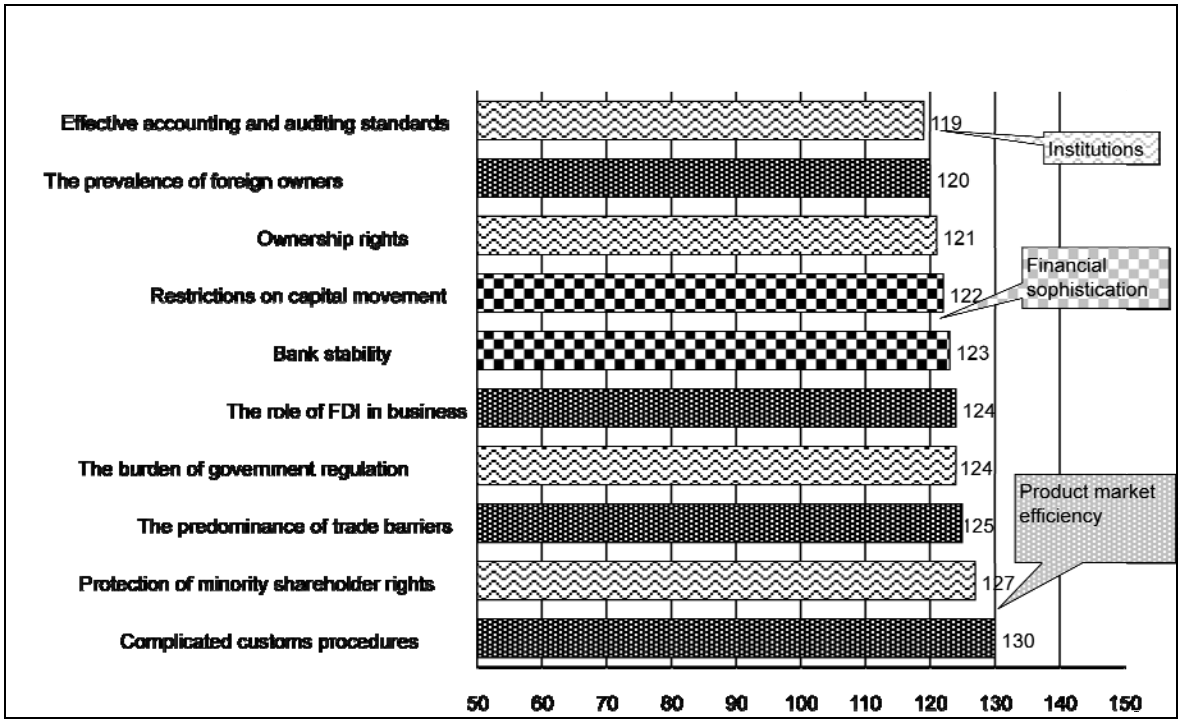
* Russia's ranking among 125 countries in 2007, 134 countries in 2008, and 133 countries in 2009 according to the global competitiveness index.
** using a maximum score of 100. In 2010, of Russia ranked 143rd among 183 countries in terms of the index of economic freedom and confirmed its status as an "non-free economy".
*** using a reverse score of 7; the higher the score, the worse the civil liberties situation. Russia has the status of an "non-free country".
**** the maximum participation of foreign investors in corporate equity in general, and in the equity of insurance companies and banks. .
Source: calculations based on CalPERS data and ratings by the World Economic Forum www.weforum.org, Heritage Foundation www.heritage.org/index/ and Freedom House www.freedomhouse.org/

The vast majority of the Russian economic and political areas analysed are witnessing either a deterioration of the scores or the persistence of low scores. Thus the unfavourable institutional environment, labor laws that are out of compliance with international standards, especially as regards hiring qualified foreign staff, the low level of investor rights protection, barriers to trade and capital movements, and a weak financial system of the main reasons that prevent the influx into Russia of the long-term funds of major international institutional investors.

Fig. 44 shows the top 10 problem areas in the Russian economy according to the global competitiveness index issued by the World Economic Forum in 2009-2010[1]. The principal

[1] The figures in *Fig 44.* signify Russia's ranking for each of the scoring criteria among the 133 countries rated.

obstacles to Russia's competitiveness belong to three main groups: product market inefficiencies (complicated customs procedures, high trade barriers, the low level of foreign direct investment and a significant number of restrictions on foreign property ownership); the unfavourable institutional environment (infringement of minority shareholder rights, the heavy burden of government regulation, insufficient protection of property rights, and the limited application of International Financial Reporting Standards); and weakness of the financial system (bank instability and restrictions on capital movements). It is obvious that most of the above factors that detract from the competitiveness of the Russian economy according to the World Economic Forum coincide with the low score areas in the Russian financial market according to CalPERS.

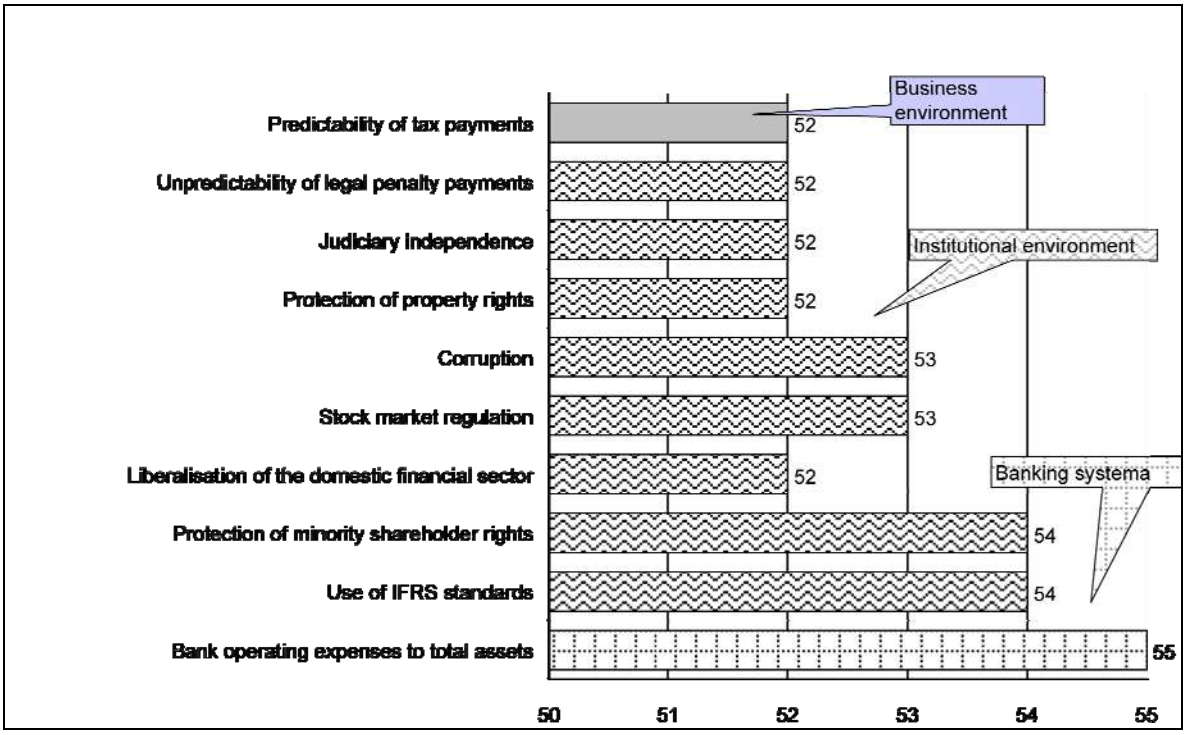


Source: Calculations based on World Economic Forum ratings (www.weforum.org)

Fig. 44. The 10 principal shortcomings of Russia measured by the global competitiveness rating in 2009-2010 (aggregate 63rd position among 133 countires scored)

Fig. 45 shows the scorecard for a more specialised World Economic Forum rating that was published in late 2009 and assessed the financial system in 55 countries with the largest financial markets. In this list Russian ranked 14th out of 55 countries. *Fig. 45* also shows the 10 worst score is received by Russia under this rating. Three groups of issues can be distinguished, including, once again, the unfavourable institutional environment as demonstrated by the limited application of international financial reporting standards, the infringements of minority shareholder rights at joint stock companies, weak stock market regulation (due to the presence of the bank of Russia among the owners of one stock exchange), corruption, barriers to entry of foreign entities into the financial markets, lack of independence in the judiciary system, difficulties in law enforcement, and breaches of property rights. Another issue of the

Russian financial system is the weakness of banks, where Russian ranks last among the 55 participant countries. Finally, the third issue is to do with the restrictive tax administration.



Source: calculations based on World Economic Forum ratings (www.weforum.org).

Fig. 45. Russia's ten principal drawbacks under the Financial Development Index, 2009–2010 (aggregate 40th position among 55 participants)

The events of 2009 leave a contradictory impression regarding the readiness of Russian authorities to radically change the investment climate in the country. On the one hand, the Russian president, D.A. Medvedev, has initiated an appeal for modernization of the society, read regearing the economy to developing value added sectors, and promoting innovation. This appeal translated into changes in the structure of government agencies, in the legislation, in decisions taken regarding the allocation of government finances.

The government opened dialogue with foreign investors regarding amendments to the Federal Law On Foreign Investment aimed at mitigating the restrictions for the access of foreign capital to strategic sectors and simplifying the procedure for approving investments into companies in these sectors[1]. The President of Russia has instructed the government to develop an action plan for improving the investment climate in Russia in 2010, including the simplification of customs procedures, the privatization of significant government stakes in state owned companies, changes to the tax legislation aimed at promoting innovation. [2].

On the other hand, civil society and foreign investors are increasingly perplexed by the legal proceedings in the Yukos case. The death of the chief legal counsel of the Hermitage Capital Management hedge fund has triggered a strong international reaction. Crimes against

[1] A. Gudkov, the Government has disappointed foreign investors // Kommersant, February 4, 2010.
[2] P.Netreba,. the Investment climate is to change in the spring// Kommersant, February 12, 2010.

journalists are pervasive, the opposition is repressed, the situation of small and medium enterprises continues worsening, the activities of state-owned companies and corporations are becoming less and less transparent.

The issue of the degree of modernisation of society that may be required by modernisation of the economy remains open. We can only stress here that an indication of the resolution of this issue will be shown by the readiness of foreign portfolio investors and other large investors involved in FDI to change their attitude to the Russian financial market by investing large amounts of long-term funds, as well as making technology investments in the country. This "miracle" failed to happen in 2009

2.4.8. The role of the stock market in economic modernisation and promoting innovation

The current crisis revealed significant problems and contradictions within the Russian economy, demonstrating its lack of readiness to the challenges of globalisation. By the end of 2009, the government and the public as a whole adopted the focus on economic modernisation. The financial market must play a crucial role in the implementation of these plans, however, the question remains of whether it is ready to tackle the challenge.

Financial crises always result in increased risks and uncertainties for entrepreneurs regarding future investment projects, in the lack of trust between creditors and debtors. For these reasons it would be unrealistic to expect effective results from the financial market at the peak of the crisis. However, an analysis of financial market functioning prior to and during the crisis gives us grounds to believe that the domestic financial market is not yet prepared to fully tackle the issues of economic restructuring, accelerating innovation, and providing social support to the public.

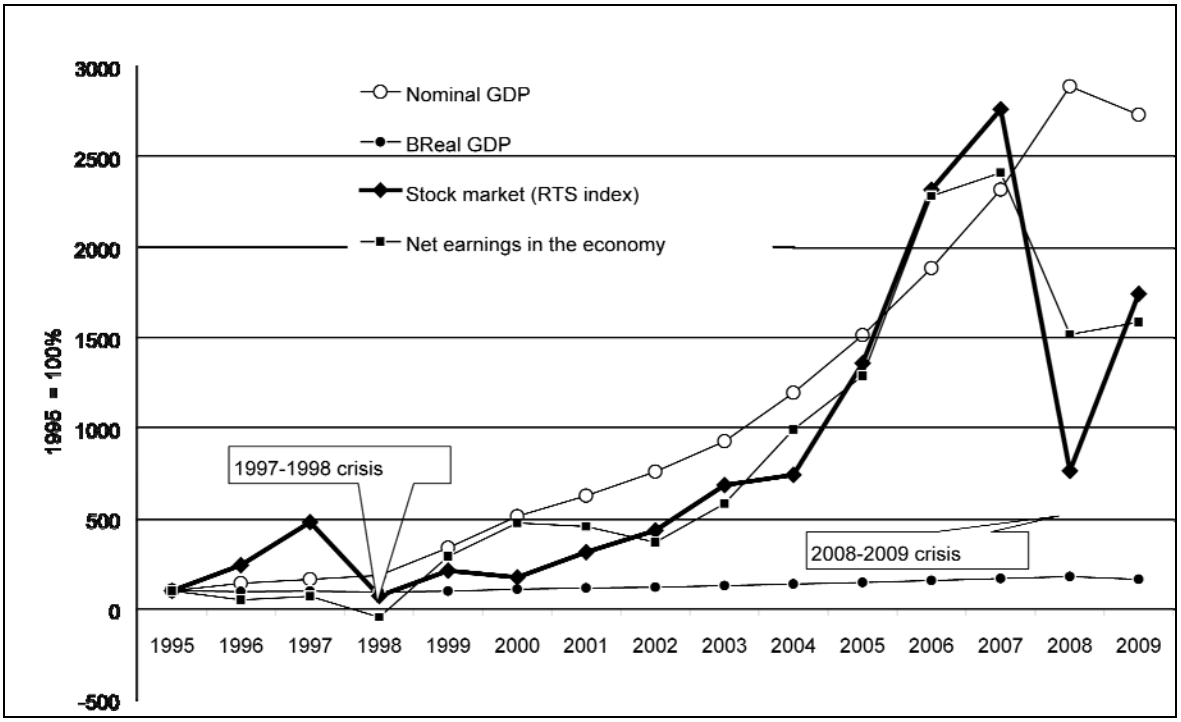
This is due to a number of reasons. First, within the current regulatory framework, the return on investment from pursuing speculative strategies in the financial market, such as carry trading or using debt leverage in repo transactions, is higher than the return on investment in new production facilities. Second, the refocusing on many banks away from lending into investments in corporate bonds results in the loss by such banks of project financing skills in the real sector, while the ruble denominated bond market that allows to attract short-term investment funds cannot serve as a means of the replenishing real company capital. The banking system is weak and incapable of large-scale lending to the economy. Third, the Russian market does not have the traditional innovation vehicles such as private equity funds and venture capital funds. Finally, the system of mobilizing long-term retail savings does not function in Russia. The low effectiveness of the domestic financial markets is exacerbated by the unfavourable investment climate for attracting foreign direct investment and long-term portfolio investment.

The return on financial and non-financial investments

In the long term, stock market growth follows the trends in fundamental indicators, such as net company earnings and gross domestic product (GDP). For example, the author's estimates of the relationship between stock market growth and the key economic indicators in 12 developed capital markets over the past 50 years shows that the average growth rates of stock mar-

ket indices are generally in line with the average nominal GDP growth rates[1]. In emerging markets, stock market growth rates tend to outstrip nominal GDP growth rates due to attracting foreign portfolio investments.

Fig. 46 Shows the relationship between the growth rates for the RTS index, GDP, and the earnings of Russian companies. It demonstrates that prior to both Russian crises the stock market index growth rates differed significantly from GDP growth rates. As markets recovered, stock market indices sought to catch up with industrial production and earnings indicators.



Source: RTS and Russian Statistics Committee data.

Fig. 46. Stock market index growth compared to fundamental indicators

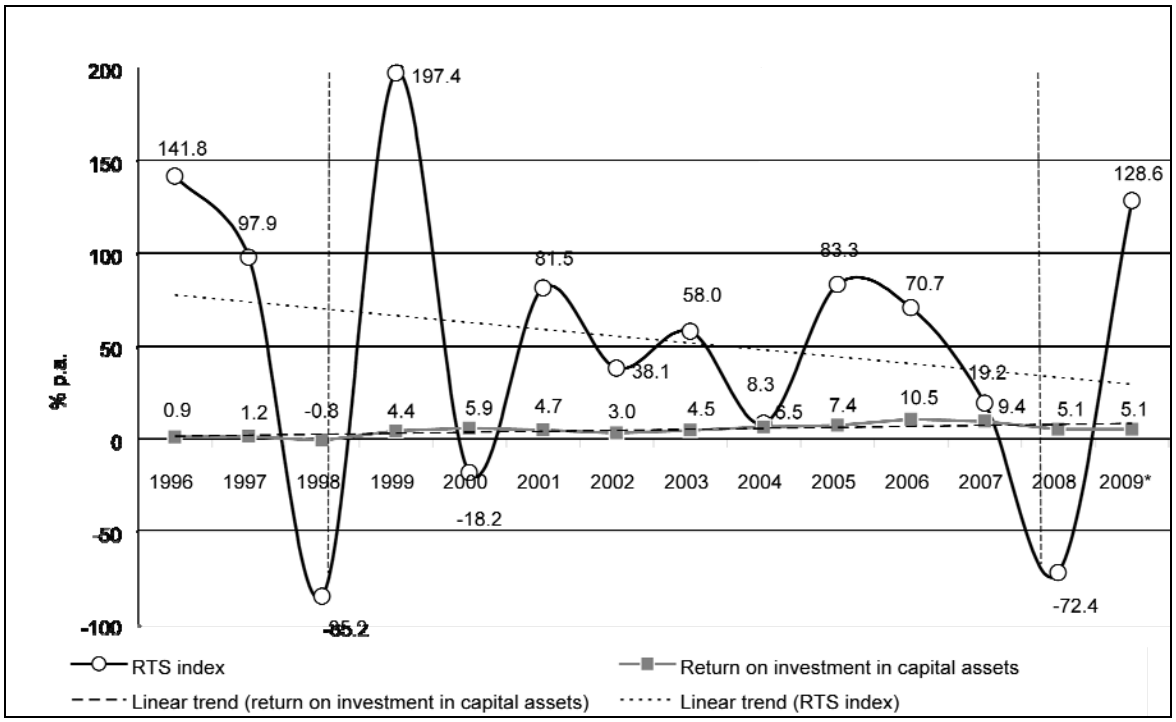
The greatest issue in the Russian stock market is the fact that the return on financial investments substantially exceeds the return on investments in industrial assets, both capital assets and working capital. As a result, instead of attracting investments in new industrial capacity, the securities market periodically functions as a "pump" funneling resources away from the real economy. The high return on investment in this market is ensured primarily by the influx of new investor funds rather than by the growth in issuer earnings. Meanwhile, in underlining the relationship between investment and economic growth, Economics Nobel Prize laureate Paul Samuelson, follower of the Neo-Keynsian model, noted that "investments… are only made by and real capital is being created". [2] In other words, real capital

[1] NAUFOR report, Section 1.3. The Russian stock market and the creation of an international financial hub. The ideal long-term development model for the Russian stock market (through 2020) Moscow, 2008. Published at www.naufor.ru

[2] Paul E. Samuelson, William D. Nordhouse, Economics /Translated from English , 16th edition. Williams publishing house, 2005, page 389.

serves as the driver of economic growth, but the Russian stock market does little to promote the accumulation of such capital.

Fig. 47 shows data regarding the return on investment in equities as exemplified by an RTS index portfolio and the return on investment in industrial capital assets, which can be used as a proxy criterion for taking investment decisions based on the return on investment in incremental industrial capacity.



Source: proprietary calculations based on RTS and Statistics Committee data

Fig. 47. The return on investment in equities and in economic assets.

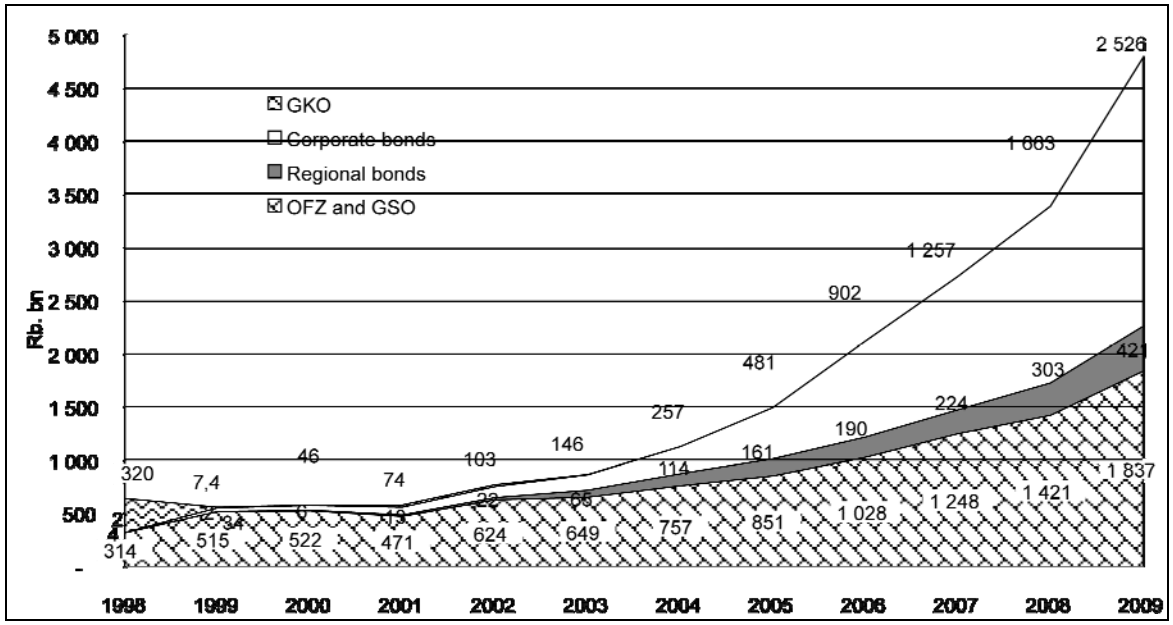
In the 14-year period from 1996 to 2009, only three years (1998, 2000, and 2008) saw substantially lower rates of return for investments in equities compared to investments in capital assets. [1] Despite the fact that the linear trends for the rate of return in the RTS index and the rate of return in production assets are getting closer, the gap between these indicators remains significant, which creates a substantial risk of the flight of domestic capital from the real economy into short-term financial market investments. This risk is also evidenced by the higher growth rates for bank investments in bonds compared to corporate loans (see *Fig. 30*).

Issues in the corporate bond market

The development of the ruble-denominated bond market was a surprising phenomenon in the 2000s (see *Fig. 48*). The total value of the ruble-denominated corporate bond market grew

[1] R.K. Vardanian, the founding manager of one of the major Russian companies, the Troika Dialog investment banking group, comments on the rate of return of financial markets operations as follows: "Frankly, it was excessive in Russia; in our sector, rates of return of 30-35% were considered the norm …" P. Rushailo, R. Vardanian: we must expect high volatility in the absence of significant growth // Kommersant Dengi, No. 6 (February15—21, 2010), page 16.

8.2 times in ten years, from RUR 0.6 trillion in 2000 to RUR 4.9 trillion in 2009. Of all ruble denominated bonds, the corporate bond market segment showed the highest growth rates. Their total market value grew 54.3 times, from RUR 46 billion in 2000 to RUR 2.5 trillion in 2009.



Source: Russian Ministry of Finance, Cbonds.ru.

Fig. 48. Ruble-denominated bond volumes

The rapid growth of the corporate bond market was due to both internal and external growth mechanisms. As shown earlier in *Figs 15*, *16*, and *20*, the basis for this growth from early 2004 to July 2008 was provided by carry trading strategies used by Russian banks and foreign hedge funds. Starting from August 2008 until now, the growth of the ruble-denominated bond market is due to the excess liquidity accumulated by banks as a result of government support measures during the crisis given the lack of loan portfolio growth. The market for direct repo transactions involving the Bank of Russia and of interbank repo transactions, which enabled the banks to borrow short term funds for long-term investments in bonds, played a significant role in the growth of the ruble-denominated bond market starting from the mid-2000s.

Most corporate bond issues have featured an issuer guarantee by way of an offer that gave bondholders the right to present these bonds to the issuer for early retirement 1-3 years following placement. Such offers de facto altered the nature of long-term bonds, converting them into short-term Financial Instruments. The funds raised by bond issues were used by issuers to finance merger and acquisition transactions, refinance loans, expand business, and fulfill other relatively short-term objectives. Due to this relatively short-term character of bond financing and the low rates of return for investments in new capital assets and other productive assets, the role of bonds in financing capital assets has been, and still is, minimal.

Table 6 shows the key indicators for the ruble denominated corporate bond market in 2000–2009, expressed in dollar terms. Despite the fast growth of corporate bond placement volumes, from US$1.1 billion in 2000 to US$29.2 billion in 2009, the amounts channelled

into capital asset financing were very low. Thus, of the total bond placement volume of US$29.2 billion in 2009, only US$0.1 billion, or 0.27% of the total placement volume, was used to finance capital asset acquisitions. The overall share of corporate bond placement volumes used to finance capital assets ranged from 0% to 3.43% throughout the 2000s.

Table 6

Market indicators for ruble-denominated corporate bonds (billions of dollars)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Total market value	1,6	2,5	3,3	4,8	8,9	17,0	33,2	49,2	67,0	80,5
Secondary market, including repo transactions	0,2	1,1	2,3	8,2	14,7	44,2	134,9	371,1	457,4	295,8
Placements	1,1	0,8	1,5	2,6	4,9	9,2	17,1	17,9	16,1	29,2
Investments in capital assets	0,0	0,0	0,1	0,1	0,1	0,3	0,1	0,2	0,2	0,1
As a percentage of total market value	0,00	0,00	1,67	2,32	1,63	1,86	0,18	0,49	0,26	0,10
As a percentage of placement volume	0,00	0,00	3,59	4,33	2,98	3,43	0,36	1,34	1,10	0,27

Source: proprietary calculations using data from MICEX, cBonds, the Bank of Russia, and the Statistics Committee.

The impact of equity IPOs on the economy

Compared to corporate bond issues, equity IPOs and SPOs are a more effective instrument of raising funds for capital asset financing. This is due to the longer-term nature of IPO proceeds. *Table 7* shows market indicators for the Russian equity market that point to the peak of IPO activity in 2006 and 2007, when companies were able to raise US$17.0 billion and US$33.0 billion respectively. In 2006, 18.6% of IPO and SPO proceeds were used by companies to finance capital assets, a ratio that declined to 11.1% in 2007. In some years, the proportion was much higher: thus in 2008, 89.7% of IPO proceeds were used for capital asset financing, next to 61.7% in 2005 and 51.2% in 2009. However, in these years the total amounts of IPO proceeds were insignificant, equal to US$1.9 billion, US$5.2 billion, and US$1.7 billion respectively. The bulk of resources raised in the stock market were used to buy out previous business owners, refinance debt, and service merger and acquisition transactions, including the purchase of large blocks of shares.

Thus it is premature to speak about a significant part equity placement and especially of corporate bond placement proceeds being used for promoting economic modernization and economic growth. Moreover, the amounts raised by companies through equity and corporate bond placement and subsequently used for capital asset acquisition is a tiny part of the overall funding for investments in capital assets, as shown in *Fig. 49* detailing the funding sources for investments in capital assets.

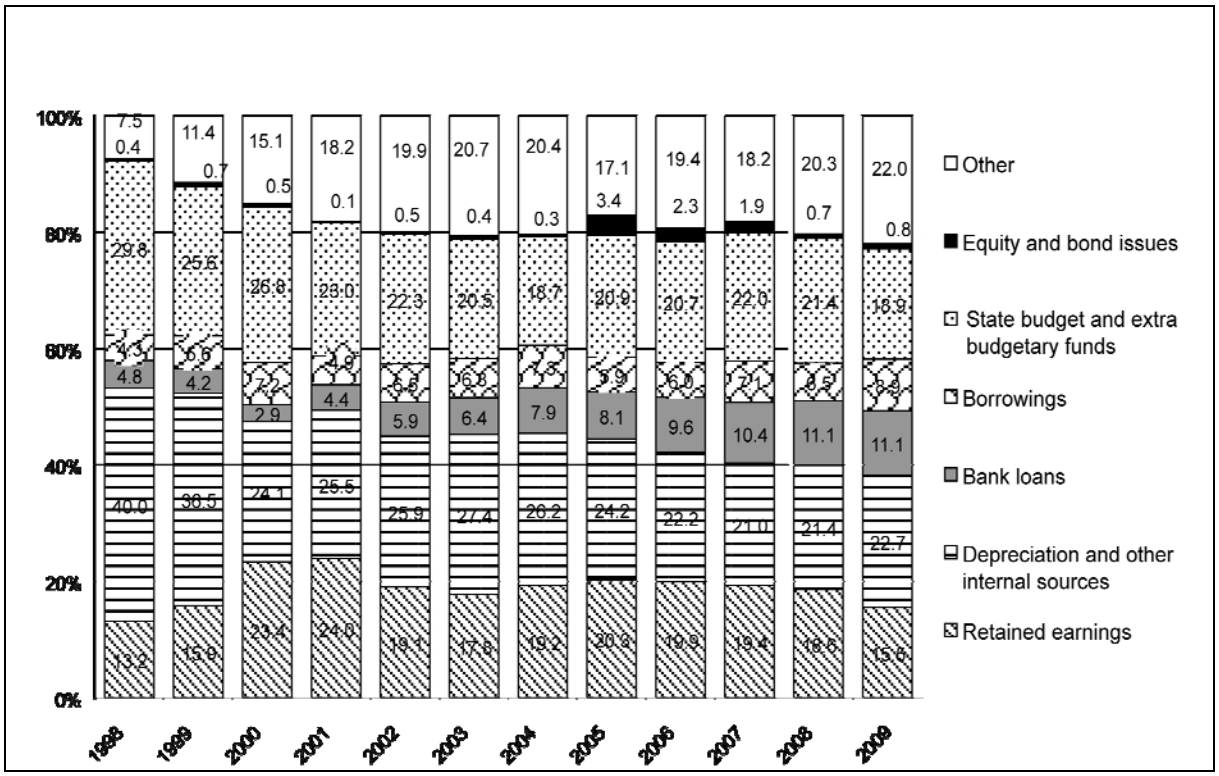
Table 7

Russian equity market indicators (billions of dollars)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Market capitalization	40,7	74,6	105,5	176,3	230,0	549,0	1057,0	1503,0	397,0	642,8
Secondary market, including foreign stock exchanges	46,7	49,4	86,8	188,3	541,3	374,0	914,2	1687,1	1982,5	1155,7

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Equity IPOs	0,5	0,2	1,3	0,6	3,0	5,2	17,0	33,0	1,9	1,7
Investments in capital assets	0,2	0,1	0,2	0,2	0,1	3,2	3,2	3,6	1,7	0,9
As a percentage of market capitalization	0,4	0,1	0,2	0,1	0,1	0,6	0,3	0,2	0,4	0,1
As a percentage of IPO volume	36,1	26,9	12,6	24,6	4,0	61,7	18,6	11,1	89,7	51,2
Merger and acquisition transaction volume	5,0	12,4	17,9	32,3	27,0	60,4	61,9	125,9	110,4	38,1*

* Estimate.
Source: proprietary calculations using data from MICEX, the Bank of Russia, the Statistics Committee, www.mergers.ru



Source: calculations using Statistics Committee data.

Fig. 49. The funding structure of investments in capital assets

The principal sources of funding for capital assets financing by real sector companies are retained earnings, government funds, extra budgetary funds, and bank loans that together accounted for 68% of all funding sources for capital asset investments in 2009. Throughout the 2000s, the share of funds raised by equity and bond placements among the total capital asset funding sources ranged from 0.1% in 2001 to 3.4% in 2005. In 2007 and 2008, it stood at 0.7 and 0.8% respectively.

The prospects of private equity funds and venture capital funds

The prospects of the Russian economy with regards to modernization are hindered by the weakness of the private equity fund and venture capital fund market segment. These funds working with Russian corporates can be divided into those created in offshore zones abroad (Svarog Capital Advisors, Russia Partners, Delta Private Equity Partners, Baring Vostok Capital, etc.), and closed-type unit investment trusts operating in accordance with the Federal Law On Investment Funds. As of mid-2009, Finance magazine estimated the net asset value of the first group of funds at approximately US$3 billion[1], while the National Fund Managers League estimated the net asset value of the second group of funds at approximately RUR 75 billion[2].

The reasons for the week development of private equity funds in Russia are indicated by the interview results from the city of 72 global private equity fund investors conducted by KPMG from December 2008 to February 2009[3]. In answering the question was a Russia appeared more attractive than other BRIC countries, 58% of respondents gave it a negative answer. Among the main reasons preventing these funds from operating in Russia in 2009-2010, investors claimed macroeconomic instability (89% of respondents); legal and regulatory restrictions (30% of respondents); unrealistic vendor price expectations (23% of respondents); political risks (16% of respondents); and the shortage of qualified fund managers (16% of respondents). It can only be added that the market for private equity transactions is at present in the hands of "monopolies" controlled by large oligarch corporations, which hinders the entry of independent market players, including major global private equity funds, and artificially limits both competition in this area and the mobilization of cutting-edge global technologies.

As regards closed type unit investment trusts investing in private equity, that growth prospects are still doubtful. In accordance with the legislation on investment funds, any information on private equity unit investment trusts is intended only for qualified investors and thus was removed from the public domain at the end of 2009. In accordance with the requirements of the Russian Federal Financial markets service, stock exchanges must create specialized trading sections for qualified investors, were participants will have access to information about such funds. It is unclear in this situation how potential investors who do not have the status of qualified investors, such as foreign investors, will be able to learn about existing and new private equity unit investment trusts. Such funds have found themselves outside of the scope of review by analysts and academics. In our opinion, the artificial information barriers introduced by the Russian Federal Financial markets service regarding the activities of private equity unit investment trusts will only result in the decrease of potential investor interest in such funds, which will have a negative impact on the growth prospects for such funds in Russia.

The creation and development of private equity funds and venture capital funds in Russia is also hindered by the lack of a government innovation development policy. At present, according to the ministry for education and science, more than 80 "technology parks" are regis-

[1] A. Golovin, Drrect investments comatose // Finance, No. 27-28 (310-311), July 27 – August 16, 2009.

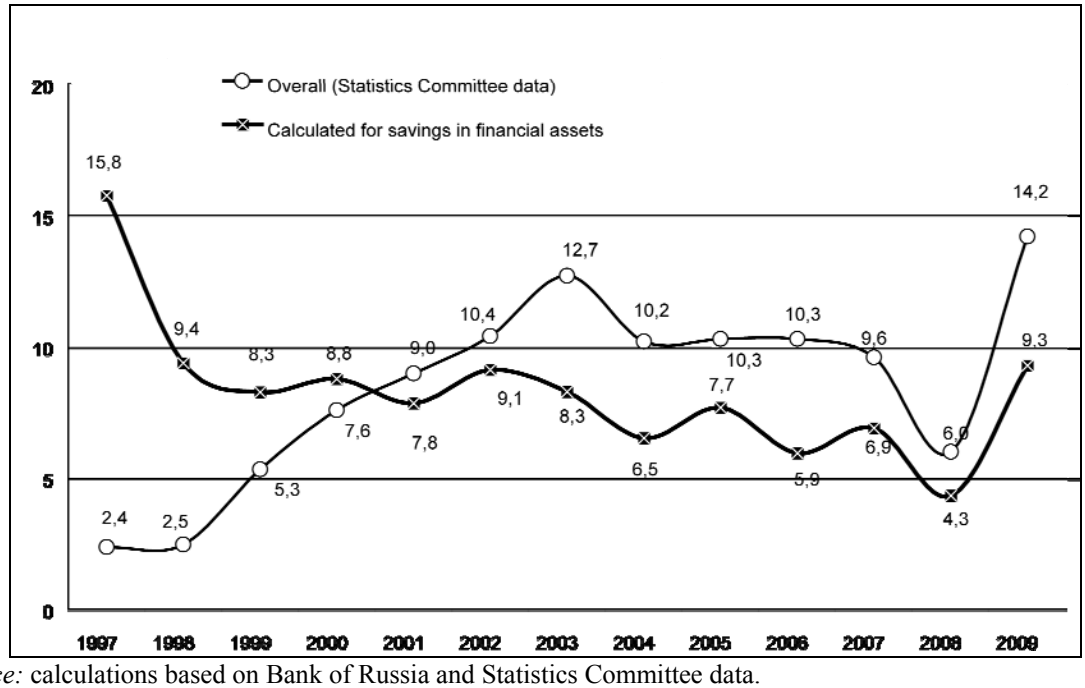
[2] At present, in accordante with the requirements of the Russian Federal Financial Markets Service, closed type unit investment trusts that invests in private equity classified as funds for qualified investors that cannot be advertised publicly. For this reason, the public information sources and unit investment trusts, www.nlu.ru and www.investfunds.ru , have stopped publishing statistics for this category of unit investment trusts.

[3] A. Golovin, Drrect investments comatose // Finance, No. 27-28 (310-311), July 27 – August 16, 2009.

tered in Russia, along with a greater number of innovation and technology centers, more than 100 technology transfer centers, 10 national innovation and analytics centers, 86 scientific and technical information centers, more than 120 business incubators, 15 innovation consulting centers, as well as a number of other innovation infrastructure entities.[1] This multitude of innovation entities is hardly justified. Further development of the innovation framework calls for the creation of centralised entities with regional representation that would undertake coordination functions with respect to the efforts of numerous local entities for the promotion of new technologies in the economy, as well as promote the dissemination of information about the capabilities of innovation organisations for enterprises in various sectors.

2.4.9. The impact on of the crisis on the domestic savings system

The financial crisis was a serious test for the savings system for individual investors. As expected, the crisis resulted in a significant growth of the public propensity for savings (a share of income allocated to savings annually), as evidenced by the data shown in *Fig. 50*. The public propensity for savings, including investments in financial assets and real estate, was estimated by the Statistics Committee to have grown from 6.0% of individual incomes in 2008 to 14.2% in 2009. The indicator of public savings in financial assets[2] that we have calculated separately has grown from 4.3% to 8.3% over the same period.



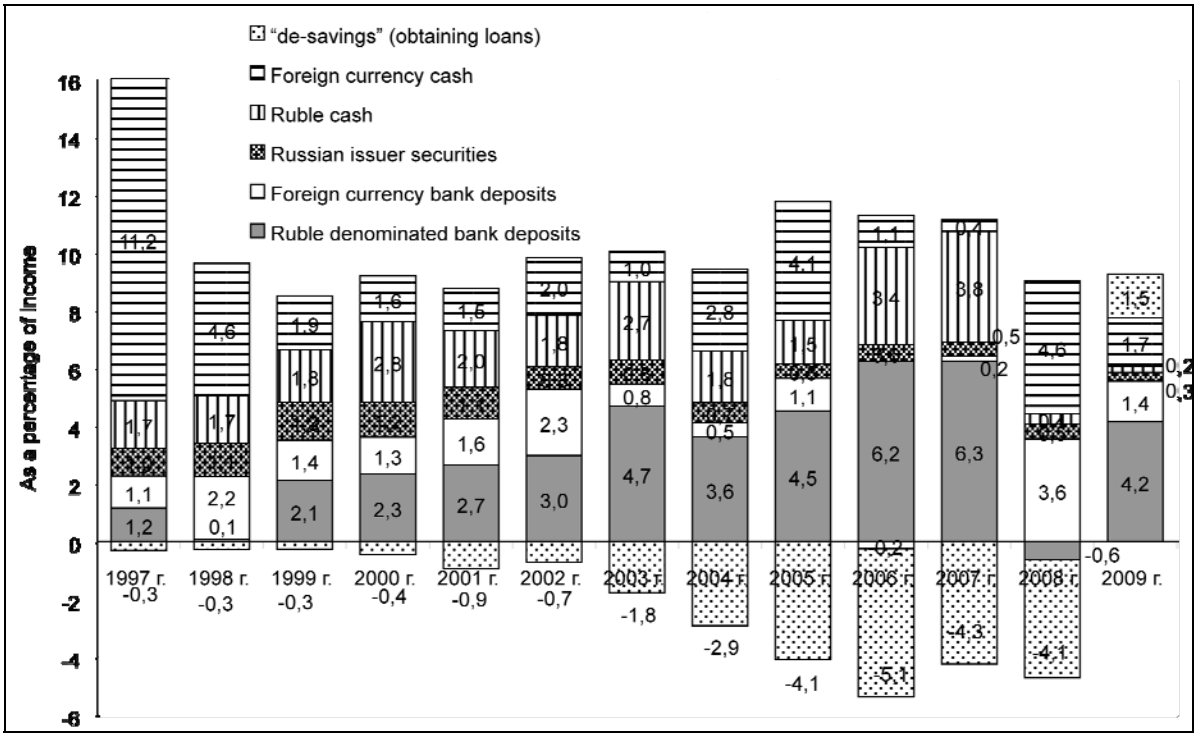
Source: calculations based on Bank of Russia and Statistics Committee data.

Fig. 50. Public propensity for savings, 1997–2009 (%)

The structure of public savings in financial assets is shown in *Fig. 51*. The 2008-2009 crisis has substantially changed the structure of public savings. At the start of the crisis, as a re-

[1] Venture Capital Investing. Business Guide // Kommersant, December 15, 2009.
[2] Including public savings in ruble denominated in foreign currency deposits, foreign currency and ruble cash, and securities less the increase in consumer lending.

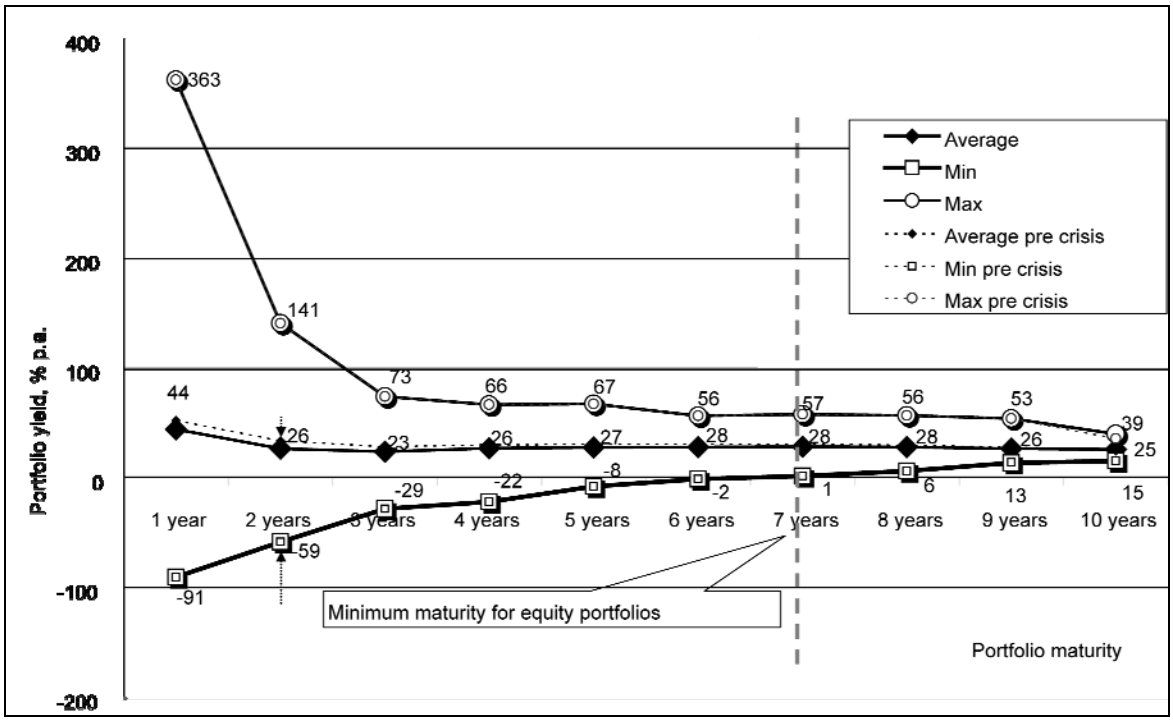
sult of the stock market slump and the ruble devaluation, the public decreased its cash savings and even decreased savings in ruble-denominated bank deposits, while savings in foreign currency cash and foreign currency deposits have substantially grown. In 2009, the public restructured their savings. As the devaluation stopped and the ruble continued to strengthen, savings in ruble-denominated bank deposits substantially increased, and the propensity for savings in foreign currency deposits and foreign currency cash decreased. For the first time during the 2000s, the savings indicators were positively influenced by the significant reduction of public indebtedness for consumer loans. The propensity for savings in securities did not experienced a significant change even during the crisis, remaining at a minimum level of 0.3 – 0.5% of individual incomes.



Source: calculations based on Bank of Russia and Statistics Committee data.

Fig. 51. Public propensity for savings in 1997–2009

For public savings to become a real catalyst of domestic market growth, it is necessary not only for millions of people to enter the market, but also for most of them to have real confidence in the potential of long-term savings strategies of 10, 20, 30 and more years. So far fewer believe it's such strategies, despite the fact that unlike speculative transactions, they can bring the greatest return to inexperienced investors. *Fig. 52* shows data on the minimum, maximum, and average portfolio yields for RTS index portfolios of different maturities from September 1995 through December 2009. For comparison purposes, the respective curves for the period from September 1995 through July 2008, i.e. up to the point preceding the latest financial crisis, are shown as dotted lines.



Source: calculations based on RTS data.

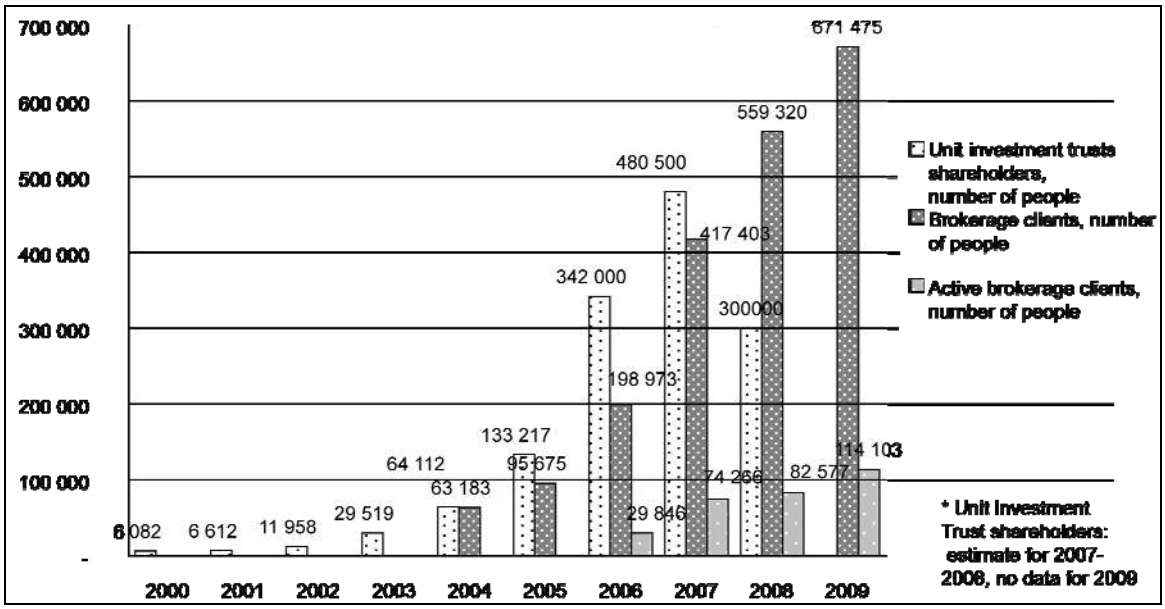
Fig. 52. Annual portfolio yields (% p.a.) for RTS index portfolios of various maturities from September 1995 through December 2009

The riskiest portfolio among the above is the one-year RTS index portfolio. In the 15-year observation period, the maximum yield for these portfolio amounted to 363% per annum, while the minimum yield amounted to a 91% drop in portfolio value. On average, investments in one-year portfolios yielded 44% over the investment period. As seen from the *Fig*., as portfolio maturity increases, the average annual yields stabilise, and the gap between the highest and lowest portfolio yields narrows. For investments in a seven-year portfolio for investors in the RTS index, minimum yields become positive at 1% per annum. Thus, only investments in the RTS index over seven years or more allow investors to avoid the diminution in the market value of their portfolio. For this reason, the minimum prudent term of investment in a diversified equity portfolio in the Russian market must amount to seven years or more. Moreover, as seen in *Fig. 52*, the yield curves for similar portfolios over the period preceding the 2008-2009 crisis practically coincide with the yield curves that extend into the crisis period, meaning that the current crisis had no impact on the minimum investment maturity for equity investments in the Russian market or on the long-term portfolio yield indicators.

Unfortunately, these advantages of long term lending in the Russian market are not sufficiently used at present. The bulk of investors focus on relatively short-term strategies. When signing agreements with financial intermediaries for brokerage services and trust management services in the securities market, the minimum acceptable investment terms for individual investors in high risk instruments are disregarded.

Fig. 53 shows available data on the number of individual investor accounts at brokerages and the number of registered accounts of unit investment trust shareholders. Unfortunately, at present NLU (the National League of Managers) does not disclose the number of unit investment trusts shareholders in a timely manner. However, assuming that this number in 2009 did

not experience a significant decrease compared to 2008, it may be estimated that the number of individual investors entering into securities transactions directly or through collective investment vehicles reached 1,000,000 in 2009.



Source: calculations based on MICEX, NAUFOR; and NLU data.

Fig. 53. The number of retail clients of fund management companies and brokerages

However, our estimates put the number of investors with a real investment potential at a much lower figure. Of the 671,000 brokerage clients in 2009, only slightly more than 25%, or about 170,000, had such investment potential. Among unit investment trusts shareholders, only about 100,000 individual investors have investment potential. The absence of a clear action plan for the pension system, high volatility in the Russian stock market, and uncertainty in the area of economic policy are likely to result in brokerage accounts and trust management accounts being unable to function as a means of accumulating long-term public savings in the foreseeable future. If the current situation continues, the growth in the client base of financial intermediaries is more likely to be due to the involvement in stock market operations of a greater number of investors prepared to risk small amounts for the sake of short term profits.

* * *

2009 became a period of unexpectedly fast recovery for the Russian stock market. The faster recovery compared to the 1998 crisis was due to the shorter duration of the oil price slump, which lasted only a quarter of the time compared to 1997-1998. With the huge foreign exchange reserves at its disposal, the state was able to prevent the spread of the financial crisis to the banking sector and to the lending market.

The financial market survived the 2008-2009 crisis. The government and the Bank of Russia showed considerable creativity in using various instruments to support banks, from offering unsecured loans to direct investments in bank equity. It is equally important to note that the bulk of funds were granted to banks on a temporary basis, and by the end of 2009 the Bank of Russia and the Ministry of Finance had effected a 50% withdrawal from the banking

sector. However, the banks were preserved in their pre-crisis shape. The multi-trillion support amounts had no effect on increasing the efficiency of banking operations. In terms of banking sector efficiency and its ability to lend to the real economy, Russia is a clear outsider in the international economic and financial sector competitiveness rankings. It is obvious that the existing banking sector is incapable of tackling the challenges of national economic modernization. As the government cuts back on its crisis mitigation support measures to banks, the absence of a clear outlook on the part of banks in terms of funding sources becomes ever more apparent. Domestic funds are too expensive, carry trading has not yet resumed, and foreign direct investment does not reach the banking sector. As the crisis nears its end, the government is increasingly facing the challenge of banking sector reform that it has tried to avoid throughout the 2000s.

The crisis has revealed equally serious problems in the stock market. It has become apparent that the rapid growth of stock prices, high liquidity, low borrowing rates for bond market issuers, and successful equity IPO and SPO placements were largely due to the growth in energy prices and to the influx of speculative portfolio investments from abroad, while there was still no steady inflow of foreign direct investment. The Russian stock market continues to be viewed as unsuitable for major conservative foreign investors. The pension savings system is not functioning. Public confidence in securities is very low. Collective investment lose value, and the effectiveness of this sector is significantly below that of foreign counterparts not only in established markets but also in other BRIC countries.

The crisis mitigation support measures used in the stock market in 2008-2009 were considerably more modest than those used in the banking sector. Moreover, the effectiveness of many such measures is doubtful. Thus, the use of RUR 175 billion to support the stock market in October 2008 – December 2009 should be considered as a highly favorable state margin loan to Vnesheconombank rather than an effective measure to support stock prices. It is also unlikely that tangible results were achieved by the restrictions on short sale transactions and margin lending. At the same time, the Bank of Russia and the Federal Financial Markets Service made considerable efforts only to maintain the stability of the ruble-denominated bond market in 2009 but also to enable it to reach record corporate bond placement volumes that, during the time of lending "blockage", became the vehicle for investing excess bank liquidity.

As the financial crisis subsides, the financial market is being faced with the increasing challenges of economic modernisation and financing innovations. It is obvious that neither the banking sector nor the domestic stock market in the current shape are capable of tackling these challenges. The system of financial intermediation in Russia developed during the 2000s with a view to servicing short-term speculative strategies. The low rates of return for investments in capital assets and a high rate of return of financial investments increased the distance between financial intermediaries and the real economy. An unsuccessful attempt at pension reform and the concentration of domestic savings in sovereign welfare funds, forcing companies and banks to resort to large scale foreign borrowings did not allow the transformation of domestic savings into a growth engine for Russian banks and investment companies. Russian banks and other financial intermediaries are becoming increasingly less competitive compared to global players.

In this situation, the key issue is not so much the strengthening of the role of Russian financial institutions in economic modernisation as a deep modernisation of the financial institutions themselves. This should be aimed at the creation of banks, nonbank financial holdings, pension funds and insurance companies that would be competitive not only in the domestic

market but also in the global market. Another option would be to develop a strategy of incorporating Russian financial intermediaries into the value chains of global financial institutions while ensuring the high level of local expertise in the rendering of financial services in Russia by such global intermediaries.

To achieve positive results in these endeavours to develop financial intermediation, new instruments of effective government presence in the domestic financial markets must be found. Accelerating innovation, not only in the financial markets but also in the real economy, is a typical "market gap" where the "invisible hand" of the market per se is unable to tackle the issue. This would require government involvement in the economic process and the establishment of an effective partnership between the state and private business. However, this requires a fundamentally new type of service by the government as well as the understanding by it of the contemporary business context, the modern strategic planning and marketing approaches at a sector and economic area level. In order to have globally competitive banks and financial holdings, the regulators must leapfrog from the current situation when the legal practices and efforts to increase the competitiveness in the domestic market are average at best to proactive supervision and prudent and effective interventions in business development strategies.

Five-year strategic development plans for the financial sector may be used as a transformation instrument. Unlike the current stock market development strategy that has been defined up to 2020, such five-year sector strategies must resemble company-level plans and contain specific targets for each year within that period, as well as a description of the objectives, tasks, and approaches, a detailed analysis of the market and market segments, the supply and demand of financial services, and data on the aggregate revenues and capitalisation of financial intrermediaries. The legislative, financial, and structural initiatives at sector level must be evaluated in terms of their impact on the five-year plans. In other words, the approaches to strategic planning that are increasingly used at company level must also be applied at sector level.

Another priority that would increase the role of financial markets in economic modernisation could be the gradual creation of a centralised innovation framework, whereby the effects of various financial institutions seeking to invest in the companies and sectors of the new economy could be coordinated.

2.4.10. Investment of pension savings in the mandatory pension insurance system

In 2009, the value of assets in the funded component of the mandatory pension system was displaying a rather uneven dynamics. In Q I 2009, their value less the amount of insurance contributions accumulated in the Pension Fund of the Russian Federation (PFR) continued to decline, having first demonstrated this trend in the autumn 2008. As seen from the data presented in *Table 1*, the drop amounted to 1.7 % (381.6 against 387.8 bn Rb)[1]. In Q II, the dynamics of this index once again became positive. The growth of asset value over than quarter was 38 % (526.6 against 381.6 bn Rb). The highest contribution to this upward dynamics resulted from the transfer, towards the very end of the quarter, of accumulated insurance contributions from the PFR – which was done after the receipt from the RF Ministry of Finance of

[1] Hereinafter, the data published by the PFR, the Federal Service for Financial Markets (FSFM), and *Vneshekonombank* are applied.

compensation for the declining value of the bonds issued within the framework of federal loans, in which these monies were invested. Net inflow of funds from the PFR to the asset managers in Q II amounted to 112.5 bn Rb out of 145 billion rubles (the sum of asset growth). Thus, by the mid-year 2009 the value of assets in the funded component of the mandatory pension system was by 31.6 % higher than its highest pre-crisis level achieved in mid-2008. In Q III 2009, asset value continued to increase, the growth rate amounting to 2.2 %.

Table 1

Value of assets in the mandatory funded pension system, 2007 - 2009 (bn Rb)*

Date	Value of assets in which pension savings transferred to asset managers were invested			Pension savings accumulated in IPF	Total
	subtotal	including in GAM	including in PAM		
01.01.2007	276.2	267.1	9.2	9.96	286.2
01.01.2008	375.1	362.9	12.2	26.8	401.9
01.04.2008	360.7	348.7	12.1	42.6	403.3
01.07.2008	366.0	353.7	12.3	43.1	409.1
01.10.2008	360.6	350.1	10.6	39.9	400.5
01.01.2009	352.2	343.1	9.1	35.5	387.8
01.04.2009	334.8	325.7	9.1	46.9	381.6
01.07.2009	459.3	446.6	12.7	67.3	526.6
01.10.2009	466.6	452.5	14.1	71.7	538.3

***** Less the amount of insurance contributions to the funded part of pension savings in the PFR.
Source: The indices of asset managers represent value of net assets as estimated on the basis of data published on the PFR's website www.pfrf.ru. The indices of IPF are based on the Summary Data on the activities of the IPF posted by the Federal Service for Financial Markets (FSFM) to its website www.fscm.ru

The share of the government asset manager (GAM), whose functions are performed by *Vneshekonombank (VEB)* in the asset value of the funded component of the mandatory pension system (less the amount of insurance contributions to the PFR) continued to decline, dropping over three quarters from 88.5 % to 84.1 %. **The share of the Independent Pension Fund** (IPF) over the same period increased from 9.2 % to 13.3 % (see *Table 2*). The main cause of this changed ratio was the switchover of insured persons from the PFR to the IPF. In spite of the financial crisis, the rate of that process altered only slightly – in Q I 2008 the share of the IPF in the assets constituting the funded component of the mandatory pension system increased by 3.9 p. p. (from 6.7 to 10.6 %), while its growth in the same period of 2009 amounted to 4.1 p. p. The share of pension savings transferred by the PFR to private asset managers (PAMs) demonstrated some growth, but still remained at a level lower than it had been prior to the onset of the crisis (2.6 % as of the end of Q III 2009, as compared to 3.0 % in the first half-year 2008).

Table 2

The distribution of assets between asset managers and the IPF within the funded component of the mandatory pension system, 2006 – 2009 (%)

	1.1.2006	1.1.2007	1.1.2008	1.1.2009	1.4.2009	1.7.2009	01.10.2009
Share of assets held by GAM	95.9	93.3	90.3	88.5	85.3	84.8	84.1
Share of assets held by PAMs	3.0	3.2	3.0	2.3	2.4	2.4	2.6
Share of assets held by IPF	1.1	3.5	6.7	9.2	12.3	12.8	13.3

	1.1.2006	1.1.2007	1.1.2008	1.1.2009	1.4.2009	1.7.2009	01.10.2009
Total	100	100	100	100	100	100	100
Including share of PAMs and IPF	4.1	6.7	9.7	11.5	14.7	15.2	15.9

Source: the indices of asset managers represent value of net assets as estimated from the data published on the PFR's website pfrf.ru; the indices of the IPF are based on the Summary Data on the activities of the IPF posted by the Federal Financial Markets Service to its website fscm.ru.

Investment of pension savings by asset managers.

The structure of investments by the GAM and of the aggregate investment portfolio of the PAMs that were investing pension savings under their agreements with the PFR is shown in *Fig. 1 – 8*. respectively.

As seen from these diagrams, the structure of the investment portfolios of asset managers as of the end of Q II 2009 was strongly influenced by the transfer of the pension contributions for the year 2007 from the PFR, which as of the reporting date remained on the bank accounts of the asset managers because the latter had had no time to invest these monies in securities. The share of securities dropped technically both in the GAM's and the PAMs' investment portfolios, while the share of monies kept with credit institutions exceeded the then existing limit of 20 % of the investment portfolio established by the law. Later on, in Q III, the share of monies kept by PAM in bank accounts dropped to 3 %, while the share of monies kept by the GAM remained close to the upper limit (18.8 % as of the end of Q III).

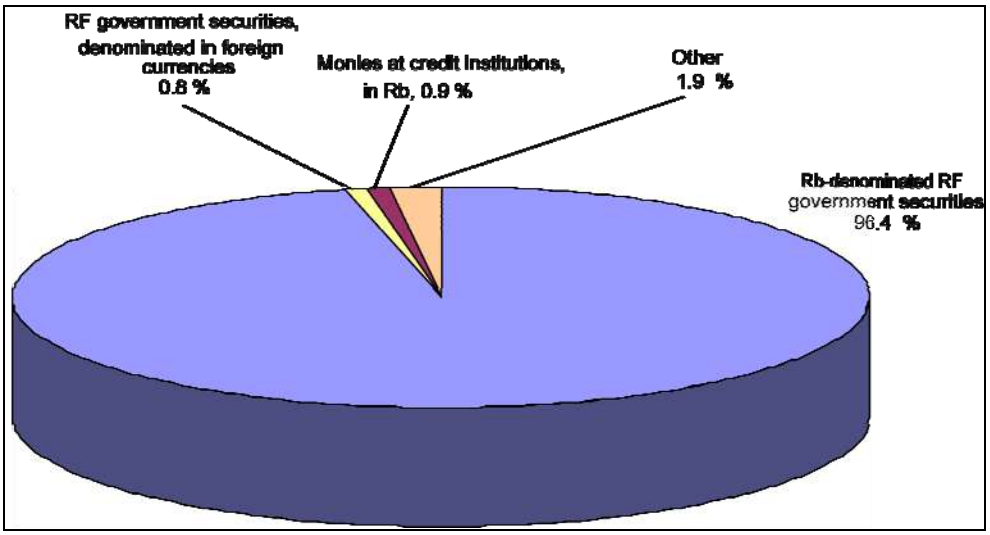


Fig. 1. The structure of the investment portfolio of the GAM (Vneshekonombank), as of the end of 2008.

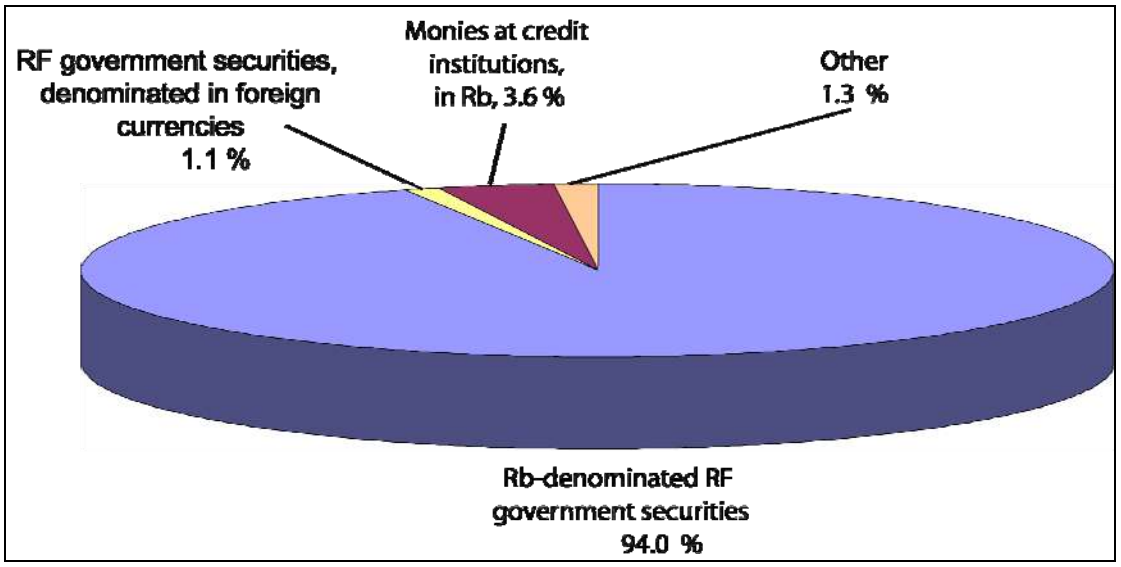


Fig. 2. The structure of the investment portfolio of the GAM, as of the end of Q I 2009.

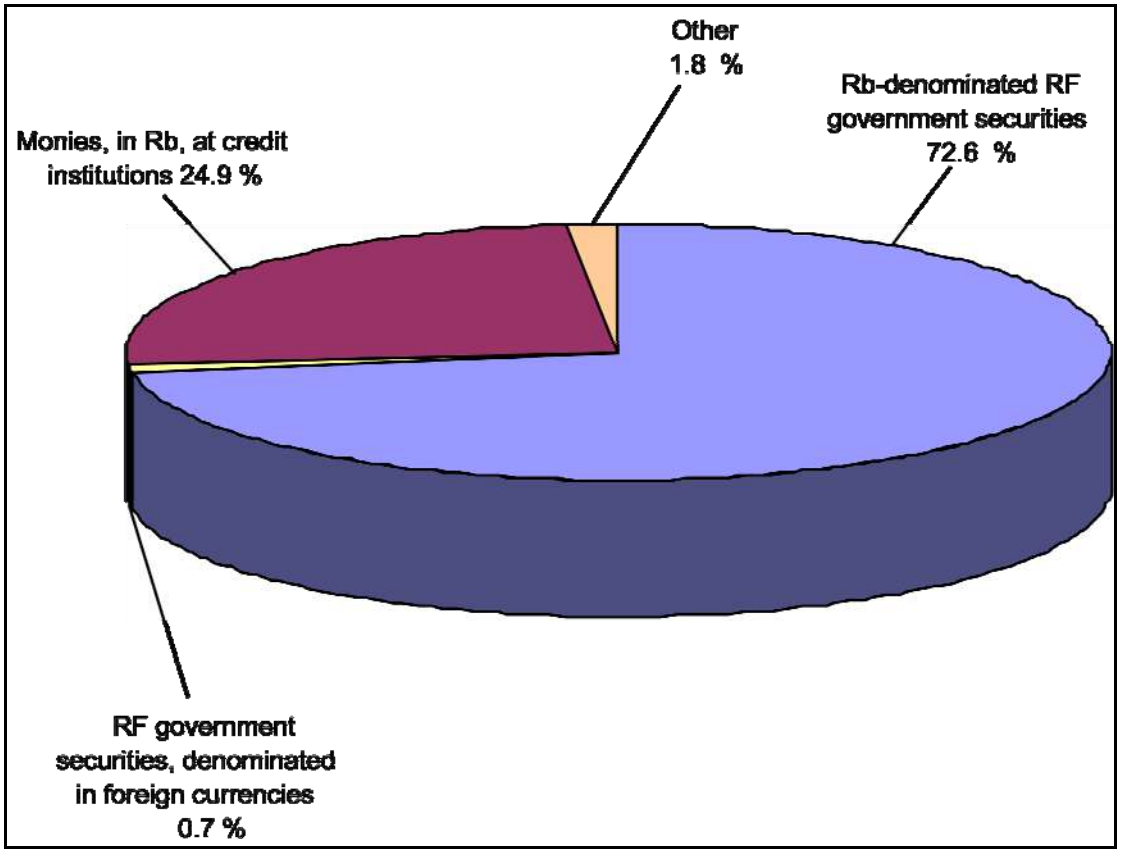


Fig. 3. The structure of the investment portfolio of the GAM, as of the end of Q II 2009.

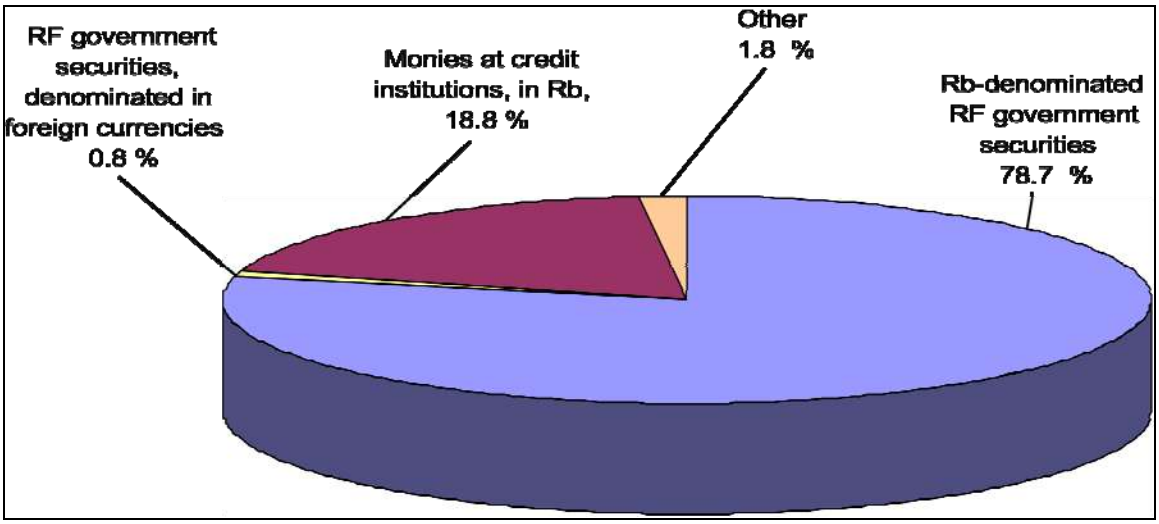


Fig. 4. The structure of the investment portfolio of the GAM, as of the end of Q III 2009

Investments by the GAM. The share of investments in RF external loan bonds in the GAM's investment portfolio during the year 2009 ied between 0.7 and 1.1 %. The share of the main instrument in which the GAM invests pension savings (RF domestic government loan bonds) dropped from 96.4 % at the year's beginning to 78.7 % as of the end of Q III.

From the point of view of the pension saving investment pattern displayed by the GAM, Q IV was the most interesting period - as in Q III the normative base for investing pension savings had undergone a few changes. Some amendments were made to FZ-111 "On the Investment of Funds to Finance the Funded part of the Labor Pension in the Russian Federation", whereby the set of instruments available for investing pension savings was expanded, including the investment of pension savings created in the name of those insured persons who had not made their choice of an asset manager.

The pension savings held in trust management by the GAM were divided into two portfolios: the default option; and the more conservative option – for those related persons who wish to limit their investments by government securities. They had to submit the applications to this effect before the end of September. Due to absence of any large-scale campaign aimed at explaining the details of such an arrangement, the number of actually submitted applications was small, and so less than 1 bn Rb was transferred to the GAM's conservative investment portfolio. Thus, the bulk of pension savings was concentrated in the default investment portfolio (the so-called general portfolio), the choices of permitted types of instruments for which have been expanded from November 2009 onwards.

By the end of 2009 the expanded investment portfolio continued to be dominated by government securities: their share amounted to 80.5 %. The share of the new instruments was approximately 6 % (the bonds of Russian economic societies – 1.6 %, mortgage bonds – 2.1 %, Rb-denominated bank deposits – 1.4 %). At the same time, the share of while the share of monies kept on credit institutions' accounts declined only slightly by comparison with the end of Q III and amounted to approximately 12.8 %.

Investments by PAMs. The dynamics of the Russian stock market in 2009 was on the whole favorable for investing pension savings. As shown by the MICEX index, growth over the year amounted to 122 %. During Q I 2009, growth on the share market as demonstrated

by the MICEX 10 index[1] was 23 %, which was to have a positive impact on the dynamics of the value of assets held by those PAMs that had a relatively high percentage of shares in their investment portfolios, and so decided not to register their losses. However, in the aggregate investment portfolio of PAMs the percentage of shares increased at a far lower rate than it would have been in the event of the asset managers preserving shares in their portfolios. If the data shown in *Fig. 5* and 6 are compared, it can be seen that the percentage of shares in their aggregate investment portfolio during that period increased by only 1.2 p.p.

Among the fixed income instruments, the most substantial drop over Q I 2009 was demonstrated by the share of corporate bonds (from 43.2 to 40.8 %), the share of subfederal bonds also declined. At the same time, asset managers increased their investments in ruble-denominated RF government securities, the share of which on the average grew from 4.8 to 5.2 %. However, the greatest growth was demonstrated by the share of 'other assets', the bulk of which is constituted by monies kept in broker accounts. The share of bank deposits dropped in Q I by 1.3 p.p.

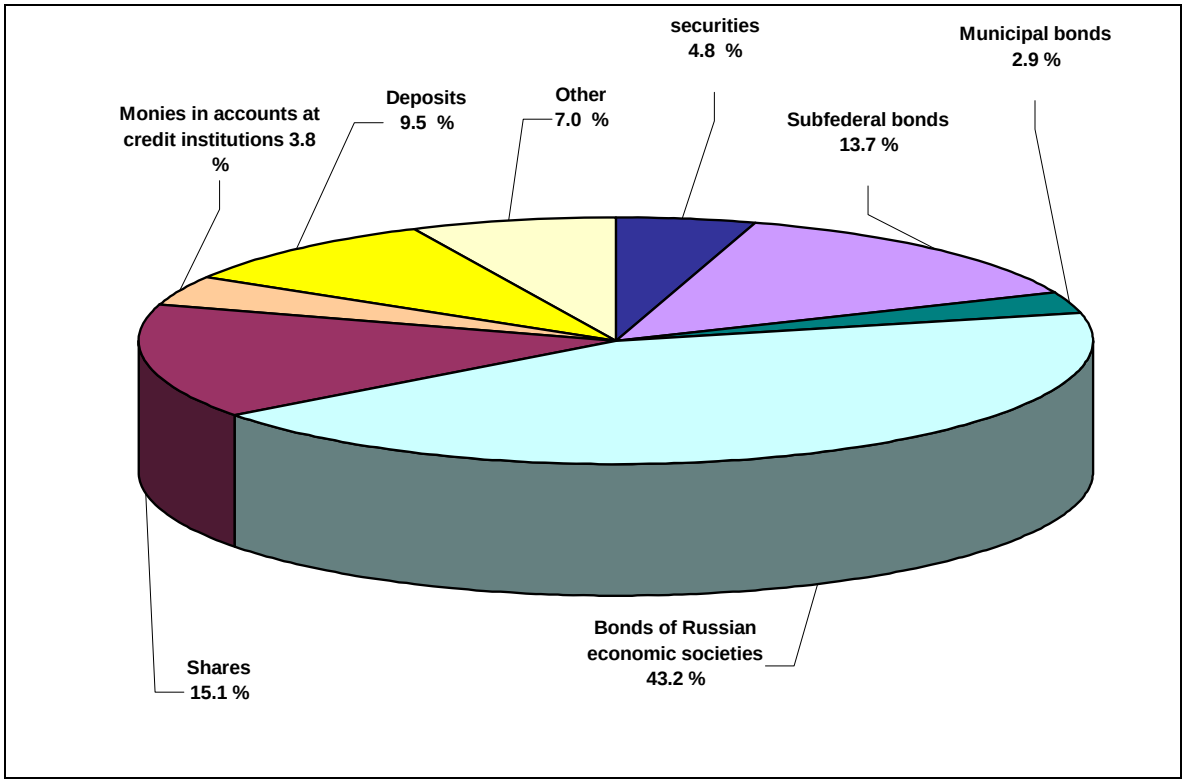


Fig. 5. The structure of the investment portfolios of private asset managers, as of the end of 2008

[1] The MICEX 10 index, while being a more narrow parameter of the stock market's dynamics (MICEX and RTS indices), is nevertheless – due to its composition – better suited to reflect the changes in prices of those shares in which pension savings can be invested. Besides, in contrast to the RTS index, it is estimated on the basis of ruble-denominated prices. However, not all of the companies encompassed by this index are included in the top quotations lists of Russian stock exchanges, and so some of them are not available for investing pension savings in.

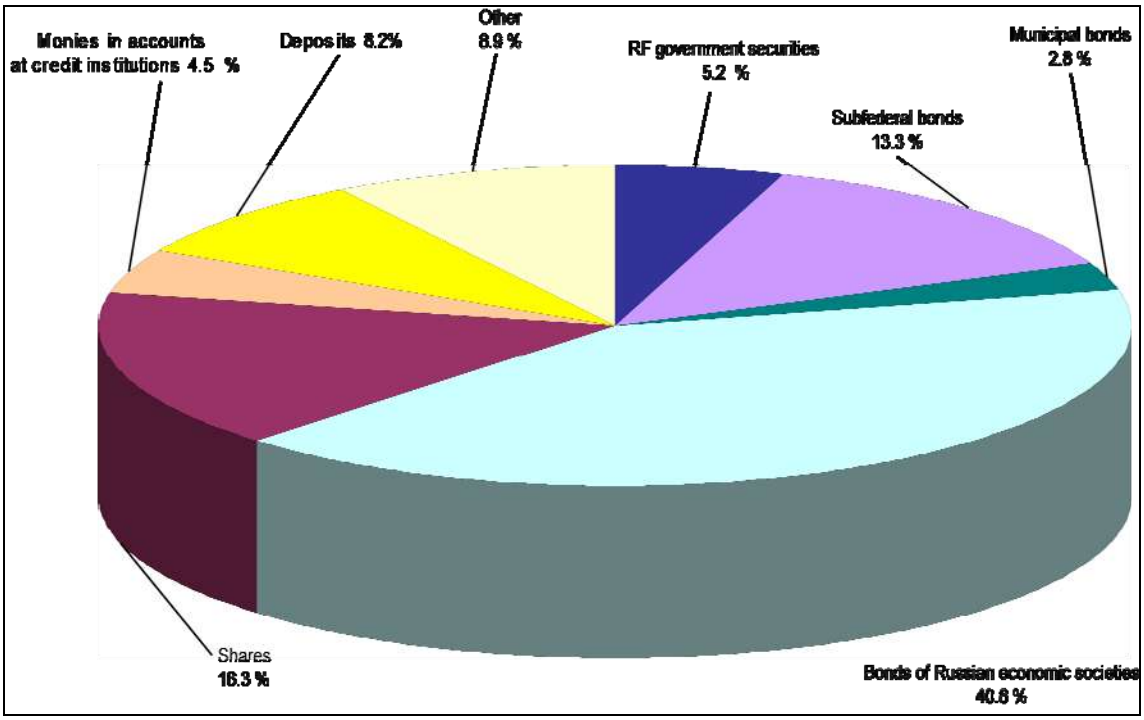


Fig. 6. The structure of the investment portfolios of private asset managers, as of the end of Q I 2009.

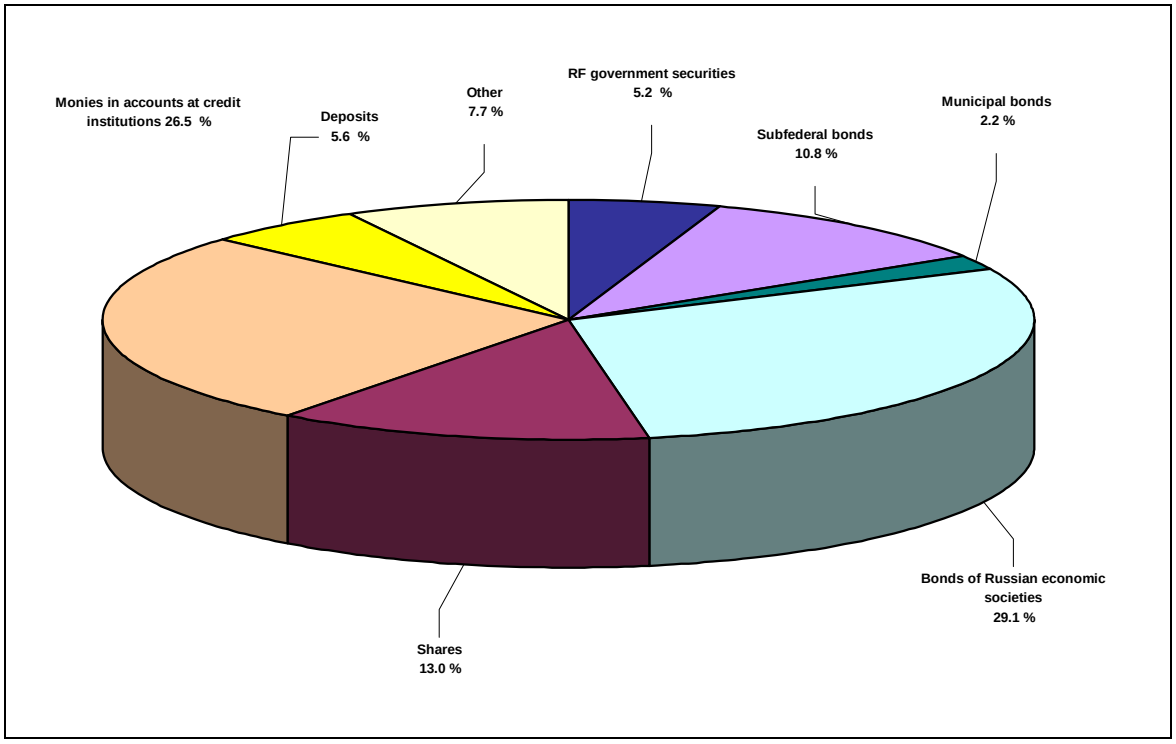


Fig. 7. The structure of the investment portfolios of private asset managers, as of the end of Q II 2009

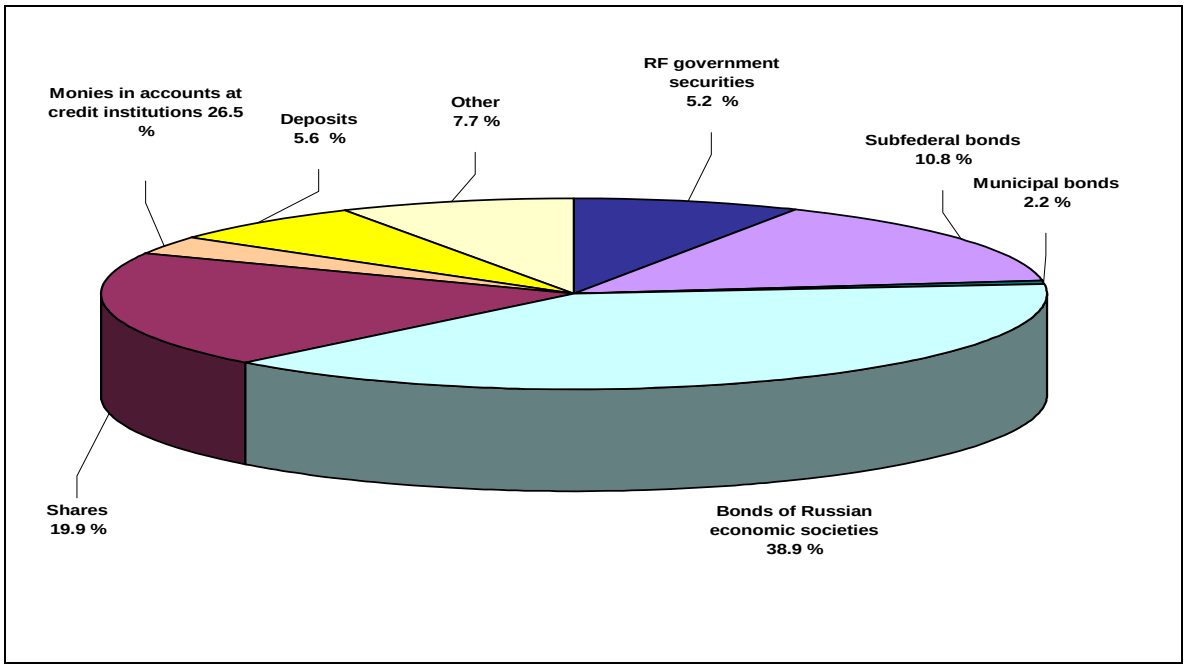


Fig. 8. The structure of the investment portfolios of private asset managers, as of the end of Q III 2009

By the end of Q III the share of equities in the aggregate investment portfolio held by PAMs increased to 19.9 % (against 15.1 % at the year's beginning). Simultaneously, PAMs continued to increase their investments in federal debt bonds (whose share over three quarters rose from 4.8 to 7.7 %). At the same time, the share of corporate bonds somewhat declined (from 43.2 to 38.9 %), as did that of bank deposits (from 9.5 to 6.2 %).

At the year's end, the structure of the investment portfolios held by PAMs began to be influenced to a certain extent by the alterations introduced in legislation on investing pension savings in Q III – IV 2009 (*Table 3*).

Table 3

Permitted assets and the upper limits established for the investment portfolio of an asset manager selected by an insured person

Assets	Restriction on percentage of assets, upper limit
Government securities of the Russian Federation	No
Government securities of subjects of the Russian Federation and municipal bonds	40
Bonds of Russian economic societies	80
Shares of Russian issuers	65
Mortgage securities issued under legislation on mortgage securities	40
Deposits and monies in bank accounts	80
Stakes (equities, shares) in index investment funds that invest in securities of foreign issuers	20
Bonds of international financial institutions	20

Other quantitative limits

Assets	Restriction, upper limit
Securities of one issuer or a group of related issuers, with the exception of government securities of the Russian Federation, securities issued against government guarantees of the Russian Federation, and mortgage securities	10 % of assets
Deposits with credit institutions and securities issued by those credit institutions	25 % of assets
Securities issued by entities affiliated with the asset manager and the specialized depositary	10 % of assets
Deposits with credit institutions affiliated with the asset manager	20 % of assets
Shares of one issuer	10 % of issuer capitalization
Bonds of one issuer, with the exception of government securities of the Russian Federation, securities issued against government guarantees of the Russian Federation, and mortgage securities	20 % of aggregate volume of issuer's bonds in circulation
Securities of one issuer in the aggregate investment portfolio, with the exception of government securities of the Russian Federation, securities issued against government guarantees of the Russian Federation, and mortgage securities	50 % of aggregate volume of one issuer's securities in circulation

Rate of return on investments

By the results of Q I 2009, the rate of return on the pension savings invested by the GAM was found to be negative (– 7.2 %), which can be explained mainly by the unfavorable dynamics of prices for RF domestic loan bonds during that period. However, if a longer period is looked at, the overall rate of return on the pension savings invested by the GAM remained positive. The maximum period for which the PFR's published data are available is three years. Over that time, the mean annual rate of return on the GAM's investments was 2.9 %. A higher result over the same period could be demonstrated only by six of the PAMs' investment portfolios.

By the results of Q II 2009, the rate of return, in nominal terms, on the pension savings by the GAM once again became positive (3,2 % per annum in the half-year), mainly due to the favorable dynamics of prices for RF domestic loan bonds over that period. Reevaluation of securities yielded in Q II a sum of 9.5 bn Rb, coupon income on OFZ amounted to 1.6 bn Rb.

The rate of return on the GAM's investments over the three first quarters of last year amounted to 4.1 % per annum, and over three years – to 3.4 %. Thus, VEB was pushed to 21st place among the investment portfolios of the asset managers investing pension savings under trust management agreements with the PFR (by the results of the year 2008, VEB was the 8th by this index, having demonstrated a rate of return of 3.7 %).

By the results of Q III 2009, PAMs mainly demonstrated a higher rate of return on their investments than the GAM did. By the results of Q I, negative rates of return were shown by only three PAMs, one of which (FB *AVGUST UK*) had only just begun to operate as a trust manager of pension savings. The rates of return displayed by the others varied from 7 to 88.7 % per annum. The mean index was 32 % per annum[1].

The rate of return on the investments made by PAMs in the first half-year 2009 was on the average 34.4 % per annum. As seen by the results of the three-year period, 33 PAMs once again displayed a positive rate of return in nominal terms. In Q III 2009, the results of invest-

[1] Relative to the average value of net assets as estimated in accordance with the requirements stipulated in Article 16 of the Federal Law "On the Investment of Funds to Finance the Funded Part of the Labor Pension in the Russian Federation" .

ing by PAMs changed only slightly. In the period from the year's beginning, for 36 companies their negative results of the previous three years were replaced by positive results. It should be noted that the investment portfolios of the leaders by the rate of return levels belonged to the category of medium-sized and small (while the average sum of managed assets as of the end of Q III was 231 mln Rb, the size of assets in the investment portfolios displaying the highest rates of return over the three previous years varied from 124 mln Rb (UK *Portfel'nye investitsii* [Portfolio investments] to 3 mln Rb (the 'conservative' investment portfolio of *Trinfiko*) (*Fig. 4*).

Table 4

The asset managers with the highest rates of return on pension savings investments

Place held by results of first three quarters of 2009	Asset manager	Rate of return on pension savings investments, % per annum		
		over 3 years (Q IV 2006 – Q III 2009)	over Q III 2009	over 12 months (Q IV 2008 – Q III 2009)
1	*Otkrytie*	11.44	30.38	20.64
2	*Portfel'nye investitsii*	9.82	94.08	41.45
3	*Trinfiko*, long-term growth IP*	8.99	135.16	57.7
4	*TrinfikoK*, balanced IP	8.85	71.22	38.97
5	*TRINFIKO*, 'conservative' IP	7.4	21.73	13.71
21	*Vneshekonombank*	3.41	4.08	1.09

* IP – investment portfolio.

2.4.11. The Market for Municipal and Subfederal Borrowing

The Dynamic of the Advancement of the Market

Russia's 2009 consolidated regional budget and budgets of the territorial government extrabudgetary funds combined posted a Rb. 329.3bn deficit equaling 0.84% of GDP. When compared with the 2008 figures, the amount of the regional consolidate budget deficit surged relative to GDP seven-fold (the 2008 deficit of the territorial budgets accounted for Rb. 48.7 bn, or 0.12% of GDP).

The RF Subjects' 2009 budgets combined reported a Rb.276.9 bn deficit, urban entities – a 39.7bn- worth deficit, the intracity urban entities of the city of Moscow and St. Petersburg – 0.07bn, budgets of municipal districts – 18.9 bn., while budgets of urban and rural settlements posted a surplus of Rb 6.2bn. The respective figures of the year of 2008 were: for the RF Subjects – deficit of Rb. 38.2bn, for urban entities – deficit of 13.2 bn, the city of Moscow and St. Petersburg – surplus of 0.1bn, municipal districts – deficit of 2.7 bn, urban and rural settlements – surplus of 5.2bn.

Table 1

Surplus (Deficit) of Territorial Budgets to Budget Expenditure Ratio (as %)

Год	Consolidated regional budget	Regional budgets*
2009	–5.3	–5.3
2008	– 0.7	– 0.7
2007	0.8	0.6
2006	3.7	4.4
2005	1.6	2.3
2004	1.1	1.6
2003	–2.6	–2.3
2002	–2.7	–3.0

* With account of the government extrabudgetary funds.
Source: calculations by IET on the basis of the Russian Ministry of Finance data.

Table 2

Surplus (Deficit) of Territorial Budgets to Budget Expenditures Ratio in 2007–2009 (as %)

Year	Budgets of the intracity urban entities of the city of Moscow and St. Petersburg	Budgets of urban entities	Budgets of municipal districts	Budgets of urban and rural settlements
2009	–0.63	–3.32	–1.88	2.63
2008	– 1.47	1.09	–0.26	2.72
2007	5.34	1.23	–0.04	2.34

Source: calculations by IET on the basis of the RF MinFin data.

As of January 2010, as many as 61 Subjects of RF reported deficit of their consolidated budgets (in 2008 – 45 regions) worth a total of Rb. 377.9 bn, or 7.8% of the revenues part of the respective budgets (in 2008 – 132.7 bn., or – 3.1%).

The median level of the budget deficit accounted 6.4% to revenues to a respective budget. The greatest budget deficit to the revenue part of the budget ratio was noted in Astrakhan oblast – 16.7%, Vologda oblast – 16.1%, Nizhny Novgorod oblast – 15.2%, Republic of North Ossetia (Alania) – 14.9%, the city of Moscow – 14.4%. Over a half (53.4%) of the aggregate deficit fell on 5 Subjects of the Federation: the city of Moscow – 38.6%, or Rb 145.7 bn, Krasnoyarsk Krai – 4.4%, or 16.5bn., Nizhny Novgorod oblast – 3.9%, or 14.8bn, Moscow oblast – 3.7%, or 12.4bn, and Republic of Tatarstan - 3.2%, or Rb12,1 bn. (*Table. 5*).

In 2009, as many as 22 Subjects boasted a surplus of their consolidated budgets (vis-avis 39 ones in 2008) The aggregate volume of the budget surplus in these regions accounted for Rb. 48.6bn, or 3.9% of the amount of the revenue part of their budgets (in 2008 – Rb. 84.0bn, or 3,9% pf the revenue part of their budgets). The median level of the budget surplus made up 1.8% of the revenue part of the budget.

The greatest surplus-to-revenue-level ratio was registered in Chukotka AO – 22.9%, Yamal-Nenetsky AO – 13.7%, Primorsky Krai – 12.7%. Nearly three-fourths (72.6%) of the aggregate surplus of the consolidated regional budget was secured by 4 Subjects of RF: Yamal-Nenetsky AO – 25.0%, or Rb 12.1bn., Primorsky Krai – 24.9%, or 12.1bn, Irkutsk oblast - 12.5%, or Rb 6.0bn, Chukotka AO – 10.3%, or Rb5.0 bn.

Change in the Structure of the Accumulated Debt

The amount of the debt accumulated by the consolidated regional budget by current borrowings in 2009 rose by Rb.289, 632.6 mln, or 0.74% GDP (*Table 3*), while the regional con-

solidated budgets' external debt shrank at Rb. 61.3mln and the domestic one rose at Rb289, 693.9 mln

Table 3

Net Borrowings by Regional and Local Budgets (в % ВВП)

Год	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Borrowings by subfederal and local governments, including	0.33	0.15	–0.29	–0.04	0.47	0.37	0.26	0.09	0.21	0.17	0.29	0.74
Repayable loans from budgets of other levels	–0.09	–0.11	–0.03	0.04	0.12	–0.1	–0.02	–0.03	–0.04	–0.01	0.03	0.33
Subfederal (municipal) bonds	–0.01	–0.05	–0.27	–0.07	0.16	0.31	0.29	0.09	0.14	0.08	0.17	0.24
Other borrowings	0.43	0.31	0.01	–0.02	0.19	0.6	…	0.03	0.11	0.10	0.09	0.17

Source: calculations by IET on the basis of the RF Ministry of Finance data

Structure of borrowings

The 2009 aggregate volume of borrowings by the regional consolidated budget accounted for Rb. 634, 384.2 mln, including external borrowings amounting 716.9 mln. Like in 2008, the sole recipient of external loans once again became Republic of Bashkortostan.

The aggregate volume of domestic borrowing by regions and municipalities accounted for Rb. 633, 667.3bn. The largest borrowers on the domestic market were: the city of Moscow – Rb. 128.4 bn, Moscow oblast – 86.1 bn, Republic of Tatarstan – 37.7 bn, Nizhny Novgorod oblast – 31.1bn, Omsk oblast – 26.1 bn, whose share combined accounted for 48.8% of borrowings. When compared with 2008, the volume of domestic borrowing in nominal terms soared by Rb. 224, 588.9 mln, or at 54.9% (54.5% in real terms).

The proportion of securities issuances in the overall volume of the domestic borrowing was 24.9%, while that of loans disbursed from higher-tier level budgets was 26.9%, and another 48.2% fell on other borrowings (primarily bank loans).

It was a relative rise in the interbudgetary borrowing that became the most significant change in the structure of the regional budgets' borrowings. Specifically, the proportion of budget loans soared from 5.0% up to 31.5% of borrowings by the Subjects of the Federation. Meanwhile, the proportion of issuances of securities slid from 51.9% to 28.5% (*Table 4*).

Table 4

Structure of the Subnational Budgets' Domestic Borrowing (as %)

	2009			2008			2007		
	Regional consolidated budget	Regional budgets	Municipal budgets	Regional consolidated budget	Regional budgets	Municipal budgets	Regional consolidated budget	Regional budgets	Municipal budgets
Securities issuances	24.9	28.5	4.4	43.7	51.9	1.9	32.1	39.5	7.1
Budget loans	26.9	31.5	0.4	5.0	5.9	0.2	3.8	4.9	0.1
Other kinds of borrowings	48.2	40.0	95.3	51.4	42.6	97.8	64.2	55.6	92.8

The greatest net-borrowings-to-budget-revenues ratio was demonstrated by Vologda oblast – 13.3%, Kostroma oblast – 12.6%, Tver oblast – 12.4%, Nizhny Novgorod oblast – 12.3%, the city of Moscow – 10.6%, Moscow oblast – 10.1%, Arkhangelsk oblast – 10.1% (*Table 5*).

The largest net borrowers became the city of Moscow – Rb.107.5 bn, Moscow oblast– 31.8 bn., Republic of Tatarstan – 13.5 bn.

The following regions to a maximum extent reduced their debt: Irkutsk oblast – by Rb 3.7 bn., Chukotka AO –2.3 bn, Kamchatka Krai –1.2 bn, Republic of Buryatia –1.2 bn.

Table 5

Execution By Subjects of the Federation of their 2009 Consolidated Budgets

	Budget revenues (as Rb. Thos)	Budget deficit (surplus) (as Rb. Thos)	Deficit (surplus)/revenue, as %	Attracted borrowings/revenues, as%	Net borrowing/revenues, as%	Expenditures on debt repayment/ revenues, as%	Net borrowing/deficit (surplus), as %
The Central Federal Okrug							
Belgorod oblast	55 738 185 303.83	4 141 897 456.85	7.43	11.39	6.51	4.88	70.96
Bryansk oblast	31 387 002 926.04	751 373 767.42	2.39	20.32	5.22	15.10	–619.57
Vladimir oblast	40 718 207 912.09	82 561 357.90	0.20	0.77	0.16	0.61	–18.36
Voronezh oblast	59 451 332 291.40	2 706 629 885.81	4.55	7.32	4.51	2.81	125.77
Ivanovo oblast	28 425 263 857.34	1 353 777 363.99	4.76	6.67	3.72	2.95	79.64
Tver oblast	45 786 911 371.16	5 704 309 284.79	12.46	20.95	12.43	8.53	153.77
Kaluga oblast	31 141 992 450.89	–178 932 348.10	–0.57	6.37	–0.69	7.06	–11.03
Kostroma oblast	18 415 962 648.28	2 314 160 317.79	12.57	33.54	12.59	20.96	79.21
Kursk oblast	30 979 830 613.95	431 742 233.15	1.39	1.41	1.34	0.06	56.31
Lipetsk oblast	36 493 848 633.88	77 425 825.09	0.21	2.26	0.20	2.07	2.53
Moscow oblast	314 250 834 941.90	4 732 199 172.27	1.51	27.39	10.12	17.27	249.97
Orel oblast	20 033 044 293.12	463 251 675.32	2.31	2.77	1.75	1.02	56.89
Ryazan oblast	31 841 054 833.59	2 775 178 399.94	8.72	36.26	9.39	26.87	87.68
Smolensk oblast	24 785 738 746.23	2 472 960 106.67	9.98	23.23	9.86	13.37	150.52
Tambov oblast	30 799 195 183.46	254 460 126.62	0.83	10.90	0.98	9.92	–55.98
Tula oblast	40 522 277 745.69	3 345 337 177.76	8.26	21.18	7.43	13.75	103.76
Yaroslavl oblast	52 085 863 047.90	1 258 676 839.39	2.42	23.89	1.39	22.51	431.50
The city of Moscow	1 010 681 522 136.46	131 955 702 354.54	13.06	12.70	10.63	2.07	73.75
Total	**1 903 538 068 937.21**	**164 642 710 997.20**	**8.65**	**15.50**	**8.74**	**6.75**	**89.15**
North-Western Federal Okrug							
Republic of Karelia	25 759 648 044,26	2 305 402 787,29	8.95	20.72	8.44	12.28	63.92
Komi Perublic	45 363 728 617.86	2 850 722 228,58	6.28	6.83	6.25	0.58	269.50
Arkhangel oblast	49 264 374 992.61	5 011 886 155,35	10.17	27.01	10.14	16.87	77.78
Vologda oblast	40 127 334 567.89	5 451 558 165,63	13.59	15.92	13.31	2.61	82.70
Kaliningrad oblast	42 059 247 911.19	–307 246 060,73	–0.73	5.40	0.68	4.72	–10.77
Leningrad oblast	62 356 683 976.42	1 566 942 046,21	2.51	1.71	1.55	0.16	21.29
Murmansk oblast	46 315 152 524.15	4 126 113 121,82	8.91	11.56	8.75	2.81	158.06
Novgorod oblast	23 657 894 733.01	1 008 244 977,70	4.26	6.51	4.13	2.38	59.04
Pskov oblast	19 824 310 562.43	55 545 966,46	0.28	0.65	0.17	0.49	4.39
St. Petersburg	319 796 900 044.13	6 721 153 341,07	2.10	0.51	0.50	0.01	24.82
Nenetz AO	9 463 669 651.52	54 183 204,47	0.57	0.34	0.34	0.00	5.09
Total	**683 988 945 625.47**	**28 844 505 933,85**	**4.22**	**5.87**	**3.40**	**2.47**	**74.63**
Southern Federal Okrug							
Republic of Dagestan	64 422 824 659.08	–105 389 478.46	–0.16	0.47	–0.31	0.78	–6.29
Kabardino-Balkar Republic	22 532 343 177.94	–481 387 007.70	–2.14	4.07	–2.63	6.70	282.27
Republic of Kalmykia	9 517 889 145.16	258 982 513.48	2.72	6.56	2.70	3.86	42.15
Republic Northern Ossetia (Alania)	17 100 779 668.73	1 059 717 500.84	6.20	21.68	5.84	15.84	39.29
Republic of Ingoushetia	14 525 128 927.17	17 498 284.00	0.12	0.41	0.41	0.00	9.18

	Budget revenues (as Rb. Thos)	Budget deficit (surplus) (as Rb. Thos)	Deficit (surplus)/revenue, as %	Attracted borrowings/revenues, as%	Net borrowing/revenues, as%	Expenditures on debt repayment/ revenues, as%	Net borrowing/deficit (surplus), as %
Krasnodar Krai	152 407 324 750.44	2 061 944 122.13	1.35	3.39	1.10	2.28	83.42
Stavropol Krai	65 431 602 771.45	4 525 768 989.04	6.92	7.33	6.88	0.45	66.27
Astrakhan oblast	28 601 743 867.17	2 810 981 780.17	9.83	52.51	9.75	42.76	58.42
Volgograd oblast	69 188 124 673.82	4 061 254 191.06	5.87	16.94	5.57	11.37	72.39
Rostov oblast	112 416 246 536.20	3 033 842 816.80	2.70	2.34	2.34	0.00	52.74
Republic of Adygeya (Adygeya)	12 278 164 926.59	476 407 531.90	3.88	7.20	3.45	3.75	39.68
Karachai-Cherkess Republic	12 330 470 530.69	316 130 455.82	2.56	8.27	2.52	5.76	84.42
Chechen Republic	65 258 784 941.45	1 395 900 000.00	2.14	3.44	3.21	0.23	23.83
Total	**646 011 428 575.89**	**19 431 651 699.08**	**3.01**	**7.60**	**2.91**	**4.69**	**45.99**
Volga Federal Okrug							
Republic of Bashkortostan	114 095 746 177.27	1 048 294 370.17	0.92	4.25	2.88	2.00	97.62
Republic of Mary El	17 100 732 333.60	683 851 463.21	4.00	15.16	3.56	11.60	106.79
Republic of Mordovia	28 438 902 589.61	463 766 776.33	1.63	5.77	1.08	4.69	–154.66
Republic of Tatarstan (Tatarstan)	140 636 971 609.40	13 859 096 321.09	9.85	26.80	9.59	17.22	111.50
Republic of Udmurtiya	41 325 619 958.27	3 869 225 490.95	9.36	13.92	8.42	5.50	99.67
Chuvash Republic – Chuvashiya	33 717 656 115.22	1 374 597 048.24	4.08	9.29	3.30	5.98	126.08
N. Novgorod oblast	97 391 066 292.50	12 050 201 127.91	12.37	31.91	12.31	19.60	81.13
Kirov oblast	38 790 861 575.24	1 951 208 953.44	5.03	11.72	4.80	6.92	57.72
Samara oblast	100 869 798 357.36	11 266 416 099.43	11.17	6.95	4.70	2.25	50.97
Orenburg oblast	64 436 217 155.39	317 724 805.41	0.49	0.63	0.29	0.34	–110.91
Penza oblast	36 635 622 192.36	1 849 468 483.76	5.05	17.77	4.99	12.78	65.80
Perm Krai	94 754 274 520.18	9 521 684 835.07	10.05	0.42	–0.73	1.15	–12.85
Saratov oblast	66 219 939 658.84	6 120 478 998.35	9.24	21.93	9.28	12.66	86.45
Ulyanovsk oblast	35 935 296 937.92	1 037 769 724.21	2.89	5.93	2.72	3.22	–616.66
Total	**910 348 705 473.16**	**65 413 784 497.57**	**7.19**	**13.43**	**5.42**	**8.09**	**78.96**
Ural Federal Okrug							
Kurgan oblast	26 609 955 616.41	278 494 439.00	1.05	4.13	1.00	3.13	236.13
Sverdlovsk oblast	139 547 962 746.17	4 566 949 161.57	3.27	4.21	3.07	1.15	101.32
Tyumen oblast	125 986 129 061.88	9 069 466 515.23	7.20	0.02	0.01	0.00	0.22
Chelyabinsk oblast	88 251 628 590.05	3 198 267 307.95	3.62	5.05	3.51	1.53	63.33
Khanty-Mansy AO	152 434 194 732.71	8 100 391 235.13	5.31	5.25	4.88	0.36	–422.45
Yamal-Nenetsky AO	88 833 384 569.03	–266 527 432.49	–0.30	0.17	–0.10	0.27	0.74
Total	**621 663 255 316.25**	**24 947 041 226.39**	**4.01**	**3.15**	**2.42**	**0.74**	**421.54**
Siberian Federal Okrug							
Republic of Buryatiya	40 589 657 386.54	–1 184 997 912.19	–2.92	7.80	–2.98	10.78	179.23
Republic of Tyva	15 709 466 795.90	32 967 603.45	0.21	0.23	0.20	0.04	4 314.94
Altay Krai	65 513 407 539.48	1 878 131 229.90	2.87	3.05	–0.09	3.14	–8.49
Krasnoyarsk Krai	155 429 378 758.06	10 253 929 464.12	6.60	9.87	6.44	3.43	60.71
Irkutsk oblast	88 570 706 990.67	–3 683 909 020.37	–4.16	10.89	–4.15	15.04	60.83
Kemerovo oblast	100 372 700 771.87	4 908 780 065.61	4.89	8.86	5.60	3.27	95.11
Novosibsrk oblast	87 021 307 853.39	1 513 384 203.57	1.74	7.31	1.28	6.03	27.52
Omsk oblast	53 936 075 350.84	4 216 251 116.18	7.82	48.45	7.81	40.64	110.41
Tomsk oblast	39 355 954 683.63	–262 992 335.63	–0.67	27.21	–0.81	28.01	–226.36

	Budget revenues (as Rb. Thos)	Budget deficit (surplus) (as Rb. Thos)	Deficit (surplus)/revenue , as %	Attracted borrowings/revenues , as%	Net borrowing/revenues , as%	Expenditures on debt repayment/ revenues , as%	Net borrowing/deficit (surplus), as %
Republic of Altay	13 455 207 734.57	435 512 296.17	3.24	7.30	2.99	4.31	–56.02
Republic of Khakassia	17 329 509 170.82	809 185 150.66	4.67	5.41	4.61	0.80	111.81
Trans-Baykal Krai	40 786 572 406.14	442 092 269.18	1.08	6.02	1.03	4.99	–141.18
Total	**718 069 945 441.91**	**19 358 334 130.65**	**2.70**	**12.07**	**2.41**	**9.65**	**72.13**
Far-East Federal Okrug							
Republic of Sakha (Yakutiya)	92 687 661 919.53	–508 119 447.75	–0.55	2.74	–1.64	4.38	75.82
Primorskky Krai	95 290 220 866.21	1 018 820 122.19	1.07	1.64	0.79	0.85	–6.26
Khabarovsk Krai	62 797 548 838.51	1 984 986 218.15	3.16	2.95	2.54	0.42	56.92
Amur oblast	40 216 389 681.58	1 469 911 098.08	3.66	7.13	3.22	3.91	132.28
Kamchatka Krai	38 529 006 297.27	–887 766 604.30	–2.30	14.37	–3.23	17.60	174.88
Magadan oblast	19 235 725 132.52	238 777 374.59	1.24	5.80	0.77	5.03	–17.60
Skhalin oblast	61 255 013 640.17	681 905 507.12	1.11	4.28	1.20	3.08	–30.23
Jewish AO	8 655 027 425.94	–48 699 734.43	–0.56	0.00	–0.37	0.37	12.43
Chukotka AO	21 916 647 109.90	–4 229 502 807.13	–19.30	13.00	–10.43	23.43	45.49
Total	440 583 240 911.63	–279 688 273.48	–0.06	4.75	–0.13	4.88	2.86
Russian Federation, total	**5 924 203 590 281.52**	**322 358 340 211.26**	5.44	10.70	4.89	5.82	87.96

Source: calculations by IET on the basis of the Russian Ministry of Finance data.

Domestic Bond Issues

In 2009, as many as 10 Subjects of the Federation and 5 municipal entities registered their bonded issue prospectuses (the 2008 figures were 24 regions and 7 municipal entities, respectively).

The 2009 total volume of issued bonds accounted for Rb. 158.1 bn vis-à-vis 178.6 bn in 2008 (down by Rb. 20.5 bn in nominal terms, or 18.6% in real terms). The volume of issued sub-federal and municipal bonds over the year slid from 0.43 to 0.41% of GDP (*Table 6*).

Table 6

The Volume of Issued Subfederal and Municipal Bonds (as % to ВВП)

Year	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Issue	0.63	0.77	0.47	0.31	0.19	0.17	0.27	0.46	0.47	0.37	0.28	0.26	0.43	0.41
Redemption	0.47	0.56	0.48	0.36	0.46	0.23	0.10	0.15	0.19	0.28	0.14	0.18	0.26	0.16
Net financing	0.16	0.22	–0.01	–0.05	–0.27	–0.07	0.16	0.31	0.29	0.09	0.14	0.08	0.17	0.24

Source: calculations by IET on the basis of the Russian Ministry of Finance data.

In 2009, the Russian Ministry of Finance registered issue prospectuses by the Republic of Chuvashia, Republic of Karelia, Krasnoyarsk Krai, the city of Moscow, Volgograd, Nizhny Novgorod, Tver, Samara oblasts, Khanty-Mansy AO, city of Krasnoyarsk, city if Volgograd, city of Kazan, town of Elektrostal (Moscow oblast).

The biggest bond issuers became the city of Moscow – Rb.115.5bn, or 73.0% of the territories' aggregate bond issue, Krasnoyarsk Krai – 10.4bn, or 6.6%, Khanty-Mansy AO – 6.0bn , or 3,8%, Moscow oblast– 3.4 bn, or 2,2%. Thus, the proportion of the 4 largest issuers combined accounted for 85.5% of the overall volume of regional and municipal bonds issues. As well, large issuers were Tver oblast – Rb. 3.5bn, Nizhny Novgorod – 3.0bn, Tomsk

oblast – 2.8 bn, Volgograd oblast – 2.4bn, Republic of Tatarstan – 2.0bn, Yaroslavl oblast – 1.9bn (*Table 7*).

Table 7

Placement of Subfederal and Municipal Bonds in 2009

Subject of the Federation	Volume of issue (as Rb. Thousand.)	The issuer's share on the total volume of issue (as %)	Issue volume to domestic borrowings (as %)
Central Federal Okrug			
Belgorod oblast	538 633.2	0.3	8.5
Tver oblast	3 000 000.0	1.9	31.3
Kostroma oblast	1 222 109.2	0.8	19.8
Moscow oblast	3 431 367.4	2.2	4.0
Yaroslavl oblast	1 861 822.0	1.2	15.0
The city of Moscow	115 420 335.5	73.0	89.9
North-Western Federal Okrug			
Republic of Karelia	1 000 000.0	0.6	18.7
Southern Federal Okrug			
Kalmyk Republic	74 094.0	…	11.9
Volgograd oblast	2 446 680.0	1.5	20.9
Volga Federal Okrug			
Republic of Tatarstan (Tatarstan)	2 000 000.0	1.3	5.3
Republic of Udmurtia	919 740.0	0.6	16.0
Nizhny Novgorod oblast	3 000 000.0	1.9	9.7
Samara oblast	2 425 000.0	1.5	34.6
Ural Federal Okrug			
Khanty-Mansy AO	6 000 000.0	3.8	75.0
Siberian Federal Okrug			
Krasnoyarsk Krai	10 369 900.0	6.6	67.6
Irkutsk oblast	1 566 640.0	1.0	16.2
Tomsk oblast	2 837 713.0	1.8	26.5
Russian Federation, total:	**158 114 034.3**	**100**	**25.0**

Source: calculations by IET on the basis of the Russian Ministry of Finance data.

It has been chiefly the largest issuers that demonstrated the highest degree of securitization of their debt. More specifically, the respective rate of the city of Moscow is 89.9%, Khanty-Mansy AO -75.0%, Krasnoyarsk Krai – 67.6%.

The 2009 aggregate volume of net borrowings on the market accounted for Rb. 97.9bn, or 24.9bn (23.3%) up in real terms vs. the 2008 figures. Meanwhile, the volume of redeemed municipal bonds was at Rb. 2.5bn greater that the volume of newly placed ones (*Table. 8*).

Table 8

Volume of Net Borrowing on the market for Sub-federal and Municipal Bonds, as Rb. thousand	Consolidated regional budget	Regional budgets	Municipal budgets
2009			
Net borrowing	95 457 576.8	97 916 509.1	–2 458 932.3
Attracted capital	158 114 034.3	153 992 570.1	4 121 464.2
Redemption of the principal debt	62 656 457.5	56 076 061.0	6 580 396.5
2008			
Net borrowing	68 851 271.9	72 984 947.8	–4 133 675.9
Attracted capital	178 565 731.4	177 324 359.3	1 241 372.1
Redemption of the principal debt	109 714 459.5	104 339 411.5	5 375 048.0
2007			
Net borrowing	25 867 011	23 691 970	2 175 041
Attracted capital	84 159 197	79 889 761	4 269 436
Redemption of the principal debt	58 292 185	56 197 791	2 094 394
2006			
Net borrowing	36 489 742	35 161 627	1 328 115
Attracted capital	73 288 653	66 524 832	6 763 820
Redemption of the principal debt	36 798 911	31 363 205	5 435 706
2005			
Net borrowing	20 887 596	16 939 894	3 947 703
Attracted capital	81 220 540	75 016 756	6 203 783

Volume of Net Borrowing on the market for Subfederal and Municipal Bonds, as Rb. thousand	Consolidated regional budget	Regional budgets	Municipal budgets
Redemption of the principal debt	60 332 944	58 076 863	2 256 081
2004			
Net borrowing	47 880 300	44 470 128	3 410 172
Attracted capital	79 436 708	74 995 965	4 440 743
Redemption of the principal debt	31 556 408	30 525 837	1 030 571
2003			
Net borrowing	41 908 199	40 043 511	1 864 688
Attracted capital	61 712 635	59 012 901	2 699 734
Redemption of the principal debt	19 804 436	18 969 390	835 046
2002			
Net borrowing	17 696 530	17 153 760	542 770
Attracted capital	29 141 777	28 169 158	972 619
Redemption of the principal debt	11 445 247	11 015 398	429 849
2001			
Net borrowing	6 601 447	6 667 592	–66 145
Attracted capital	15 123 785	14 226 931	896 854
Redemption of the principal debt	8 522 338	7 559 339	962 999
2000			
Net borrowing	–1 877 328	–2 286 175	408 847
Attracted capital	13 042 220	10 090 208	2 952 012
Redemption of the principal debt	14 919 548	12 376 383	2 543 165

Source: the RF Ministry of Finance

Most regions that regularly issue bonds continued doing so in 2009. More specifically, the Republic of Chuvashia has regularly issued bonds since 1999, Volgograd oblast- since 2000, Irkutsk oblast – since 2001, Krasnoyarsk Krai- since 2003 (*Table 9*).

Table 9

Registration of Prospectuses of Issues of Subfederal and Municipal Bonds in 1999–2009

Issuer	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Subjects of the Federation											
Republic of Chuvashia	*	*	*	*	*	*	*	*	*	*	*
Volgograd oblast	*	*	*	*	*	*	*	*	*	*	*
Irkutsk oblast			*	*	*	*	*	*	*	*	*
Krasnoyarsk Krai					*	*	*	*	*	*	*
Republic of Karelia						*	*	*	*	*	*
Nizhny Novgorod oblast						*	*	*	*	*	*
Tver oblast				*	*		*	*	*	*	*
Samara oblast					*		*	*	*	*	*
The city of Moscow	*	*	*	*	*	*	*	*		*	*
Khanty-Mansy AO				*	*						*
St. Petersburg	*	*	*	*	*	*	*	*	*	*	
Tomsk oblast		*	*	*	*	*	*	*	*	*	
Moscow oblast				*	*	*	*	*	*	*	
Republic of Sakha (Yakutia)				*	*	*	*	*	*	*	
Yaroslavl oblast					*	*	*	*	*	*	
Lipetsk oblast						*	*	*	*	*	
Kaluga oblast						*		*	*	*	
Penza oblast								*	*	*	
Republic of Udmurtia							*		*	*	
Ulyanovsk oblast									*	*	
Republic of Komi		*	*	*	*	*	*	*		*	
Belgorod oblast				*	*		*	*		*	
Kurgan oblast								*		*	
Stavropol Krai			*							*	
Republic of Bashkortostan			*	*		*	*	*	*		
Voronezh oblast						*	*	*	*		

Issuer	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Irkutsk oblast								*	*		
Novosibirsk oblast	*				*	*	*		*		
Kostroma oblast				*	*		*		*		
Krasnodar Krai						*			*		
Ivanovo oblast									*		
Republic of Kalmykia									*		
Tula oblast								*			
Khabarovsk Krai				*	*	*	*				
Kabardino-Balkar Republic		*					*				
Leningrad oblast			*	*	*	*					
Yammal-Nenetsk AO					*	*					
Bryansk oblast						*					
Murmansk oblast				*	*						
Republic of Mordovia				*							
Sakhalin oblast				*							
Kursk oblast				*							
Primorsky Krai		*									
Municipalities											
Krasnoyarsk					*	*	*		*	*	*
Volgograd	*	*	*	*	*		*	*		*	*
Kazan							*	*	*		*
Elektrostal (Moscow oblast)									*		*
Smolensk											*
Tomsk					*	*		*	*	*	
Lipetsk								*	*	*	
Magadan								*	*	*	
Bratsk										*	
Novorossiysk										*	
Yekaterinburg		*	*	*	*	*	*	*	*		
Klinsky district, Moscow oblast							*	*	*		
Noginsly district, Moscow oblast						*		*	*		
Blagoveshchensk								*	*		
Cheboksary	*						*		*		
Balashikha (Moscow oblast)									*		
Novosibirsk					*	*	*	*			
Odinstovsky district (Moscow oblast)							*	*			
Astrakhan								*			
Bryansk								*			
Voronezh								*			
Orekhovo-Zuevo, Moscow oblast								*			
Yaroslavl								*			
Yuzhno-Sakhalinsk					*	*	*				
Novocheboksarsk	*		*			*	*				
Angarsk							*				
Vurnarsky district, Republic of Chuvashia							*				
Shumerlya, Republic of Chuvashia							*				
Ufa				*	*	*					
Barnaul						*					
Perm						*					
Nizhny Novgorod				*							
Kostroma	*	*									
Arkhangel'	*										
Dzerzhinsky	*										

Source: MinFin RF.

Credibility of the Territorial Governments

Credit Rating

Russia's 2009 sovereign rating by forex-denominated obligations granted by Standard&Poor's and Fitch Ratings remained unchanged at the level of BBB. Meanwhile, both agencies raised the rating dynamic forecast from "negative" to "stable". In the first half 2008, the country's rating was BBB+ (positive forecast).

In 2009, having raised Russia's credit rating, Standard&Poor's also raised those of the city of Moscow, St. Petersburg and Tomsk oblast to "stable". At the same time the agency lowered its credit rating forecasts to "negative" for Volgograd and Vologda oblasts, Krasnoyarsk Krai, Novgorod oblast, Novosibirsk, Samara oblast, Republic of Sakha (Yakutia), Tver oblast and suspended Moscow oblast's credit rating and revoked those of Kaluga oblast, Republic of Tatarstan, the city of Bratsk, the town of Balashikha, Klinsky district, and Omsk. (*Table. 10*).

Table 10

Standard&Poor's Ratings in the 1st Quarter 2010

Issuer	Denominated in foreign exchange /Forecast	In the domestic currency/ Forecast
Sovereign ratings		
Russian Federation	«BBB»/Stable/	«BBB+»/Stable/
Regional and local government ratings		
Bashkortostan	BB+/Stable/	BB+/Stable/
Bratsk	revoked	
Volgograd oblast	BB–/Negative/	BB–/Negative/
Vologda oblast	BB–/Negative/	BB–/Negative/
Urban district Balashikha	revoked	
Dzerzhinsk	B–/Stable/	B–/Stable/
Irkutsk oblast	B/Stable/	B/Stable/
Kaluga oblast		evoked
Klinsky district		evoked
Krasnodar Krai	BB/Stable/	BB/Stable/
Krasnoyarsk Krai	BB+/Negative/	BB+/Negative/
Lenigrad oblast	BB/Stable/	BB/Stable/
City of Moscow	BBB/Stable/	BBB/Stable/
Moscow oblast	suspended	
Nizhny Novgorod	BB–/Stable/	BB–/Stable/
Novgorod oblast	B/Negative/	B/Negative/
Novosibirsk	BB–/Negative/	BB–/Negative/
Omsk	revoked	
Samara oblast	BB+/Negative/	BB+/Negative/
St. Petersburg	BBB/Stable/	BBB/Stable/
Sakha (Yakutia)	BB–/Negative/	BB–/Negative/
Sverdlovsk oblast	BB/Stable/	BB/Stable/
Stavropol Krai	B+/Stable/	B+/Stable/
Surgut	BB–/Stable/	BB–/Stable/
Tatarstan	revoked	
Tver oblast	B+/Negative/	B+/Negative/
Tomsk oblast	B–/Stable/	B–/Stable/
Ufa	BB–/Stable/	BB–/Stable/
Khanty-Mansy autonomous okrug	BBB–/Negative/	BBB–/Negative/
Yamalo-Nenetsky autonomous okrug	BB+/Stable/	BB+/Stable/

Source: Standard&Poor's.

2.5. The Scenarios of Social and Economic Development of the Russian Economy in the 2010–2012 period

Prerequisites

For the purpose of analyzing the stability of the budgetary system of the Russian Federation, the main three scenarios of development of internal and external economic processes in the mid-term prospect (the 2009-2012 period) are considered herein. The above period can be unambiguously defined as the period of exit from the crisis. It should be noted right away that in all the scenarios the main principles of the economic policy of the Russian government irrespective of the dynamics of economic indices, situation on foreign markets and the course of the election campaign in 2011 and 2012 are assumed to be unchanged.

The most probable scenarios include the following:

1. The scenario of inertial exit from the crisis;
2. The scenario of rapid exit from the crisis;
3. The scenario of delayed exit ("the second wave") from the crisis.

1. The Scenario of inertial exit from the crisis corresponds in its main preconditions to the base scenario of social and economic development of the Russian Federation developed by the Ministry of Economic Development of Russia as the basis of the draft federal budget of the Russian Federation in 2010 and planned for 2011 and 2012.

It is assumed, in particular, that the economies of the leading countries are likely to overcome the crisis in the year 2011, while in Russia due to its high dependence on global commodity markets the sustained economic growth may start even later. The adopted crisis exit strategies will ensure a smooth switchover (without a new distress) from the aggressive anti-crisis policy pursued by many states to a reduction of the debt burden accrued during the crisis and a "disposal" of nationalized capital assets and financial assets. In 2010, the global economic growth will not exceed 0.5–1% (mostly due to high growth rates in China, India, Brazil and other developing countries, while in the USA and the EU states growth rates are low, but positive), while in 2011-2012 it will amount to 2.5–3.0% a year. In other words, in the period under review the global economic growth will be slower than that which was observed prior to the 2008 crisis.

The forecast of smooth exit by the world's leading economies from the crisis without serious changes in the structure of the global economy made means that exchange rates of the world's leading currencies will remain practically unchanged. It is expected, in particular, that despite problems of some countries in the Euro zone (primarily in Greece, Spain and Portugal) the Euro currency will remain stable, and within the framework of this scenario the USD/Euro exchange rate is expected to be at the level of 1.35–1.4 in the 2010-2012 period.

Accordingly, oil prices on the world market will remain practically unchanged; additional demand in oil and petrochemicals due to economic growth in China and developing countries in the above period can be compensated by OPEC and other oil-producing countries' return to its former production volumes (since summer 2008 OPEC has repeatedly passed decisions on reduction of oil production quotas). As in the updated scenario prepared by the Ministry of Economic Development of Russia, it is assumed that in 2010 the price of oil (Urals) will amount, on average, to 65 USD/barrel, while in the 2011-2012 period, to 70 USD/barrel.

Due to such a level of oil prices on the world market, there are no reasons to believe that new oil and gas fields in Russia are developed and put on production soon. It means that volumes of production and, probably, export of hydrocarbon materials from Russia will go down.

Though metals prices rose by 25-60% in the first six months of 2009 they will be below the pre-crisis level in the period under review. By the end of 2012, the growth in prices on ferrous and non-ferrous metal products is expected to be within the range of 10–15%. However, the situation in the Russian iron and steel industry is likely to improve as the global volume of demand (in physical terms) in metals will increase as compared to that which was observed at the end of 2008 and in 2009.

Stabilization in the financial sector of the world's leading economies with interest rates gradually rising there will result in a new stage of global invertors' activities in developing countries. However, it is believed that due to slow rate of economic recovery and weak trends in the leading international commodity markets a renewal of foreign capital inflow to Russia is only possible as late as 2011. In 2010, the influx of direct foreign investments will be compensated by Russian investors' greater activities in purchasing of such assets abroad as have fallen in price during the crisis, while new private loans are spent primarily on repayment of the existing debts. Thus, the net capital outflow from the private sector is expected to be followed by capital inflow only late in 2011 and 2012.

As regards domestic conditions and trends in development of the Russian economy, the scenario in question points to the prospect of rather slow exit from the crisis. It is evident that pre-crises indices (that is, those which prevailed prior to 2008) as regards the volume of real GDP, industrial output, investments in capital assets, retail sales, households' real income will not to be achieved by the end of 2012.

As regards the fiscal policy, the year 2009 and the year 2010 are expected to be rather difficult. With fixed expenditure of the federal budget remaining at the level determined in the draft federal budget in the year 2010 and planned for 2011 and 2012 and oil prices, within the range provided for in the scenario in question, the federal budget is likely to be in deficit in 2011 and 2012. As the Reserve Fund is only sufficient enough to cover the deficit of the federal budget till the end of the first half of 2010, the Ministry of Finance of Russia is expected to borrow actively both on the international capital market (in 2010) and the Russian capital market (throughout the entire period). Accordingly, in 2010 the above policy will permit to reduce somewhat capital flight from the Russian Federation. However, in any case a substantial pressure on interest rates is expected on the domestic market which situation holds back the demand by Russian private investors in borrowed ruble funds and, thus, slows down the renewal of the volume of investments in this country.

The forecasts stated herein regarding the level of prices on oil and metals are unlikely to ensure in the period under review a sustained current account surplus. Taking into consideration the forecast regarding changes in the capital flow balance, fast accumulation of international reserves by the Bank of Russia and respective issuing activity by it are not expected. If the budget deficit is financed on market terms it means that such a tough monetary policy is carried out as makes it possible to ensure a sustained reduction in the inflation rate to a single-digit value.

2. The scenario of rapid exit from the crisis. This scenario is partially similar to the "oil" scenario of the Ministry of Economic Development of Russia and is based on the idea of successful and fast implementation of crisis exit strategies in all the leading states. Under the scenario in question, in 2010 the global economic growth is expected to be at the level of at least

2.5% a year, while in the 2011-2012 period, at that of 3.5-4.5% a year. It means that the above indices will be close to the pre-crisis ones.

Such an explosive growth of the global economy is likely to trigger a new rise in prices on global commodity markets (both through expansion of the demand (in physical terms) and due to participants' growing expectations). It is believed that in the scenario in question oil prices in 2010 may grow to 80 USD/barrel (Urals), while in the 2011–2012 period, to 100 USD/barrel. By the end of 2012, prices on metals will go up by at least 15–30% on the mid 2009 level.

In such a situation, it is expected that (as in the first scenario provided that the fixed expenditure remains the same as in the federal budget passed by the law) the federal budget deficit will be observed only in the 2009-2010 period, while in the 2011–2012 period the federal budget is drawn up with a surplus again.

It is evident that the above scenario entails preservation of such main global structural problems, including those in the primary sector and financial sector as well as threats as existed before the crisis. However, it is believed that such threats (a new serious financial and economic crisis of the global economy) may only come true beyond the horizon of the period under review (after 2012).

Within the framework of the scenario in question, it is assumed that the existing global capital which is being withdrawn from low-income 'reliable' assets in developed countries will be more actively transferred (than in the case of the scenario of inertial exit from the crisis) to emerging markets, including Russia. As a result, as early as 2010 Russia may have a zero capital flight balance, while in the 2011–2012 period a double surplus of the balance of payments is likely to be observed again. Such a situation will result in nominal and actual appreciation of the ruble and slow reduction in the rate of inflation.

In our opinion, appreciation of the ruble, high nominal interest rates (because of the inflation rate) on loans in rubles as well as prevailing conservative expectations of Russian economic agents (in a situation where dependence on trends in the global market is becoming greater than before) do not permit to expect fast recovery of growth rates in the real sector to the pre-crisis level within the framework of the scenario in question. The main imbalances in the Russian economy which existed before the crisis will inhibit the rate of economic recovery despite high prices on hydrocarbon materials and other main Russian export commodities. However, in the period under review accelerated growth in GDP will be observed both in the global economy in general and in Russia, in particular, while negative trends may arise only after the year 2012.

3. The scenario of delayed exit from the crisis ("the second wave" of the crisis). Within the framework of that scenario, a downbeat development of both the global economy and the Russian economy is considered. The scenario in question is based on the idea that either the second wave of the crisis may arise in the global economy or some developments may cause greater uncertainty in the world (that is, provoke a new crisis). Such factors include the following:

1. Such mistakes in realization of the crisis exit strategy as were made by economic authorities of developed countries, for instance, a premature sharp increase in base interest rates, governments' inability to resist further build-up of the budget deficit and other;

2. Such hidden risks in the economy of the USA and Europe as may come into life: a further growth in the rate of unemployment, crisis in the commercial real property sector, new wave of writings-off by financial institutions of toxic assets and other;

3. Ceasing of the effect produced by fiscal stimulus measures in the economy of China which factor in a situation of stagnating demand may result in a dramatic slowdown of the Chinese economy with eventual adverse social and political implications to follow.

Irrespective of the specific factors behind the protracted crisis, under the scenario in question it is believed that recession of the global economy will be observed in 2010 as well, while in 2012 economic growth amounts to maximum 1.5–2%.

As regards the Russian economy, it means the following:

- Prices on Russian main export commodities will go down. In 2010 and 2011, price on oil (Urals) will drop to 40 USD/barrel, while in 2012 it does not exceed 50 USD/barrel. Metal prices will be at the level which prevailed in winter 2008–2009, that is, 30% below the level of the second half of 2009. Accordingly, irrespective of the price factor there are no factors behind an increase in the Russian export in physical terms;
- Russia like other developing countries will be considered as a zone of higher risks for global financial players. Accordingly, in 2010 and 2011 a negative capital flight balance will be observed (to finance the deficit of its federal budget the Russian Federation as a sovereign borrower will experience borrowing limitations on the foreign market as well), while in 2012 a zero balance as regards that component of the balance of payments is quite possible.
- It is unlikely that the Government of Russia is able to finance in full the declared nominal volumes of expenditure at the expense of domestic and foreign market borrowings. Due to the above, the balance of payments and the monetary and fiscal balance can be supported only through depreciation of the ruble nominal exchange rate.

The forecast of the dynamics of macroeconomic and financial variables, as well as indices of the federal budget of the Russian Federation are based on the structural econometric model of the Russian economy developed at the Institute for the Economy in Transition.

Calculations by the Scenario

It is to be noted that for the purpose of limitation of subjective interpretation of quality changes in the economy and behavior of economic agents (for instance, a dramatic change in expectations in a situation of a steep fall in oil prices, volatile nominal fluctuations of the exchange rate and other) and due to use of the academic economic and mathematical tools technique for quantitative estimation of the scenarios, such responsible and efficient behavior of economic agents as is impossible in practice is anticipated, that is, in each scenario such an equilibrium is received for those specific conditions of variables as is impossible in practice with the specified criteria set. It concerns, in particular, the scenario in which a fall in oil prices is anticipated.

The outputs of calculations of the main macroeconomic and financial indices for the above scenarios are shown in *tables 42–44*.

Table 42

The scenario of inertial exit from the crisis

	2007	2008	2009	2010	2011	2012
Oil price (Urals, USD/barrel)	72.52	93.9	60.7	65	70	70
Real GDP growth rate, %	8.10	5.60	–7.90	4.30	3.00	3.70
Nominal GDP (billion rubles)	33103	41256	39016	44142	48604	53675
GDP deflator, %	13.92	18.02	2.68	8.47	6.90	6.49
Nominal GDP (billion USD, at the average annual rate)	1295	1664	1232	1549	1736	1897
Growth rates of fixed investment, %	21.10	9.90	–16.20	–4.50	3.10	3.80
Rates of growth in households' real income, %	10.40	1.90	2.30	6.20	1.10	2.50
Rates of growth in real retail sales, %	15.20	13.50	–5.50	1.50	2.10	3.50
Federal budget revenues (% GDP)	23.50	22.48	18.80	17.00	16.50	16.20
Federal budget revenues (billion rubles)	7779	9276	7337	7504	8020	8695
Federal budget expenditure (% GDP)	18.07	18.35	25.34	22.40	19.32	18.04
Federal budget expenditure (billion rubles)	5983	7571	9887	9887	9390	9681
Surplus / deficit (–) of the federal budget (% GDP)	5.43	4.13	–6.54	–5.40	–2.82	–1.84
Balance of the Reserve Fund as of the year end (billion rubles)		4028	1831	0	0	0
Balance of the National Welfare Fund of the Russian Federation as of the year end (billion rubles)		2584	2769	2736	2848	2975
Export (billion USD)	354	472	303.3	321	338	344
Import (billion USD)	225	293	192.7	235	264	288
Trade balance (billion USD)	129	179	111	85	73	56
Current account balance (billion USD)		102	47.5	42	30	10
Capital account balance (billion USD)	72.3	–138.8	–45.2	–15.0	0.0	30.0
Balance of payments (billion USD)	173	–45	–3.4	16.5	25.3	40.3
Private sector' foreign debt (billion USD)	400	451.9	425.4	410.4	410.4	440.4
Private foreign debt/GDP ratio, %	30.9	27.2	34.5	26.5	23.6	23.2
International reserves of the Central Bank of Russia (billion USD)	476	427	439.0	466	496	536
Change in the USD/Rb nominal exchange rate, %	–5.93	–3.01	27.74	–10.04	–1.75	1.07
Nominal Rb/USD exchange rate (Rb/USD)	25.57	24.80	31.68	28.50	28.00	28.3
Euro/USD exchange rate (USD/Euro)	1.371	1.468	1.39	1.35	1.4	1.4
Nominal RUR/Euro exchange rate (Rb/Euro)	35.06	36.41	44.13	38.48	39.20	39.62
Bicurrency basket exchange rate (Rb)	29.84	30.02	37.28	32.99	33.04	33.39
Change in real effective ruble exchange rate, %	4.20	5.10	–5.60	8.92	3.74	2.53
Index of real effective ruble exchange rate (June 1998 = 100)	112.7	118.5	111.9	121.8	126.4	129.6
Interest rate on loans in rubles (% annually)	10.0	12.2	15.3	9.7	8.0	7.8
Growth rates of consumer price index, %	11.9	13.3	8.8	7.4	6.9	6.6
Wide monetary base (as of the year end (billion rubles)	5513	5579	6467	7406	8423	9551
Growth rates of wide monetary base, %	33.74	1.19	15.93	14.51	13.74	13.39
M2 as of the year end (billion rubles)	13272	13493	15698	17989	20576	23453
M2 growth rates, %	47.54	1.67	16.34	14.60	14.38	13.98
Money multiplier	2.41	2.55	2.43	2.43	2.44	2.46
Monetization of GDP (M2/GDP) , %	40.1	32.7	40.2	40.8	42.3	43.7

Table 43

The scenario of rapid exit from the crisis

	2007	2008	2009	2010	2011	2012
Oil price (Urals, USD/a barrel)	72.52	93.9	60.7	80	100	100
Real GDP growth rate, %	8.10	5.60	–7.90	5.50	4.20	3.20
Nominal GDP (billion rubles)	32987	41668	39016	45024	50434	55739
GDP deflator, %	13.53	19.62	1.67	9.38	7.50	7.09
Nominal GDP (billion USD, at the average annual rate)	1290	1680	1232	1637	1889	2152
Growth rates of fixed investment, %	21.10	9.80	–16.20	–1.30	5.50	6.80
Rates of growth in households' real income, %	10.40	6.50	2.30	6.50	2.00	3.00
Rates of growth in real retail sales, %	15.20	11.00	–5.50	2.10	3.50	4.30
Federal budget revenues (% GDP)	23.58	22.26	18.80	17.70	17.00	16.50
Federal budget revenues (billion rubles)	7779	9276	7337	7969	8574	9197
Federal budget expenditure (% GDP)	18.14	18.17	25.34	21.96	18.62	17.37
Federal budget expenditure (billion rubles)	5983	7571	9887	9887	9390	9681
Surplus / deficit (–) of the federal budget (% GDP)	5.44	4.09	–6.54	–4.26	–1.62	–0.87
Balance of the Reserve Fund as of the year end (billion rubles)		4028	1831	0	0	0
Balance of the National Welfare Fund of the Russian Federation as of the year end (billion rubles)		2584	2769	2703	2803	2879
Export (billion USD)	354	472	303.3	360	412	419
Import (billion USD)	225	293	192.7	253	299	351
Trade balance (billion USD)	129	179	111	107	114	68
Current account balance (billion USD)		102	47.5	63	71	22
Capital account balance (billion USD)	72.3	–138.8	–45.2	0.0	20.0	40.0
Balance of payments (billion USD)	173	–45	–3.4	53.1	85.7	61.8
Private sector' foreign debt (billion USD)	400	451.9	425.4	425.4	445.4	485.4
Private foreign debt/GDP ratio, %	31.0	26.9	34.5	26.0	23.6	22.6
International reserves of the Central Bank of Russia (billion USD)	476	427	439.0	502	593	655
Change in the USD/Rb nominal exchange rate, %	–5.93	–3.01	27.74	–13.19	–2.91	–3.00
Nominal RUR/USD exchange rate (Rb/USD)	25.57	24.80	31.68	27.50	26.70	25.9
Euro/USD exchange rate (USD/Euro)	1.371	1.468	1.39	1.35	1.4	1.4
Nominal RUR/Euro exchange rate (Rb/Euro)	35.06	36.41	44.13	37.13	37.38	36.26
Bicurrency basket exchange rate (Rb)	29.84	30.02	37.28	31.83	31.51	30.56
Change in real effective ruble exchange rate, %	4.20	5.10	–5.60	12.92	5.52	7.20
Index of real effective ruble exchange rate (June 1998 = 100)	112.7	118.5	111.9	126.3	133.3	142.9
Interest rate on loans in rubles (% annually)	10.0	12.2	15.3	10.6	8.5	8.6
Growth rates of consumer price index, %	11.9	13.3	8.8	8.3	7.5	7.2
Wide monetary base (as of the year end (billion rubles)	5513	5579	6467	7919	9158	10742
Growth rates of wide monetary base, %	33.74	1.19	15.93	22.45	15.64	17.30
M2 as of the year end (billion rubles)	13272	13493	15698	19234	22383	26377
M2 growth rates, %	47.54	1.67	16.34	22.53	16.37	17.84
Money multiplier	2.41	2.55	2.43	2.43	2.44	2.46
Monetization of GDP (M2/GDP) , %	40.2	32.4	40.2	42.7	44.4	47.3

Table 44

The scenario of delayed exit from the crisis

	2007	2008	2009	2010	2011	2012
Oil price (Urals, USD/barrel)	72.52	93.9	60.7	40	50	50
Real GDP growth rate, %	8.10	5.60	–7.90	–4.10	2.00	2.20
Nominal GDP (billion rubles)	32987	41668	39016	40965	44709	48797
GDP deflator, %	13.53	19.62	1.67	9.48	7.00	6.79
Nominal GDP (billion USD, at the average annual rate)	1290	1680	1232	1241	1424	1569
Growth rates of fixed investment, %	21.10	9.80	–16.20	–8.70	–1.90	0.80
Rates of growth in households' real income, %	10.40	6.50	2.30	2.10	0.50	1.70
Rates of growth in real retail sales, %	15.20	11.00	–5.50	–0.50	–1.40	–0.30
Federal budget revenues (% GDP)	23.58	22.26	18.80	15.80	15.50	15.00
Federal budget revenues (billion rubles)	7779	9276	7337	6472	6930	7319
Federal budget expenditure (% GDP)	18.14	18.17	25.34	24.14	21.00	19.84
Federal budget expenditure (billion rubles)	5983	7571	9887	9887	9390	9681
Surplus / deficit (–) of the federal budget (% GDP)	5.44	4.09	–6.54	–8.34	–5.50	–4.84
Balance of the Reserve Fund as of the year end (billion rubles)		4028	1831	0	0	0
Balance of the National Welfare Fund of the Russian Federation as of the year end (billion rubles)		2584	2769	2949	3017	3120
Export (billion USD)	354	472	303.3	245	278	282
Import (billion USD)	225	293	192.7	169	202	226
Trade balance (billion USD)	129	179	111	76	76	55
Current account balance (billion USD)		102	47.5	32	33	9
Capital account balance (billion USD)	72.3	–138.8	–45.2	–35.0	–10.0	5.0
Balance of payments (billion USD)	173	–45	–3.4	–12.5	18.3	14.3
Private sector' foreign debt (billion USD)	400	451.9	425.4	390.4	380.4	385.4
Private foreign debt/GDP ratio, %	31.0	26.9	34.5	31.4	26.7	24.6
International reserves of the Central Bank of Russia (billion USD)	476	427	439.0	437	460	474
Change in the USD/RUR nominal exchange rate, %	–5.93	–3.01	27.74	4.17	–4.85	–0.96
Nominal RUR/USD exchange rate (Rb/USD)	25.57	24.80	31.68	33.00	31.40	31.1
Euro/USD exchange rate (USD/Euro)	1.371	1.468	1.39	1.35	1.4	1.4
Nominal RUR/Euro exchange rate (Rb/Euro)	35.06	36.41	44.13	44.55	43.96	43.54
Bicurrency basket exchange rate (Rb)	29.84	30.02	37.28	38.20	37.05	36.70
Change in real effective ruble exchange rate, %	4.20	5.10	–5.60	–4.05	7.00	4.86
Index of real effective ruble exchange rate (June 1998 = 100)	112.7	118.5	111.9	107.3	114.8	120.4
Interest rate on loans in rubles (% annually)	10.0	12.2	15.3	12.4	10.7	10.8
Growth rates of consumer price index, %	11.9	13.3	8.8	8.4	7.0	6.9
Wide monetary base (as of the year end (billion rubles)	5513	5579	6467	6599	7292	8098
Growth rates of wide monetary base, %	33.74	1.19	15.93	2.04	10.49	11.06
M2 as of the year end (billion rubles)	13272	13493	15698	16049	17862	19967
M2 growth rates, %	47.54	1.67	16.34	2.24	11.30	11.79
Money multiplier	2.41	2.55	2.43	2.43	2.45	2.47
Monetization of GDP (M2/GDP) , %	40.2	32.4	40.2	39.2	40.0	40.9

In case of **the scenario of inertial exit from the crisis,** the received quantitative values of the dynamics of the main indices of the social and economic development of Russia and those of the monetary field point to the fact that positive rates of growth in real GDP will not exceed 3.5–4.5% until the end of 2012. The higher rates of growth in real GDP (4.3%) are observed in 2010 (to a great extent due to a lower base in 2009), however, the economic growth will slow down later. By the end of 2012, the real GDP of Russia will exceed the 2008 level

by the mere 2.5%. At the same time, with the growth of the ruble real exchange rate and decline of the population of the Russian Federation taken into account per capita GDP in Russia (at the current rate) will exceed the 2008 level by 15–20% in 2012.

Renewal of the economic growth is ensured both by stable oil prices within a range that is comfortable for the Russian economy and a renewed influx of foreign capital to Russia which situation permits financing Russian companies' investment needs.

According to the forecast, in the 2010-2011 period growth of the domestic consumer demand will lag behind investment activities. It can be explained by the fact that unlike the situation which prevailed before the 2008-2009 crisis the level of employment in the economy is expected to go down as industries in the period of exit from the crisis seek to raise labor efficiency by reducing the number of their personnel or hiring new workers at a slow rate, and, thus, increase production capacities. In our opinion, substantial growth of demand in labor and, as a consequence, growth of real wages and consumer activities is possible only starting from the year 2012.

At the same time, in the 2010-2011 period households' real wages will not only be preserved, but also increase by 8.3% which situation is related to a substantial growth in pensions and households' savings.

Though oil prices are expected to be at a quite "comfortable" (but not high enough) level (it will not cause a currency or financial crisis) the situation in public finances within the framework of the scenario in question remains rather complicated. With the above precondition regarding preservation of fixed expenditure of the federal budget in the amount determined by the Federal Law on the Federal Budget in the Year 2010 and Planned for 2011 and 2012 Period observed, the federal budget will remain in deficit within the entire period under review. The Reserve Fund is sufficient enough to finance the federal budget deficit only in 2010.

As resources from the National Welfare Fund are not expected to be used for financing the budget deficit, accumulations in the National Welfare Fund will amount to 6–6,5% of GDP.

An important condition of renewal of both positive growth rates of investments (in real terms) in capital assets and real growth of GDP is a return by Russian companies and banks to the international capital market, as well as maintaining of sustained influx of direct foreign investments to the Russian Federation. According to the calculations, to ensure the preset rates of growth in investments a sustained net influx of foreign capital to Russia should begin not later than in the second half of 2011 and it should be in the amount of up to 15-20 billion rubles a year.

It is to be noted that in the period under review growth in negative balance of the services account, as well as factor payments and interest payments is anticipated. Accordingly, in the 2011–2012 period reduction in the current account surplus of the Russian Federation to USD 10-30 billion is expected.

As it is believed that in switching over to the inflation targeting regime the Central Bank of Russia will reduce its participation in the foreign exchange market the international reserves of the Bank of Russia will grow rather slowly. By our estimate, by the end of 2012, the volume of such reserves will amount to USD 530–540 billion, which value is below the maximum level registered in the 2007–2008 period.

The balance of payments surplus in the period till the year 2012 will ensure stability of the ruble exchange rate to the currency basket (preservation of the USD/Euro ratio in the bicurrency basket at the level of 0.55: 0.45 is expected). Changes in exchange rates of USD and

Euro to the ruble are determined mainly by a change in mutual quotations of the reserve currencies on the international market. Growth in volatility of the ruble exchange rate to USD and Euro as a result of weakening of the Bank's of Russia impact on the exchange rate has no effect on the overall annual values of the exchange rate as alternate fluctuations offset one another.

At the same time, reduction in the annual growth rate of the consumer price index to 6.5–7.0% will permit to slow down to a great extent the rates of real appreciation of the ruble. In particular, by the end of 2012 the real effective ruble exchange rate will appreciate by maximum 10% and 17% on the figure registered at the end of 2007 and that at the end of 2008, respectively. Accordingly, the positive dynamics of Russian export volumes is expected to be preserved in a situation of stagnating prices on raw materials on international markets. Imports will grow faster than exports throughout the entire period under review. However, due to a lower level of consumer activities import volumes in 2012 are unlikely to exceed the 2008 record high figures.

The model suggests serious changes in the monetary field of the Russian economy. Firstly, as was stated above the model points to a substantial reduction (below the double digit value) in the rate of inflation to 6.5–7.0%.

Secondly, change in the regime of the Bank's of Russia monetary policy means that the Bank of Russia will be more active on the government securities market (it can be explained by the fact that apart from resources from the Reserve fund and external borrowings the Bank of Russia will need more funds to finance the federal budget deficit), in refinancing commercial banks against securities it will acquire in its portfolio (for instance, corporate bonds) and in provision of long-term secured loans (with a maturity of minimum one year) to commercial banks.

Change in the main methods of the monetary authorities' policy is to result in growth in real interest rates in the economy. In the 2010–2012 period, the real interest rate on loans (with a maturity of up to one year) to non-financial private sector will be within the range of 1.5–2.0%. Meanwhile, the money multiplier (the ratio of M2 to the reserve funds) is anticipated to be preserved at the current level of around 2.45. In other words, in the period under review no such active growth in credit expansion of the banking sector as was observed prior to the 2008 crisis is expected.

Summing up the outputs of the analysis of **the scenario of inertial exit from the crisis**, it is important to point out its specific features which are as follows:

1. Renewal of the volume of real GDP and investments (in real terms) in capital assets up to the pre-crisis level is possible only at the end of 2012.

2. Ensuring of such volumes of investments in capital assets as would be relevant to the respective GDP growth is possible in as situation of stable oil prices in the range of at least 60-65 USD/barrel and in case of return by Russian companies to the international capital market.

3. Mandatory switchover to new mechanisms that ensure the Central Bank's of Russia money supply is required as well as growth in real value of money in the economy.

4. Factors behind the federal budget deficit still prevail; the Reserve Fund will be spent up completely, while accumulations in the National Welfare Fund grow at a very low rate.

5. The inflation rate will substantially go down in a situation where the real effective ruble exchange rate slowly appreciates and the money supply and monetization of the Russian economy grow fast.

Taking into account the actual situation in the first quarter 2010, **the scenario of rapid exit from the crisis** is quite probable though the scenario of inertial exit from the crisis has been selected as the base one so that direct comparisons against the scenario of the Ministry of Economic Development of Russia and federal forecasts for 2010 and 2012 could be made.

Increase in average prices on oil (Urals) to 80 USD/barrel in 2010 and 100 USD/a barrel in the 2011–2012 period (in the fourth quarter 2009 and the first quarter 2010 oil prices amounted to about 70–75 USD/barrel) will permit the Russian economy to grow by 5.5% as early as 2010, while in the 2011–2012 period growth in real GDP is to amount to 3.5–4.5% a year (though growth rates will eventually slow down). By the end of 2012, real GDP will be 5% higher than that in 2008. In 2012, per capita GDP (expressed in USD at the prevailing exchange rate) will increase up to USD 15,000, that is, a 20–25% increase on the 2007 figure.

As regards dynamics of investments in capital assets, households' real income and retail sales, the scenario in question does not differ much by the main trends from that of inertial exit from the crisis, however, in the 2010–2011 period the overall growth rates of all the indices will be substantially higher.

Under this scenario, despite higher prices on international commodity markets, the federal budget revenues are insufficient for the planned expenditures to be financed in full, either. In the 2011–2012 period, the federal budget deficit will decrease to about 1–1.5% of GDP, however, replenishment of the Reserve Funds will not take place even in a situation of higher prices on oil (100 USD/barrel).

A favorable foreign economic situation within the framework of the scenario in question permits to ensure stability of the balance of payments of the Russian Federation. Throughout the entire period under review, the balance of payments as well as its both components are in surplus. In particular, the balance of payments is in the range of USD 70–90 billion a year, while the annual influx of private capital to the Russia amounts to USD 55 billion.

Under the scenario in question, the Bank of Russia cannot escape a substantial growth in international reserves as result of a return to the policy of containment of ruble nominal appreciation. Thus, by the end of 2012 international reserves of the Bank of Russia will amount to USD 650–660 billion and surpass the 2008 level.

In the в 2010–2012 period, the nominal Rb/USD exchange rate will appreciate to 26.0–27.0 rubles for a USD, that is, a 15-20% increase on the level registered at the end of 2009. At the same time, though the inflation rate (according to the consumer price index) keeps going down it is still higher (7.0–7.5%) than that in the scenario of inertial exit from the crisis. As a result of that, there will be a sustained real appreciation of the ruble, and by the end of 2012 the real effective exchange rate of ruble will exceed by nearly 25% the 2008 level.

As in the scenario in question the Central Bank of Russia is expected to switch over to the inflation targeting regime and use of interest rates as a main operating instrument (though a particular attention will still be paid to the foreign exchange market), the real value of money in the economy will grow as well. By our estimate, the real interest rate on loans with a maturity of one year to the non-financial sector will amount to 1.5–2.0%. At the same time, monetization of the economy will increase to 47.3% of GDP.

Thus, the main difference between **the scenario of rapid exit from the crisis** from that of **inertial exit from the crisis** is as follows:

1. The scenario in question is closer both to the actual situation which was observed in the past two quarters and current trends than that of inertial exit from the crisis;

2. Renewal of the real volume of GDP and investments in capital assets is faster;

3. There is a favorable situation as regards the balance of payments and its components as well as fast accumulation of international reserves;

4. The federal budget remains in deficit, and there are no accumulations in the Reserve Fund;

5. The inflation rate goes down slowly, while the ruble exchange rate appreciates fast in a situation of higher growth rates of money supply and monetization of the Russian economy;

6. The central Bank of Russia has a limited potential to carry out a switchover to the inflation targeting regime. It has to pay more attention to the situation on the foreign exchange market.

Under **the scenario of delayed exit from the crisis**, negative growth rates of investments in capital assets still prevail in the 2010–2011 period, while in 2012 they slightly exceed the zero level (0.8%). Real GDP decreases in 2010 (a 4.1% decrease), however, in the 2011–2012 period there is positive growth in real GDP (around 2% a year) due to the effect of a low base (on the basis of the results in 2009-2010 period) and adjustment of the Russian economy both to lower prices on oil and lower real ruble exchange rate. Thus, by the end of 2012 the real GDP will be nearly 10% lower than that in 2008.

Calculations within the framework of the scenario in question point to the fact that with oil prices below 50 USD/ a barrel (Urals) consumer activities will keep decreasing up to the year 2012 included which situation precludes to a great extent a renewal of positive GDP growth rates. Some growth in households' real income (by 0.5–1.5% a year) can be explained by increase in social transfers from the budget and wage indexation in the public sector.

The federal budget deficit does not drop below 4.5% of GDP which factor poses a serious threat to stability of the entire financial system of the Russian Federation. It is believed that with given oil prices there is still limited potential to finance the federal budget deficit through external financing, while domestic borrowings in the amount of up to 15% of GDP create within a period of three years a situation which is similar to that in the 1996–1998 period where the government securities market virtually became a financial pyramid and the only market which attracted capital inside Russia. Thus, as regards the fiscal policy the scenario in question points to the fact that the main parameters of the federal budget expenditure need be reviewed for the sake of fiscal stability.

Under the scenario in question, the net private capital flight from Russia is observed up to 2012. Thus, the balance of payments surplus can be ensured only by an increase in the current account surplus which factor with the given oil prices suggests a reduction in imports through depreciation of the ruble exchange rate.

By our estimate, if the Bank of Russia gives up the idea of active interventions on the foreign exchange market (within the limits of a switchover to inflation targeting regime) stabilization of the balance of payments is possible with a nominal devaluation of the ruble to the level which was observed in the first half of 2009 (that is, 37–38 rubles for the bicurrency basket). It is to be noted that the model does not take into account possible "swings" in the exchange rate, and greater fluctuations towards depreciation of the ruble exchange rate are quite possible within each year limits. The model points to the fact that in 2012 some nominal appreciation of the ruble is possible, however, it will still be 5–10% below the level registered at the end of 2009.

Under the scenario in question, the inflation rate remains quite high, that is, in the range of 7.0–8.5%, as the Bank of Russia (even after it has minimized its participation in the foreign exchange market) is unable to give up both support to the banking system and indirect financ-

ing (through operations on the secondary market) of the federal budget deficit. In addition to the above, the exchange rate will have an impact on the prices. Thus, the model points to the fact that nominal depreciation of the ruble will be completely offset by inflationary pressure, while by 2012 the real effective ruble exchange rate remains at the 2008 level.

In a volatile situation, the precondition regarding use by the Bank of Russia of interest rates as the main instrument results in growth in real value of the money in the economy. By our estimate, under the scenario in question the real interest rate on bank loans will not fall below 4%. Accordingly, banks' lending activities will be low, while monetization of GDP remains at the level of 40% of GDP.

Summing up the outputs of the analysis of **the scenario of delayed exit from the crisis**, it is to be noted that in the scenario in question the Russian Federation is not expected to exit from the crisis in 2010–2012 period which can be characterized as a period of protracted stagnation. Though the year 2012 is characterized by some positive developments it is a turning point from stagnation to growth, while the period of sustained growth may begin starting from 2013 provided that relevant external scenario conditions are in place.

Chapter 3. Real Sector

3.1. Macrostructure of Production

3.1.1. Impact of Domestic and Foreign Demand on the Dynamics and Structure of GDP in 2008–2009

Vigorous expansion of the Russian economy, which in 2003-2007 was determined by annual average GDP increment at about 7%, by investment in fixed capital at about 14%, and by final household consumption at 11%, notably slowed down in 2008. GDP growth amounted to 5.6% in 2008 and approached 2001-2002 levels, which were minimal for the entire decade of restorative development. Slowdown of investment in fixed capital in 2008 to 9.1% against 21.1% in 2007, which was not offset by corresponding consumption growth of the population determined gradual contraction of domestic demand. In the wake of the growing inflation and slowdown in real income growth rates of the population to 2.7% against 12.1% in 2007 and real wages and salaries to 9.7% against 17.2%, retail turnover growth rates constituted 113.0% and were by 3.1 percentage points below the level of the preceding year, and paid services delivered to the population – by 104.9% against 107.9% a year ago. Slowdown of industrial output rates to 102.1% against 106.3% in 2007 exerted a significant effect on the domestic market (*Table 1*).

Table 1

Principal Indices of Macroeconomic Indicators in 2008–2009, in % to Preceding Year

	2008					2009				
	year	quarter				year	quarter			
		I	II	III	IV		I	II	III	IV*
Gross domestic product	105.6	108,7	107,5	106.0	101.2	92.1	90.2	89.1	91.1	97.4
Expenditure on final household consumption	111.3	112.2	113.4	112.2	108.0	91.9	96.8	93.0	88.4	89.0
Investment in fixed capital	109.8	123.6	117.4	111.7	97.7	83.0	84.4	79.0	81.0	86.9
Commissioning of new residential housing	105.3	108.1	99.1	105.7	105.1	93.3	102.4	97.2	98.9	85.9
Industrial output volume	102.1	106.2	105.5	104.7	93.9	89.2	85.7	86.4	89.0	97.4
Natural resources production	100.2	100.7	100.3	100.6	99.0	98.8	96.2	96.9	97.8	103.9
Manufacturing industries	103.2	108.7	108.1	106.4	92.3	84.0	79.2	78.4	85.0	93.5
Electricity, gas and water production	101.4	105.6	102.1	104.3	94.6	95.2	94.9	93.7	89.7	100.4
Agricultural production	110.8	105.5	106.9	113.0	115.6	101.2	102.3	100.9	98.0	106.4
Transportation turnover	100.7	105.1	102.9	101.4	93.6	89.8	83.7	81.3	93.2	101.8
Retail turnover	113.5	117.2	114.8	114.9	108.6	94.5	99.9	94.4	90.8	93.9
Paid services delivered to the population	104.9	107.7	105.6	105.3	102.0	95.7	99.1	95.3	93.7	95.1
Foreign trade turnover	132.2	148.8	147.9	149.3	95.4	65.0	56.2	55.5	60.0	91.2
Export	133.1	153.3	151.3	152.8	89.5	64.3	52.1	53.9	60.3	97.0
Import	130.6	140.8	143.0	142.1	105.3	66.0	63.7	58.2	595	83.4
Real disposable money income	101.9.7	107.5	105.7.0	104.56	93.1.2	102.3	100.4	103.1	96.8	108.6
Real wages and salaries	111.5	113.4	112.5	112.2	105.0	97.2	99.2	96.1	94.8	99.0
Real pensions	118.1	119.0	113.9	122.7	116.9	110.7	106.1	113.3	109.1	114.2
Average annual number of employed in the economy	100.6	100.8	101.2	100.7	99.6	97.6	97.7	97.1	97.9	98.8
Total number of unemployed	104.4	96.5	94.2	105.6	123.7	131.7	134.8	152.1	132.2	112.0
Number of officially jobless claims	89.7	89.7	89.3	88.9	91.1	148.9	126.5	157.4	163.0	152.3
Consumer prices indices	113.3	104.8	103.8	101.7	102.5	108.8	105.4	101.9	100.6	100.7
Foodstuffs	116.5	105.7	105.4	100.7	103.9	106.1	105.0	101.9	98.9	100.3
Non-food products	108.0	102.0	102.4	101.9	101.4	109.7	103.8	102.4	101.9	101.2
Paid services	115.9	107.5	103.1	102.9	101.6	111.6	108.5	101.0	101.3	100.6
Price indices of industrial goods producers	93.0	103.0	113.6	100.5	79.1	113.9	104.4	105.3	104.5	99.1
Mineral resources production	61.6	93.8	126.1	94.4	55.1	149.2	108.5	127.9	110.6	97.3
Manufacturing	101.9	104.0	111.7	103.0	85.2	105.9	101.3	101.5	103.6	99.4
Electricity, gas and water production	118.0	119.0	99.2	102.0	98.1	118.3	118.1	99.7	100.2	100.3

* Preliminary data

Source: Federal service of state statistics.

Macroeconomic situation in 2008 was determined by utmost instability of main indicators over the entire year. GDP growth rates slowed down from 8.5% in the 1Q to 1.2% in the 4Q. Sluggish growth of the first half of the year backed by accumulated potential and favorable trend in the world market for mineral resources, in the second half of the year changed to a downturn trend in the economic development and was determined by a sharp deterioration of foreign economic trend and by a crisis of financial and credit institutions. In September-December 2008 the situation was aggravated by extension of the crisis to the entire economy. Highest cuts in output were recorded in construction, transportation and industrial sectors. The volume of industrial output in the 4Q 2008 constituted 93.9%, merchant cargo turnover – 93.3% of the same period a year ago. Slowdown in investments in fixed capital lasted two quarters in a row, and in December 2008 their volume was lower by 2.3% against December 2007. Gross capital formation in 2008 was estimated at 110.3% against 121.1% in 2007.

Commerce took over pole positions in the national economy starting with the second half of 2008. The share of wholesale and retail sectors in GDP constituted 21.7% in 2008. Consumer demand continued to be determined by household expenditures. Numbers for household consumption in 2008 constituted 11.5% against 13.6% in 2007. However, due to downward trend in labor compensation and consequently in income there was stagnation in retail turnover and paid services delivered to the population. In spite of the fact that retail turnover volumes in the 4Q of 2008 decelerated to 8.2% against 16.7% in the same period a year ago, and investments in fixed capital were cut down to 1.9% against 20.6% in 2007, they helped maintaining positive trend in GDP growth in October-December, although at the minimal level observed since 2001.

Economic expansion in 2006-2008, essentially, represented a stage of quantitative accumulation and was not accompanied by structural changes in the investment sector, foreign trade, production, as well as by institutional reforms ensuring favorable conditions for effective activity of economic agents. This fact has predetermined vulnerability of Russian economy in the wake of the global changes which took place in the world markets.

Economic slowdown over entire 2008 and the recession in 2009 were caused by simultaneous contraction in foreign and domestic demand. Where by the end of three quarters of 2008 domestic demand constituted 11.1% against 13.6% in 2007 and notably exceeded external demand, which allowed to offset reverse effects of negative global business environment in commodities and financial markets, then from November-December 2008 the situation takes a U-turn. Slump of world prices on raw materials and a dip in world demand observed since the 3Q 2008 was accompanied by a fall in export volumes in physical and value terms. In the 4Q 2008 export in value terms fell by 10.5% and by 8.3% (according to SNA methodology) regarding similar period of a year ago.

Contraction in export volumes amid threefold slump in domestic demand dictated downward trend in GDP growth in the 4Q to 1.2% against the same period of the preceding year. This trend was aggravated by a large scale capital outflow. If in the 1Q of 2008 there was an upward trend of foreign capital inflow in the volume of USD 17.4 bn, then in the 2Q capital outflow reached USD 149.8 bn. Aggregate impact of the factors determined a recession observed at the onset of 2009.

Under the effect of the contraction of investments, industrial and consumer demand observed in the 1Q of 2009, GDP fell by 9.8% amid approximately similar rates of contraction in domestic and external demand to stand at 14%. Capital outflow in the 1Q remained at a rather

high level and constituted USD 35.1 bn under average value of USD 43.5 bn in October-December 2008.

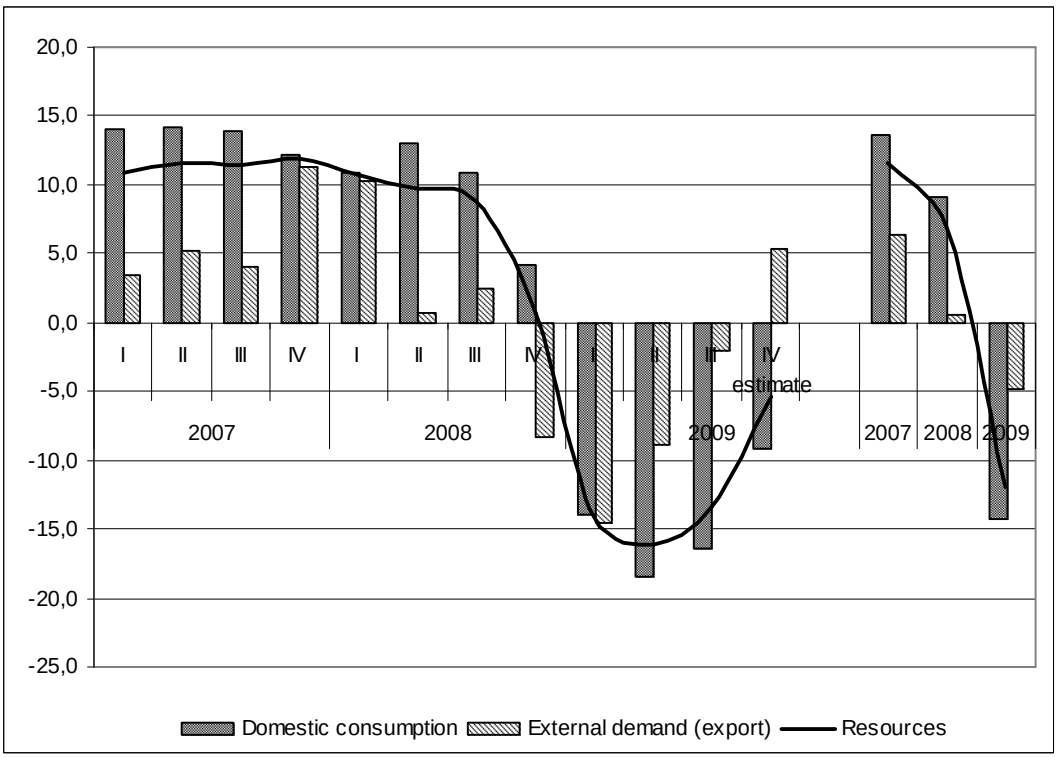
From the 2Q of 2009 against the background of gradual revival of world mineral resources market and adjustment of financial institutions to the crisis developments, economic recession marked gradual dissipating of momentum. In the first half of 2009 GDP contracted by 10.4% and in the third quarter – by 8.9%, in the fourth quarter recession slowed to 2.6% against the same period of a year ago. Note that this trend was due to gradual dissipating of momentum of export contraction (external demand). On the whole, at year end (2009) GDP averaged at 92.1%, and export in physical terms – 95.2% against preceding year.

Due to gradual revival of world prices on hydrocarbons from the 2Q of 2009 export contraction slowed in comparison with corresponding period of the previous year, and against preceding quarter of 2009 export marked an upward trend.

This development, undoubtedly, positively affected industrial output. From the 2Q of 2009 recession in domestic production slowed mainly due to output of the external sector and export of fuel and energy resources, and from the 3Q that was true of manufacturing industries. In the fourth quarter of 2009 amid industrial output reduction by 2.6% against the fourth quarter of 2008, extraction of natural resources marked upturn by 3.9%. Quarter on quarter recession in domestic market conditioned by the contraction in consumer demand under the impact of household income downturn, as well as by negative trend in the investment sector remained as a warning sign in the 2-3Q 2009. Volatility of recovery trends from the consequences of the global crisis and recession in domestic market, high risks have led to resumption in capital outflow in volumes comparable to those recorded at the onset of the year – USD 33.4 bn, which entirely offset positive impact of capital inflow at USD 4.5 bn recorded in the second quarter of 2009.

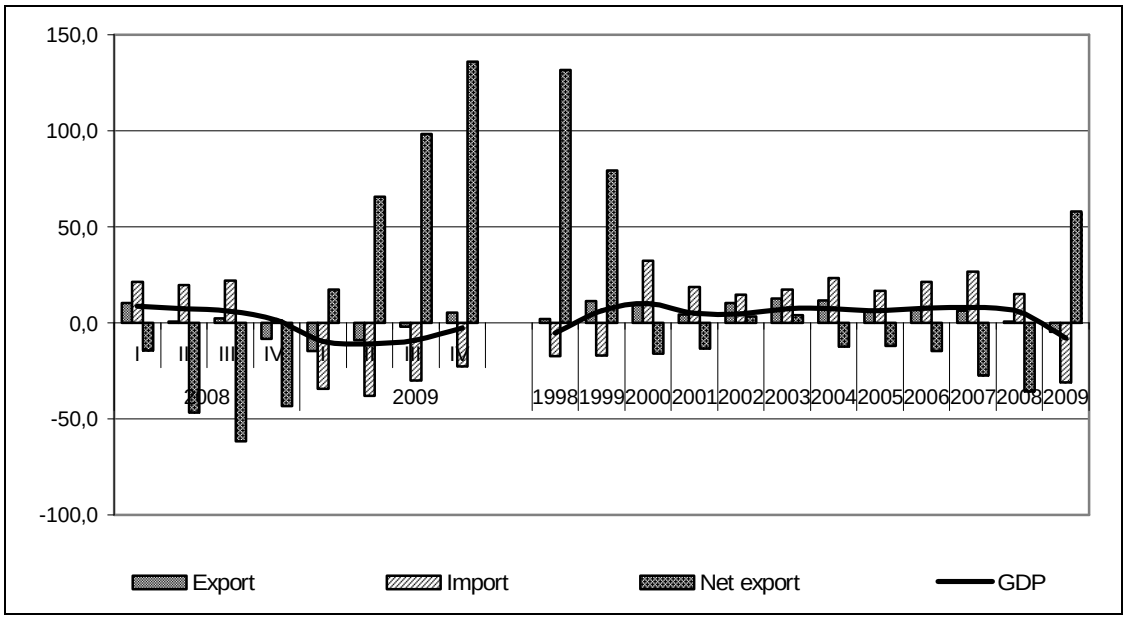
Trend in the 4Q was due to restorative export upsurge (in domestic prices according to SNA methodology) against similar period of 2008. Upward trend in economic contraction, positive projections for the future of Russian economy coupled with revision of international ratings from negative to stable favorably affected the financial sector and contributed to the inflow of capital at USD 11.6 bn. As a result, on the whole by the year end (2009) capital outflow constituted USD 52.4 bn against USD 132.8 bn a year ago.

Upward revision of the credit rating of Russia from negative to stable and confirmation of the currency rating at the level of BBB by Standard & Poor's represented positive signs. It is worth noting that a year ago S&P was one of the first who reacted to the financial crisis in Russia by decreasing sovereign credit rating on obligations in domestic and foreign currencies from BBB+ to BBB and constructing negative projections. After S&P have positively revised its projection only Fitch maintained negative projection on sovereign credit rating of Russia at the level of BBB. Earlier Moody's downgraded Russia's sovereign credit rating to Baa1, however, with a positive projection. S&P experts noted that positive revision of rating would depend on strict control over budget expenditures over the next annual cycle and consistency of promotion of declared structural economic reforms.



Source: Federal service of state statistics.

Fig. 1. GDP Adjustment along Domestic and External Demand Components in 2007–2009, in % to Corresponding Quarter of the Preceding Year



Source: Federal service of state statistics.

Fig. 2. Changes in Dynamics of GDP, Export, Import and Net Export in 1998–2009 and Quarter-on-Quarter of 2008–2009, in % to the Corresponding Period of a Year Ago

When analyzing the effect of the movement and structure of foreign economic turnover in the heat of 2009 crisis, one should pay attention to the fact that reduction in physical volume of export was relatively insignificant amid import volumes collapse (***Fig. 2***). As a result, for the first time since 1998 crisis, dynamics of net exports posted positive indices and exerted positive impact on macroeconomic indicators.

It is worth noting that the period of 2000-2008 was marked by higher-than-anticipated growth of imports against exports both in physical and value terms, which, finally, led to an absolute reduction in the share of net exports in GDP. If in the 4Q of 2008 rates of imports growth in physical terms marked positive trend and constituted 101.2%, then in the 1Q of 2009 there was a slump at 34.3% and in the 2Q – at 37.9% against corresponding period of a year ago. Contraction of Russian imports was due to the devaluation of the exchange rate of the ruble, fall in real household income, contraction of investment, and difficulty in obtaining credits by trade firms.

Furthermore, amid devaluation of the exchange rate of the ruble, contraction of imports in value terms was very sharp and constituted in the 2Q 58.2% of the same period of 2008, in the 3Q – 59.3%, and for the entire year averaged 66.0%

Reduction in import volumes significantly affected the behavior and structure of the domestic market. Analysis of the domestic market resources shows that since 2005 there was a positive trend in imports share in commodity turnover and investments. The share of import in the structure of stock of goods in the retail sector in 2008 went up to 47% against 45% in 2005 and 40% in 2000. At the same time, this growth came on the back of increased share of non-food products; meanwhile the share of foodstuffs remained practically unchanged. In 2008 import of foodstuffs in the structure of stock of goods in the retail sector constituted 34.0% and of non-food products – 54.4%. High ratio of foreign made goods ensured the balance between demand and supply also in the investment market. In the investment market the share of import of investment in machinery and equipment went up to 20.0% in 2008 against 17.8% in 2007. Although growth of imports contributed to the formation of competitive environment. However, high share of imports in the retail sector turnover and in the investments in machinery, equipment and means of transport increased dependency of goods balance in domestic market on the fluctuations in foreign economic environment. The first warning sign was observed in 2007 when to an increase in world food prices the Russian economy responded with contraction of imports and increase in domestic prices on imported and domestic products. However, adopted measured aimed at market stabilization amid high growth rates of domestic output down to mid-2008 ensured dynamic expansion of retail sector turnover.

From the 4Q 2008 behavior and structure of domestic market was changing under the influence of simultaneous contraction both of goods volumes and domestic production, and imports. According to estimates, in 2009 imports in physical terms contracted by about 31%, output of domestic products of final consumption and services – by about 2.7%, which resulted in contraction of domestic market by 14.3%. This situation was true of the 1998 crisis.

Large scale reduction in import volumes in 2009 determined structural changes in stocks of the domestic market. Against the background of contraction of domestic demand, reduction in household income and devaluation of the exchange rate of the Ruble there was strengthening of domestic producers' position in the consumer market. By the 3Q of 2009 on the domestic market the share of imports in stock of goods in the retail sector fell to 41%. At the same time, simultaneously there were unfavorable changes in the general structure of imports, when sharp

reduction in import of investment products was taking place amidst reorientation to import of consumer goods and products of intermediate demand (*Table 2*).

Table 2

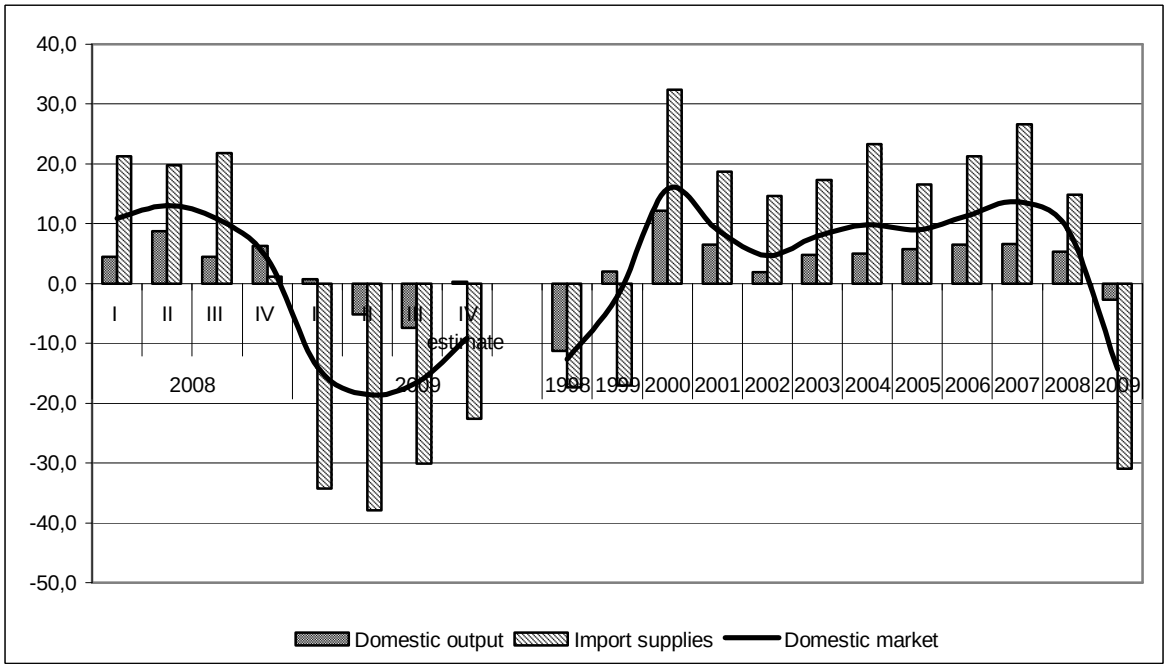
Proportion of Consumer, Intermediate and Investment Products in the Overall Volume of Imports to the Russian Federation (Balance of Payments Methodology, in % to total)

	Products		
	consumer	**investment**	**intermediate**
		2008	
I quarter	45.0	22.6	32.4
II quarter	41.3	23.9	34.8
III quarter	43.6	24.2	32.2
IV quarter	37.8	24.4	37.8
Year	41.8	23.8	34.4
		2009	
I quarter	46.8	18.6	34.9
II quarter	44.0	18.1	38.4
III quarter	43.8	19.7	36.6

Source: Federal service of state statistics.

It is worth noting that the factor which maintained domestic market in the first half year of 2009 represented accumulation of stocks of end products summarizing 2008 results. Excess of supply over demand which emerged for the first time since 1998 financial crisis exerted ambiguous effect: on the one hand, in the first half of 2009 slump of domestic output against the background of demand contraction turned out to be especially deep, and on the other hand, the use of stocks partly offset the drop in imports, which share in the stocks went down by 6.3 percentage points in comparison with the same period previous year. In the 3Q of 2009 the situation notably deteriorated due to inventory depletion and strengthening of the downward trend of supply of domestic goods and services in the domestic market. Contraction of effective demand, deficit of current assets required for purchasing raw materials, high cost of credits strengthened the impact of negative factors on the performance of national economy. However, highest since the onset of 2009 drop in supply of domestic goods and services was partly offset by expansion of imports against the preceding quarter of the current year, and which allowed weakening the downward trend of domestic market contraction. In the 4Q of 2009 amid further slowdown of contraction of imports and stabilization of supple of domestic goods and services, domestic market demand fell by 9.2% against 14.6% on average for January-September 2009. At the same time, in October-December 2009 significant reduction in recession rates of both investment and consumer markets could well be observed.

Analysis of economic dynamics across components of external and domestic demand demonstrates exceptionally high dependence on foreign economic factors. Absence of significant structural changes, inertia development of both export-oriented sectors and goods production for the final consumption, based on the extensive use of principal factors, high share of imports in the stocks of domestic market conditioned low competitiveness of Russian economy in the wake of the restorative growth in 2000-2008 and represented factors characteristic of deep systemic crisis of 2009.



Source: Federal service of state statistics**.**

Fig. 3. Changes in Growth Rates of Domestic Demand across Components in 1998– 2009, quarter-on-quarter 2008–2009, in% to the Corresponding Period Preceding Year

3.1.2. Principal Features of GDP Usage

In the wake of the growing global crisis and contraction of the revenues of the economy, modification in ratio between gross national savings and final consumption could well be observed since 2008. At the end of 2009, the share of gross national savings in GDP fell to 25.3%, which is comparable with crisis 1998 year. Net reduction in the national savings' volume came on the back of contraction of both net exports and gross capital formation be means of sharp decrease of stocks.

Sharp decline in the investment growth rates, commissioning of fixed assets and rapid increase in the unfinished construction in 2007-2008 exerted negative influence on economic performance in the end of 2008 and on the situation in 2009. Amidst the situation formed in the capital and saving market, the share of investments in fixed capital in GDP fell by 1.9 percentage points in 2009 against the corresponding period of the preceding year and constituted 19.3%.

Parameters of 2009 were determined by the downward trend in the investment movement. At the same time, curtailing of the investments took a more negative form than GDP dynamics. In 2009 there was a U-turn in the investment trend which was effective during 2000-2008, and for the first time since 1998 crisis, and a slump in the investment into fixed assets was recorded (a slight contraction was observed in 2002) (*Table 3.*). Fall of investments into fixed capital in 2009 constituted 17.0% amidst GDP contraction by 7.9% against correspondingly 12.0 and 5.3% in 1998.

Table 3

Structure of GDP Usage on Gross Savings and Investments in Fixed Capital in 2008–2009 in Current Prices, in % to Total

	2008					2009				
	year	quarter				year	quarter			
		I	II	III	IV		I	II	III	IV
GDP	100	100	100	100	100	100	100	100	100	100
Of which:										
Gross saving	34.3	32.5	35.8	38.5	31.2	25.3	18.5	22.0	29.6	29.0
Reference:										
Share of investment in fixed capital in GDP	21.2	15.1	20.1	20.7	26.8	19.3	15.1	18.5	18.9	23.7

Source: Federal service of state statistics.

Since the 4Q of 2008 the share of expenditure on final consumption in GDP structure went systematically up which was conditioned by contraction of output volumes in GDP. Thus, amid limited resources, expenditure on final consumption in 2009 took the lion's share in GDP – 74.7% against 65.5% in 2008 (*Table 4*).

Table 4

Structure of GDP Usage in 2008–2009, quarter-on-quarter, in % to total, in current prices

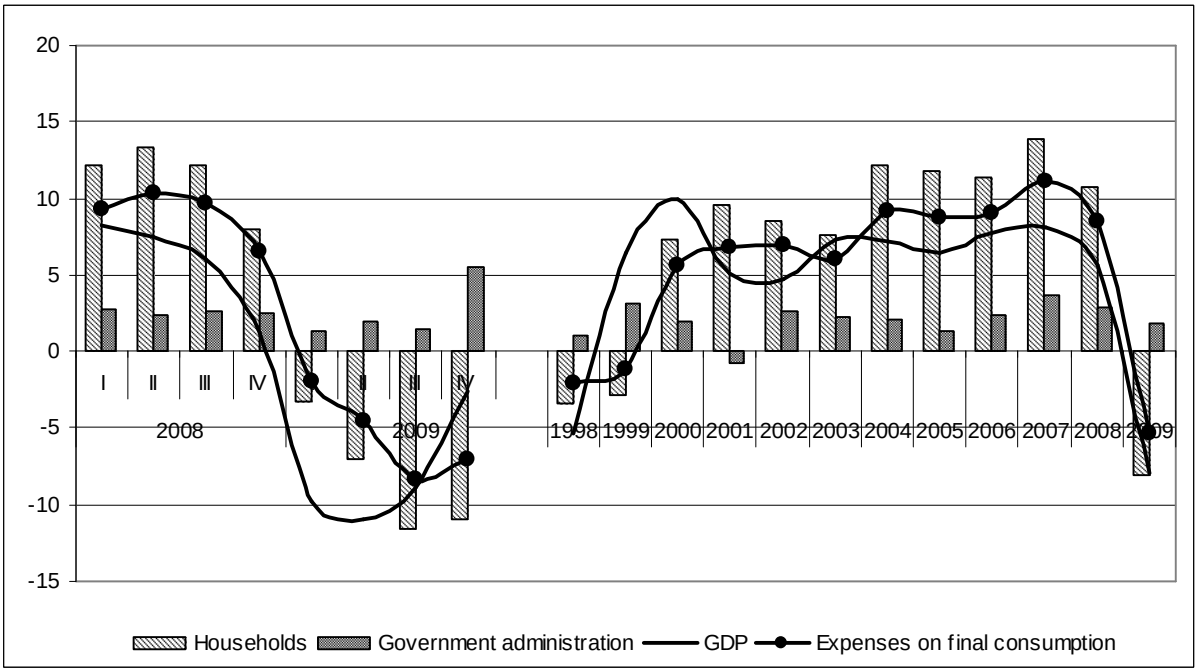
	2008					2009				
	year	quarter				year	quarter			
		I	II	III	IV		I	II	III	IV
GDP	100	100	100	100	100	100	100	100	100	100
Expenditure on final consumption	65.5	67.5	64.2	61.5	68.8	74.7	81.5	78.0	70.4	71.0
Households	47.7	48.3	46.8	45.8	51.6	53.9	57.0	55.8	50.9	52.6
Government administration	17.3	18.6	16.9	15.3	16.7	20.3	23.7	21.6	19.0	17.8
Gross capital formation	25.4	20.0	25.5	29.0	26.5	18.0	12.4	14.9	21.8	21.3
Gross fixed capital formation	22.2	16.2	20.8	21.7	27.8	20.2	16.5	19.8	19.6	24.1
Change in stocks	3.2	3.8	4.7	7.3	–1.3	–2.2	–4.1	–4.9	2.2	–2.8
Net exports	9.1	12.5	10.3	9.5	4.7	7.3	6.1	7.1	7.8	8.0

Source: Federal service of state statistics.

Trend for outrunning upturn of expenses on final consumption was effective over recent seven years and was maintained by constant advance of household income and the revenues of the economy. Over the period of 2001-2008 amid rally in household final consumption by 1.89-fold, real household income went up by 2.23-fold, real wages and salaries – by 2.85-fold, and the real volume of pensions – by 2.22-fold. Strong upsurge in final consumption represented a principal factor for sustainable growth of the Russian economy.

The global crisis of 2008-2009 painfully affected the living standard of the population. It was characterized by a deeper fall in the living standard against the preceding period than the 1998 crisis. Amidst preserving growth rates of real household income at 1.9% against 2008, the final consumption contracted by 5.4%, of which household consumption – by 8.9%. It is worth noting that dynamics of household consumption was significantly affected by the reduction in real wages and salaries to stand at 2.8% against 2008, and upturn of nominal wages and salaries by 8.5% which was minimal since 1998. In this situation issues of complying with government social guarantees and commitments became paramount. In order to maintain the living standard along with social stability, government expenses went up in 2009 to 20.3% of GDP, and by 3.0 percentage points exceeded the level of a year ago. Dynamics of social support re-

mained in the positive territory over the entire year (*Fig. 4*). In 2009 average volume of pensions went up by 22.6%, and in real terms – by 10.2%



Source: Federal service of state statistics.

Fig. 4. Dynamics of Expenditure on Final Consumption in GDP across Components in 1998–2009, quarter-on-quarter 2008–2009, in % to corresponding period of the preceding year

3.1.3. Changes in the Structure of GDP Generation across Income Sources

Support of domestic market in 2009 was based on the redistribution of income from enterprises to the population. The share of labor remuneration in GDP went up to 51.9% and by 4.6 percentage points exceed the level of 2008. However, in real terms wages and salaries in the 1Q of 2009 fell by 0.8%, in the 2Q – by 3.9%, and in the 3Q – by 5.2%. In the 4Q of 2009 real wages and salaries went up by 10.2% against previous quarter current year, as a result downturn to similar period of a year ago constituted 1.0%.

Comparison of the movements of employment, labor remuneration and GDP shows that outrunning growth of wages and salaries against labor productivity have increased the burden on the economy and negatively affected economic results.

In the wake of the production slump which took place in the 1Q of 2009 the share of net taxes on production and exports in GDP constituted 16.7%, and gross revenues and mixed income – 31.4% against correspondingly 19.9% and 32.8% in 2008 (*Table 5*).

Table 5

Structure of GDP Generation across Sources of Revenues in 2008–2009, in % to Total, in Current Prices

	2008					2009				
	Year	quarter				year	quarter			
		I	II	III	IV		I	II	III	IV
GDP	100	100	100	100	100	100	100	100	100	100
Compensation of employees (Including hidden compensation and mixed income)	47.3	48.3	46.8	42.3	45.9	51.9	56.2	53.7	47.2	51.8
Net taxes on production and imports	19.9	20.5	21.2	20.2	19.1	16.7	17.8	18.5	19.7	11.6
Gross revenues of the economy and gross mixed income	32.8	31.2	32.0	37.5	35.0	31.4	26.0	27.8	33.1	37.6

Source: Federal service of state statistics.

Behavior of financial results posted by enterprises and organizations was determined, on the one hand, by the fall of output practically in all sectors, and on the other, by price rise of producers mainly in natural resources sector and increase in tariffs by natural monopolies. As a result of differently directed outcome of these factors, structural changes in redistribution of income across types of activity have strengthened. Profitability of sold goods, products and works at the end of January-September 2009 constituted 11.2% and fell by 4.6 percentage points in comparison with the same period of the preceding year.

Table 6

Profitability of Sold Goods, Products, Works, Services and Return on Assets of Organizations across Types of Economic Activity in First Half of 2008 и 2009, in %

	Profitability of soled goods, products, works and services		Return on assets		Reference		
					January-September 2009 to January-September 2008		September 2009 to December 2008
	2008	2009	2008	2009	Rates of financial result	Indices of physical volume	Price indices
Total	15.8	11.2	6.8	3.8	64.1	88.2	
Of which: agriculture, hunting and forestry	15.0	11.4	4.5	2.9	73.3	99.2	96.3
Fisheries, fish-farming	10.7	25.9	4.8	13.0	290.0	109.5	
Natural resources	36.2	31.3	14.6	8.5	72.2	97.0	153.5
Manufacturing industries	20.6	12.3	12.1	3.9	35.5	82.5	106.5
Production and distribution of electricity, gas and water	3.6	7.3	0.6	2.9	320	93.1	118.0
Construction	5.6	5.0	2.6	1.5	58.6	81.6	99.8
Wholesale and retail sectors; maintenance of transport means, motorcycles, household appliances, and personal items	11.3	7.0	7.0	3.6	56.8	94.7	108.1
Transportation and communications	16.4	15.8	5.0	3.9	99.8		110

Source: Federal service of state statistics.

Production slump and other crisis developments turned out to be ambiguous. Correspondingly development processes are evolving unevenly and have their own features.

Production and distribution of electricity, gas and water remained the most profitable economic activity in January-September 2009. This is due to an upsurge of regulated tariffs by 21.1% from 1January 2009 and reduction in production costs. At the same time, it should be noted that significant upturn of tariffs and free prices on electricity positively affected profitability of production and distribution of electricity, gas and water, and made recession in other sectors especially in processing sector more acute.

Domestic production reacted to a fall in investment activity and contraction of domestic and foreign demand by reduction in producers' prices in the 4Q 2008 by 20.9% compared with the 3Q. Amid slump in world prices on energy and mineral resources, producers' prices in natural resources sector in the 3Q 2008 fell by 5.4% in comparison with preceding quarter, and in the 4Q – by 44.9%. Drastic changes in the level and structure of prices was accompanied by a decline in economic profitability which resulted in negative revision of corporate investment programs, and in stagnation of production and layoffs. However, already in the end of the 1Q 2009 industrial goods producers' price index constituted 104.4% with respect to the last quarter a year ago, when the price take-off in mineral sector stood at 8.5%, in processing industry – at 1.3%, and in production and distribution of electricity, gas and water – at 118.0%. Price hike on raw materials and energy was followed by an increase in prices in manufacturing sector by 6.5%. However, even under such restrained price policy domestic producers have not managed to strengthen their positions on the domestic market.

In the 4Q 2009 the price fall could be observed in industry which represented one the reasons for alleviating the recession consequences by the end of the year.

Deterioration of financial outcome recorded in manufacturing industry was first of all determined by deep contraction in domestic and foreign demand. Mostly the crisis affected manufacturing enterprises which find themselves in a financial predicament, especially those which were oriented to domestic demand. At the same time, price fluctuations affected less the financial outcome of these enterprises than contraction of production. Among factors which determined vulnerability of the manufacturing industry in the wake of the crisis, one should note high level of debt obligations as well as general inefficiency of production.

Among sectors engaged in production of consumer goods, food processing sector was in the best shape, including production of beverages and tobacco. Reduction in the output volumes at the peak of the crisis turned out to be moderate – within 4% and starting from March the trend became positive. In the 2Q 2009 food processing industry balanced result was by 34% higher than for the corresponding period a year ago. Positive upsurge of revenues continued in the 3Q 2009. Due to comparably high level of competitiveness of domestic foodstuffs in price and quality amid devaluation of the exchange rate of the ruble one could observe import substitution in the food processing sector. In spite of the fall in revenues in the mineral extraction sector at the end of January-September 2007 by 27.8% against similar period of the previous year, income was obtained first of all due to stabilization of the world energy market, price growth on energy resources, decrease in export duties for the oil sector, as well as preservation of high export prices for natural gas.

In construction sector contraction in the investment demand and unavailability of credits – under strong dependence of this sector on bank loans – has resulted to a notable reduction in the construction volumes. As a result, balanced revenues amounted to 58.6% of corresponding amount for January-September 2008.

Reduction in commercial freight traffic for January-September by 24.0% to the corresponding period of a year ago resulted in an increase of financial result in transportation by 4.6% due to rise of tariffs on cargo carriage by 10.0%.

In the structure of working population, 92% are employed that is why the issues of labor remuneration and employment seems to remain a big issue. Amidst the reduction of the real wages and salaries and real income of households in 2009 high numbers of unemployment remained. In 2009 in comparison with the same period a year ago the number of employed in the

economy plummeted by 1.7 mln people to stand at 69.4 mln, and overall number of jobless (according to WLO methodology) reached 6.0 mln or 8.4% of economically active population. The number of officially jobless claims registered by the state employment service stood at 2.1 mln, and the level of registered unemployment – 2.8% against 1.8% in 2008 (*Table 7*).

The situation was aggravated by an increase to 1.6 mln of employed who have been transferred to part-time employment and those who have been sent to forced leave and work stoppages. Moreover, negative impact of such factors as limitation of professional mobility, reduction in secondary and informal employment was especially true in monosectoral cities. It is worth noting that the situation became worse in the small business sector. Small business employed 6.2 mln in 2008 which constituted 11.4% of an average annual number of employed as a whole in Russian economy. Against the background of sharp changes which took place in the development of Russian economy in the wake of the global financial crisis and its extension to include the real sector in the 4Q 2008, the number of workplaces at small enterprises (excluding micro enterprises) shrank.

Tension coefficient (number of jobless claims registered by the state employment service per a vacancy) compared with December 2008 surged from 1.9 to 3.2. Requirement in employees reported by the employers to the state employment service went down by the end of December 2009 against similar month a year ago by 170 thousand, the number of vacancies by the end of 2009 nearly halved to stand at 223.3 thousand.

Table 7

Main Indices of Labor Market in 2008–2009

	2008	Quarter				2009	Quarter			
		I	II	III	IV		I	II	III	IV
Number of employed in economy (by the end of the month), mln	70.9	69.9	71.4	71.9	70.4	69.4	68.2	69.4	70.4	69.5
Number of unemployed (average per month), thousand	4.8	5.1	4.3	4.5	5.4	6.3	6.8	6.5	6.0	6.0
Unemployment level, in % to the economically active population	6.4	6.7	5.6	5.9	7.1	8.4	9.1	8.6	7.8	8.0
Number of jobless claims registered by the state employment service, thousand	1.4	1.6	1.4	1.3	1.4	2.1	2.0	2.2	2.1	2.1
Level of registered unemployment, in % to economically active population	1.8	2.1	1.9	1.7	1.8	2.8	2.6	2.8	2.7	2.7
Average monthly payable salary in organizations, Rb	17290	15424	16962	17556	18966	18785	17441	18419	18673	20626
Wage arrears (mln Rb, on average quarterly)	3337.7	2857.3	2756.3	2801.7	4935.3	6662.4	6575.3	8486.7	6409.7	5178.0
	in % to the corresponding period of a year ago									
Number of employed in economy (by end of month)	100.6	100.8	101.2	100.7	99.6	97.8	97.7	97.1	97.9	98.7
Number of unemployed (on average per month)	104.4	96.5	94.2	105.6	123.7	131.1	134.8	152.1	132.2	112.0
Number of jobless claims registered by the state employment service	89.7	89.7	89.3	88.9	91.1	148.0	126.5	157.4	163.0	153.2
Average monthly payable salary in organizations	125.9	128.0	129.2	129.0	119.5	108.5	112.8	108.0	105.7	108.1
Average monthly payable salary	110.3	113.4	112.5	112.2	105.0	97.2	99.2	96.1	94.8	99.0
Wage arrears	77.5	62.0	60.7	65.8	129.2	199.6	230.1	307.9	229.8	104.9

Source: Federal service of state statistics.

Factors of Economic Growth of GDP and Value Added in 2008–2009

Below we present the results of decomposition of the output growth indicator (GDP) in 2008-2009 obtained in accordance with methodology described in IET publication (Factors

of Economic Growth. Academic papers, #70. Moscow, IET, 2003. www.iet.ru). The basis of decomposition is the resolution of economic growth into extensive and intensive components which allow estimating the quality of growth and forecast further trends of economic growth. Presented results specify transformation of the economic growth structure and permit separating paramount factors which conditioned changes in the output growth rates.

Last two years GDP dynamics is characterized by a sharp slowdown in growth rates turned to a more significant contraction than in 1998 (-7.9% by the end of 2009). Quarterly GDP during entire 2008 was marked by more than sevenfold slump in growth rates: if in the 1Q GDP growth against the same period of a year ago stood at 8.7%, then in the 4Q – only 1.2%. In 2009 for the first time in 10 years real GDP growth rates turned to be negative, constituting quarter-on-quarter correspondingly: -9.8% in the 1Q, -10.9% - in the 2Q, -8.9% in the 3Q, and -1.7% in the 4Q 2009.

Except the 4Q 2008 where positive rates of GDP growth were observed amid contraction in the labor and capital costs, changes in GDP volume and fixed assets costs are marked by unidirectional dynamics: upsurge in output was followed by the increment of principal extensive factors (1-3Q 2008), and contraction of output – by their reduction (1-4Q 2009).

According to decomposition findings (Table 8) in 2008 fixed capital costs determined 56.9% of GDP growth, in 2009 their input went down to 41.8%. At the same time, changes in the output growth rates were accompanied by transformations which took place in their structure which revealed themselves most vividly in 2009. These transformations can mainly be attributed to the distribution of input in the GDP growth rates between principal factors – labor and capital. Over last ten years output growth at the expense of costs of main factors to a greater extent was determined by the change in the volume of capital attracted to production - on average by 32%, meanwhile contribution of labor costs constituted only about 7%. In 2009, on the contrary, contraction of actually worked hours determines 30% of the output growth rates which threefold outpaces capital costs in the GDP growth rates.

According to decomposition of quarterly indices (Table 9) in 2008-2009 GDP growth rates on average at 16% are conditioned by the changes in labor costs, at that contribution of this component went up (from 4.7% in the 1Q 2008 to about 100% in the 4Q 2009). More significant contribution in GDP growth rates are determined by the changes in the volume of industrial capital, which constitute on average 21%, however as against labor costs contribution of capital costs contracted from 50.1% in the 1Q 2008 to 24.0% in the 3Q 2009 (in the 4Q 2009 contribution of capital costs was negative). As a result, where in January-September 2008 contribution of capital outpaced labor input by about ninefold, than in the first half year 2009 contribution of capital in GDP growth rates was about one third of the labor contribution and matched it only in the 3Q 2009.

The year 2009 as distinct from preceding years demonstrates changes in the GDP growth structure which are conditioned by the reduction in the capital costs which are simultaneously followed by an increase in labor costs. These structural modifications express the impact of crisis developments in the economy on the behavioral strategies of producers who in the process of adapting to the new economic conditions apply first of all a more flexible tool – control over the volume of labor costs.

Table 8

Decomposition of the Annual Rates of Growth of GDP and Gross Value Added of Industrial Production in 2005–2009[1]

	GDP	Factor costs	Including						Combined Factor productivity
			Labor	Of which:		Capital	Of which:		
				Number of employed	Hours worked*		Volume of fixed capital*	Capacity utilization***	
Rates of growth									
2005	6.40	2.05	0.03	0.26	–0.23	2.02	1.05	0.98	4.35
2006	7.70	4.10	0.43	0.25	0.18	3.67	1.34	2.33	3.60
2007	8.10	3.60	0.65	0.57	0.08	2.95	1.69	1.25	4.50
2008	5.60	3.19	0.15	0.31	–0.16	3.04	1.95	1.10	2.41
2009	–7.90	–3.31	–2.37	–1.09	–1.28[2]	–0.94	1.58[3]	–2.52[4]	–4.59
in % to the GDP growth rates									
2005	100	32.07	0.45	4.07	–3.62	31.63	16.35	15.27	67.93
2006	100	53.29	5.60	3.28	2.32	47.68	17.40	30.29	46.71
2007	100	44.45	8.07	7.05	1.02	36.38	20.90	15.48	55.55
2008	100	56.92	2.61	5.49	–2.88	54.32	34.77	19.55	43.08
2009	100	41.84	30.00	13.86	16.14	11.84	–20.05	31.89	58.16

* per a worker.
** For 2005–2008 on the data of physical volume of fixed capital.
*** Estimate of fluctuation in capacity utilization in the economy as a whole is constructed on the data of the electricity consumption volume

Negative trends in the number of employed (stock of labor) in the wake of the financial crisis were observed since the 4Q 2008 which was marked by the contraction in the number of employed at 0.6% and strengthened in 2009 to stand at - 2.4% in the 1Q, - 2.8% in the 2Q, - 2.1% in the 3Q and - 1.4% in the 4Q. Negative trend in the number of employed was mainly conditioned by the reduction in the share of working population in total population and the share of economically active population in the number of able-bodied population. In the same 4Q 2008 sharp fall in working time per an employed was observed.

Analysis of the changes in the labor costs structure following crisis developments in the economy represents the fact that manipulation of the length of a working-day became the principal tool for the labor market adaptation to the changes taking place in the labor market. Changes in the number of employed represented the paramount component of labor costs which determined their contribution to GDP growth rates up to mid-2008. In the 3Q 2008 growth rates of the stock of labor matched its utilization rates. In the 4Q contribution of hours worked to the GDP growth rates exceed nearly threefold contribution conditioned by the changes in the number of employed. In 2009 average quarterly reduction in the hours

[1] Disagreement with previously published findings is due to the change in the data presented by the Federal service of state statistics (Rosstat).
[2] Annual estimation is constructed on the data for January-September 2009.
[3] Preliminary data – growth evaluation of the physical volume of fixed assets in 2009 which is constructed on the assumption of constant coefficient of capital consumption and constant share of investment directed to their renewal.
[4] Preliminary data – evaluation of capacity utilization is constructed on an assumption of constant share of electricity consumption in production volume.

worked per a worker exceed average reduction in the number of employed ensuring on average 28% of GDP growth.

Table 9

Structure of Rate of Growth of Quarterly GDP (Against the same period a year ago)

	I quarter 2008	II quarter 2008	III quarter 2008	IV quarter 2008	I quarter 2009	II quarter 2009	III quarter 2009	IV quarter 2009
				Growth rates				
GDP	8.70	7.50	6.00	1.20	–9.80	–10.90	–8.90	–1.70
I. Factor costs	4.76	3.25	4.95	–0.61	–4.93	–4.24	–4.30	–0.38
I.1 Labor	0.40	0.36	0.58	–1.08	–3.90	–3.02	–2.16	–1.78
Employment	0.35	0.53	0.30	–0.26	–1.37	–1.50	–1.12	–0.76
Hours worked	0.06	–0.17	0.28	–0.82	–2.53	–1.52	–1.04	–1.02[1]
I.2 Capital	4.36	2.89	4.37	0.47	–1.03	–1.22	–2.14	1.40
Fixed costs	1.56	1.69	1.91	1.82	1.44	1.43	1.32	1.20
Utilization of production capacity	2.80	1.20	2.46	–1.35	–2.47	–2.65	–3.45	0.20
II. Total factor productivity	3.94	4.25	1.05	1.81	–4.87	–6.66	–4.60	–1.32
				In % of the GDP growth rates				
GDP	100	100	100	100	100	100	100	100
I. Factor costs	54.8	43.3	82.5	–50.9	50.3	38.9	48.3	22.3
I.1 Labor	4.7	4.8	9.6	–90.1	39.8	27.7	24.3	105.0
Employment	4.0	7.1	4.9	–21.6	14.0	13.8	12.6	44.9
Hours worked	0.7	–2.3	4.7	–68.5	25.8	13.9	11.7	60.1
I.2 Capital	50.1	38.5	72.9	39.1	10.6	11.2	24.0	–82.6
Fixed assets	18.0	22.5	31.9	151.5	–14.7	–13.1	–14.8	–70.9
Level of production capacity utilization	32.1	16.0	41.0	–112.4	25.2	24.3	38.8	–11.8
II. Total factor productivity	45.2	56.7	17.5	150.9	49.7	61.1	51.7	77.7

As in the case of labor costs, crisis developments in the economy led to capital cost trend to become negative which happened not in the end of 2008 but in the 1Q 2009. In 2008-2009 main factor which determined changes in capital costs and also their trend a year later was volatility of the utilization of production capacity. Capital costs utilization growth demonstrates stable decrease up to the 4Q 2009, so from the end of 2008 they became negative. On average decline in the growth rates of this component amounts to 2.1 percentage points quarter-on-quarter (in accordance with the linear trend at 2.3 percentage points[2]). At the same time, in the last quarter 2009 utilization of production capacity levels posts insignificant upturn.

Capital stock represents the only factor which has a negative contribution to GDP growth rates. In other words, it is the only indicator which is amid output contraction posts increment. It is worth noting that the rates of upsurge of fixed capital are falling. In accordance with estimation methodology[3] dynamics of capital stock is determined by the changes in the

[1] Estimate for the 4Q are constructed on the data for January-September 2009

[2] Estimates of reduction in growth rates according to the linear trend are considered with an aim of reducing dependence of estimation results from the choice of initial and final year of the period under consideration.

[3] In the absence of quarterly statistics, estimation of fixed capital growth is based on an assumption of constant coefficient of capital consumption and constant investments directed on their renewal. It should be noted that

investment volume in fixed capital which demonstrates negative trend from the 4Q 2008. As a result, fall in the volume of funds directed to the renewal of fixed capital taking into account the level of their depreciation have resulted in quarter-on-quarter decline in capital stock advance at 0.23 percentage points.

Over last two years dynamics of the combined factor productivity is marked by a sharp reduction in growth rates. Productivity growth rates (Table 8) in 2008 stood at 2.4% which is half the average level of the indicator in 2005-2007, and in 2009 for the first time since 1998 there is a decline in productivity rates. At the same time, the rate of decline outpaces corresponding value for 1998. In 2008-2009 combined factor productivity is the only reason for the change in GDP growth rates.

When analyzing quarter-on-quarter dynamics (Table 9), changes in combined factor productivity represent dominant factor which determines on average 64% of the output rates of growth. As in the majority of components under consideration, combined factor productivity demonstrates reduction in the growth rates in 2008 and transition to negative territory in 2009, reaching its minimum level in the 2Q 2009 which amounted to -6.7% and subsequent contraction to the level of -1.3% in the 4Q 2009.

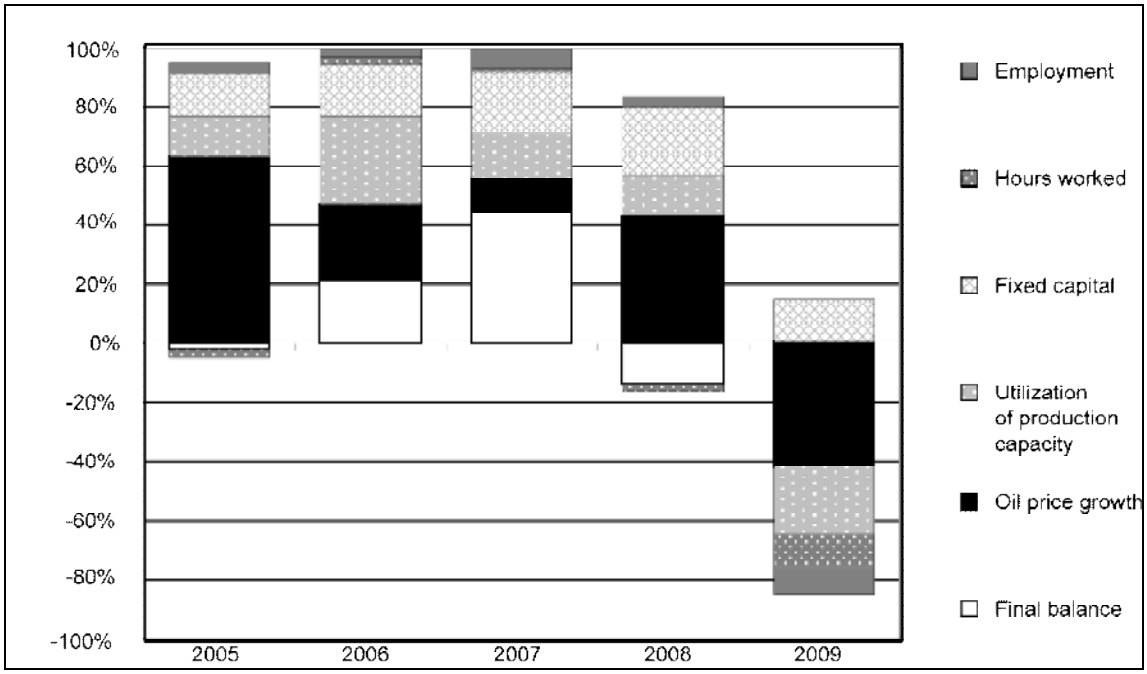


Fig. 5. Growth Structure of GDP in 2005–2009

Obtained estimate of combined factor productivity should not be viewed as purely "technological" component which marks adjustment in factor productivity. It reflects the impact of indices which are not accounted in the estimation of principal costs as well as shifts due to the method of estimation. For example, the use of cost indicators of output and capital may shift "physical" estimation of combined factor productivity due to unevenness of GDP prices

obtained estimation may be shifted due to the fact that it does not take into account time lag between the moment when investment if received and the moment of their usage.

dynamics and fixed capital.[1] At the same time, precisely this unevenness mark Russian economic system which is determined by high oil price volatility. That is why, in short-term period market factors may exert more important influence on growth compared to technological ones.

In accordance with obtained findings[2] in 2008-2009 oil price fluctuations determine the lion's share of rates of growth of combined factor productivity and GDP. On average in the period under consideration changes in the price factor determined about 60% of the output growth rates, meanwhile technological productivity ("final balance") – about -10%. At the same time, as a result of taking pricing environment on the world raw material market as a separate factor, changes in the rates of growth of "technological" component differ from combined factor productivity behavior. Rates of growth of "balance" turn to negative territory from 2008, meanwhile in 2009 technological productivity practically did not change.

Thus, changes in the dynamics of rates of growth of GDP observed in 2008-2009 are accompanied by transformation in the structure of growth rates which is marked by a reduction in the contribution of capital costs with simultaneous increase of contribution of labor costs amid combined factor productivity preserves its dominant role. At the same time, changes in the growth rates and labor costs, and capital costs are mainly determined by fluctuations in the level of their utilization (worked hours and intensity of utilization of production capacity).

Growth rates of the majority of components (except fixed costs) demonstrate same dynamics: decline in growth rates in 2008, transition to negative territory by the end of 2008 - beginning of 2009 and reduction in the negative trend by the end of 2009.

On average in 2008-2009 contribution of productivity in GDP growth constitutes about 50% without oil prices and -10% after the exclusion of market movement in the world raw materials market. At the same time, it should be noted that in 2009 estimates of technological productivity demonstrate near zero rates of growth.[3]

3.1.4. Dynamics and Structure of Production across Types of Economic Activity

Over the period of 2008-2009 Russian economy behavior can be divided into several definite periods. In the first half of 2008 economic situation was determined by several factors and trends of economic growth which were set up during 2006-2007. From the second half of the year developments occurring on the global financial markets and slump in prices and demand observed on the world raw materials market significantly affected the economy. Up to mid-

[1] "Cost" estimation of productivity agrees with "Physical", in the event the economy is in long-period equilibrium and perfect competition. In other words, where all possible exogenous shocks are accounted in the current equilibrium of the system.

[2] Separation in the combined factor productivity market component and execution of subsequent decomposition of output growth rates is based on the availability of statistically important interconnection between combined factor productivity growth rates and world oil prices growth rates, which is estimated by regression on annual data for the period from 1993 through 2008. Obtained as a result "final balance" cleared from the effect of price fluctuations on the world raw materials market represent a more reasonable feature of technological productivity, i.e. intensive component of output growth.

[3] One should not consider this fact as proof of positive changes in technological characteristics of enterprises performance. In part this result may be attributed to applied methodology for balance division. Furthermore, in the last half year under consideration estimations of combined factor productivity may be shifted due to exogenous shocks determined by world economic situation created by the global financial crisis.

2009 economic situation was determined by inertia effect and factors which were set up during the period of acute stage of the global financial crisis of 2008. However, staring with the second half of 2009 economic situation rebounded on the back of restorative external demand and government stimulus plan. When comparing 2008 indices with those of 2009 we should take into consideration both qualitative features of economic performance and quantitative features as well (base effect).

Table 10

Dynamics of GDP Physical Volume and Gross Added Value across Types of Economic Activity in 2008-2009, in % to corresponding period a year before

	2008	Quarter				2009	Quarter		
		I	II	III	IV		I	II	III
Gross added value	105.6	108.7	107.5	106.0	101.2	92.1	90.2	89.1	91.1
Of which: agriculture, hunting and forestry	107.4	104.3	105.6	109.5	110.1	98.3	97.6	98.2	98.1
Fishing, fish farming	94.4	105.1	111.8	89.8	86.8	98.4	107.8	105.6	100.4
Extraction of mineral resources	100.1	101.7	102.2	101.7	96.1	98.1	97.8	94.9	97.7
Manufacturing industries	100.2	106.6	105.1	104.7	89.9	86.1	76.5	81.3	85.4
Production and distribution of electricity, gas and water	100.9	104.1	105.1	104.0	92.9	94.0	94.7	93.3	90.1
Construction	111.9	131.3	118.1	109.5	104.1	83.6	79.1	79.5	80.3
Wholesale and retail sectors	109.5	114.2	109.7	105.5	105.4	91.7	95.1	88.7	91.0
Hotels and restaurants	110.7	112.9	110.1	110.0	108.7	84.6	87.8	84.8	80.6
Transportation and communication	106.3	110.6	109.5	106.2	103.6	97.7	92.6	89.8	95.1
Financial activity	104.0	108.6	107.8	106.8	103.7	94.3	100.3	94.6	94.2
Transactions with real estate	113.6	108.9	111.2	111.0	111.6	94.7	92.2	94.7	92.8
Government administration and defense, compulsory social insurance	103.0	104.0	103.2	103.5	103.6	103.2	102.4	103.2	103.3
Education	100.0	101.3	101.0	100.5	100.0	98.7	99.4	99.2	99.5
Pubic health and provision of social services	100.0	100.5	100.7	100.7	100.7	100.6	98.5	98.5	98.6
Delivery of other utility, social and personal services	97.8	105.2	105.7	106.8	99.5	81.7	91.3	87.5	68.5

Source: Federal service of state statistics.

In 2008 macroeconomic situation was marked by gradual negative development trend recorded practically across all sectors of the economy. Contraction of the investment activity from the 3Q 2008 was followed by a downturn in the construction sector which lost its first place to retail sector. Economic situation also conditioned decline in demand for infrastructure sector services.

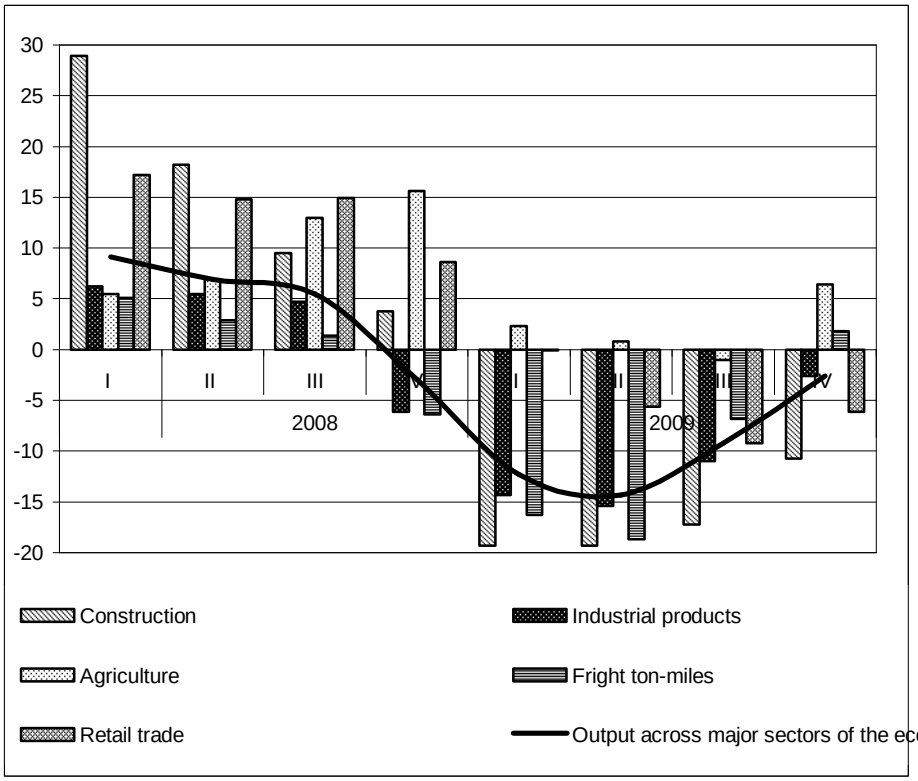
Largest production slump across major sectors of the economy took place in the first half of 2009 when the downturn constituted 13.6%. By the year end on the whole, the slump amounted to 9.4%. Downward trend was observed practically across all types of economic activity. Industrial slump for 2009 against a year ago amounted to 10.8%. Absolute reduction in output volumes predetermined contraction in demand for the services provided by the natural monopolies. Freight ton-miles volume shark by 10.2%, of which by railway transport – by 11.9%, production and distribution of electricity, gas and water – by 4.8%. And such sector as communications which posted over recent years stable high behavior, although remained in the

positive territory, but lowed notably from 4Q 2008: in 2009 increment in communications services soot at 2.7% against 11.9% a year earlier.

Under the effect of downward trend of investments in the fixed capital by 17.0% construction sector posted reduction at 16.0% vis-à-vis 2008.

In 2009 one of the paramount problems was emergence of downward trend in consumption demand on the domestic market effective from February 2009. For 2009 retail sector turnover dipped by 5.5%, of which foodstuffs – by 2.5% and non-food products – by 8.3%. The volume of paid services rendered to the population fell to 95.7% of the 2008 level.

Consumer inflation from the onset of the current year amounted to 8.8% against 13.3% in 2008. At the same time, price hike on foodstuffs was 106.1% against 108.0%. However, against the background of slowdown of inflation the behavior of the population on the consumer market was marked as very cautious. Low effective demand of the population coupled with internal constraints in activity of commercial enterprises conditioned by insufficient financial resources, high interest rates on credits, rental value and tax burden negatively affected the movement of retail trade and have resulted in growing recession in the second half of 2009 regarding same period of the preceding year.



Source: Federal service of state statistics.

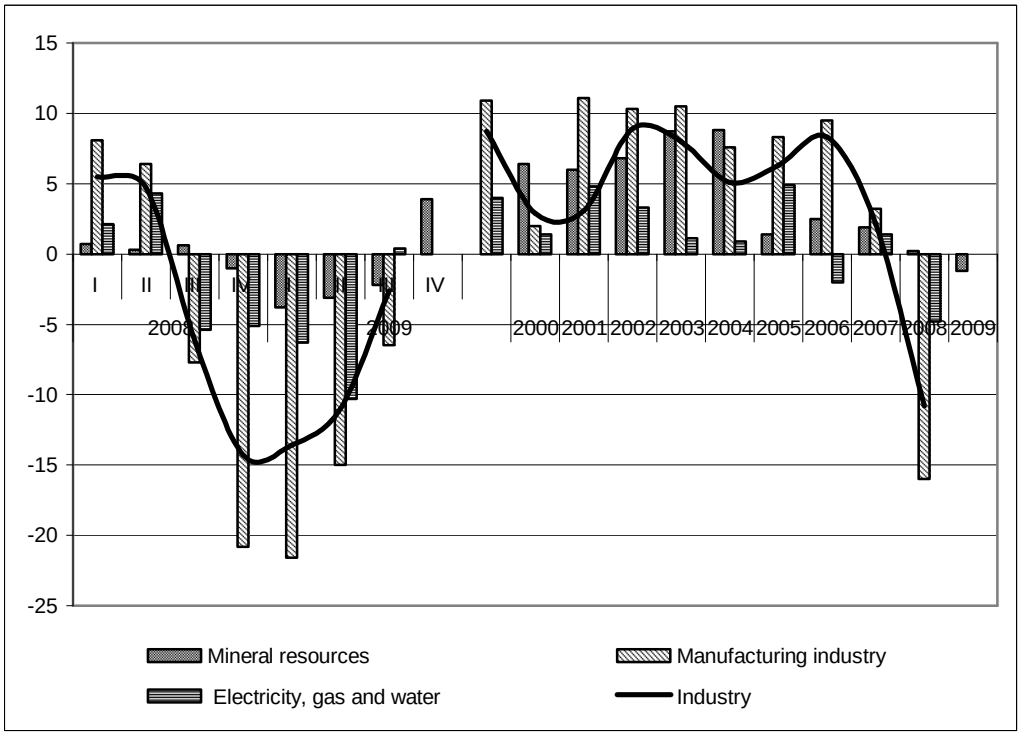
Fig. 6. Change in Output Movement across Major Sectors of Economy in 2008–2009, in % to the same period of the preceding year

In industry production slowdown rates in 2008 primarily were observed in the export oriented sectors and later expanded to manufacturing industries which recently were marked by

high rates of growth. In the 4Q 2008 for the first time since 1998 negative trend was recorded in industry.

From autumn 2008 situation in the mining sector deteriorated due to the fall of demand and contraction of prices on raw materials and products of metallurgical sector on the world market which was aggravated by the contraction in domestic demand under the effect of production slump in machine-building industry and construction complex. In the 4Q 2008 downswing in extraction of fuel and energy raw materials constituted 1.2%, in the extraction of other types of natural resources – 2.4%. Reaction of mining and extracting industries to the movements in the global and domestic markets was less important in comparison with the reaction of the manufacturing industries. The fall in manufacturing industry by 7.5% against the 4Q 2007 exceptionally negatively affected domestic product market as well as labor and capital markets.

Highest fall in the industrial production took place in the first half of 2009, when the slump constituted 14.8% and in manufacturing industries – 21.3%. From the onset of the second half of the year, the situation rebounded on the back of restorative external demand and government stimulus plan, and by the end of the year on the whole, the industrial production shrank by 10.8% of the level a year ago including in extracting industries – by 1.2%, and in manufacturing industries – by 16.0% (*Fig. 7*).



Source: Federal service of state statistics.

Fig. 7. Movement in Production Growth Rates across Types of Economic Activity in Industry 2000–2009, quarter-on-quarter of 2008–2009, in % to same period of the preceding year

Industrial production index across type of economic activity "Production and distribution of electricity, gas and water" in 2009 vis-à-vis the same period a year ago constituted 95.21%. 992 bn kWh of electricity were produced in 2009, which stands at 94.3% of the 2008 level.

Low levels of electricity production were conditioned both by decline in domestic demand and reduction in net-power flow to Finland, the Baltic states and CIS (Trans-Caucasian region and Belarus).

The movement of manufacturing industries is significantly differentiated across types of economic activity. At the same time, ratio between production rates of capital and consumer goods exerts the highest effect (*Table 11*).

Table 11

Production Rates Movement across Types of Activity in Manufacturing Industries in 2007–2008, in % to corresponding period of the preceding year

	2008	Quarter				2009	Quarter			
		I	II	III	IV		I	II	III	IV
Manufacturing industries	103.2	110.7	108.1	106.4	92.3	84.0	79.2	78.4	85.0	93.5
Food processing, including beverages and tobacco	101.1	106.4	103.9	101.7	93.7	99.5	96.7	97.4	99.9	104.3
Textiles and garment manufacture	95.5	102.6	101.8	97.9	83.8	84.2	78.8	76.7	82.0	99.8
Leather manufacture, products of leather and footwear	101.7	106.6	108.5	105.1	92.9	98.0	83.0	96.5	103.8	109.6
Timber processing and woodwork	101.4	115.6	110.9	102.4	83.6	87.5	70.8	75.4	84.4	99.0
Cellulose and paper, publishing and printing activity	100.8	107.8	106.0	101.2	88.9	99.4	82.0	85.3	86.0	98.2
Coke and petroleum products production	102.7	105.0	101.6	102.9	101.2	94.6	96.3	99.3	100.5	101.7
Chemical production	95.8	103.7	103.1	101.8	78.5	87.8	77.6	88.3	95.4	117.6
Rubber and plastic goods	112.5	130.4	116.5	119.0	101.0	85.4	82.7	84.6	89.1	94.4
Production of other non-metallic mineral goods	99.1	108.6	109.1	100.2	86.4	75.2	67.8	69.1	76.3	87.1
Metallurgy and production of finished metallurgical goods	99.8	108.6	101.1	100.5	94.7	86.1	72.3	75.7	88.0	108.7
Machines and equipment	104.0	116.4	105.4	111.6	88.0	71.6	74.3	60.1	74.4	79.7
Electrical equipment, electronic and optical equipment	92.1	93.3	91.3	98.9	87.0	68.4	56.6	63.1	72.1	81.6
Means of transport and transport equipment	109.5	114.4	119.1	116.4	91.3	62.0	64.5	58.1	53.4	71.9
Other	104.6	118.6	116.2	106.6	106.1	82.2	79.3	70.9	86.6	91.2

Source: Federal service of state statistics.

Amidst rather significant fluctuations in rates of growth across type of activity in manufacturing industries, slump in output in machine-building sector was a predominant factor which negatively impacted the level of business activity in connected industries engaged in production of constructional materials and other types of intermediary goods. Setback in production recorded in machine-building sector starting from the 4Q 2008 assumed acute forms and during the entire 2009 was marked by a downward trend significantly lower the average level across manufacturing industries. Compared with 2008 production of machines and equipment constituted 71.6% of the same level a year ago, production of electrical equipment, electronic and optical equipment – 68.4% and production of means of transport and transport equipment – 62.0%

Scaling back production of means of transport and transport equipment in 2009 was observed across all goods nomenclature. Fall of demand for railway services, reduction in the volume of purchases and arrears for orders payment on the part of OAO “Russian Railway System” continue negatively affecting production volumes of railway equipment.

Production of automobiles in 2009 against the same period 2008 constituted 40.6% and trucks – 35.7% of 2008 level.

Government stimulus measures directed to support domestic automobile industry including those aimed at stimulating demand were of palliative nature and have not resulted in reducing crisis developments in domestic automobile industry.

Over recent years imports continued affecting the behavior and development of machine-building industry. It was due to non-competitiveness of many types of machine and equipment vis-à-vis imported analogues judging by "price/quality" criterion, as well as lack of capacities for production of modern types of equipment significantly limited the market for domestic machine-building industry. Impact of imports considerably differs across different sectors of the economy and products markets. On the investment machine-building market surge of imports was a driving force behind the implementation of the investment projects, modernization of production and implementation of technological innovations. At the same time, escalating competition with imports was observed, in particular, in such machine-building sectors as, machine-tool manufacture, agricultural machinery industry, road-building machinery, automobile industry. These industries remained with low investment activity, high consumption of fixed capital, backward technologies and they were very promising for the implementation of projects of industrial assembly and transfer of activities of foreign companies on Russian soil. Outrunning growth of output volumes recorded on the enterprises with foreign capital changes conditions for competition and provided incentives for conventional sectors. However, in the wake of the crisis these sectors turned out to be most vulnerable due to the fact that over prolonged period of time nothing has been done regarding the development of production of inventory materials by the domestic enterprises. With account of wide network in machine-building industry and, in particular, in automobile industry contraction of output impacted associated sectors, infrastructure and painfully reflected on the employment level.

In the sector of intermediary demand goods suffered most in construction materials production (75.2% against 2008 level), chemicals (87.1%), rubber and plastics (87.7%, timber and woodwork products (82.3%) and in cellulose and paper (87.5%.

Domestic market demand for metal was ensured by the development of metal-intensive sectors: machine-building, construction, defense and fuel and energy complex. Metallurgical index and production of finished metal products in 2009 stood at 86.1% to the level of 2008, including metallurgical production – 86.5% and production of finished metal goods – 83.2%. With account of output of principal consumers, consumption of the domestic market of rolled metal products slumped to 62.3% against a year ago.

In the sector of consumer goods in 2009 the index of textile and garment manufacture constituted 84.2% against 2008, leather, leather goods and hoot wear – 98.0% and foodstuffs including beverages and tobacco – 99.5%. Downward trend of output volumes in light industry in the heat of economic instability is due both to the difficulties with attraction of working capital (due to increased period taken by commercial organizations to return funds due to short-term loans problems) and postponed consumer demand.

Deeper recession in domestic production of consumer goods were not offset by imports and negatively affected the movement and structure of consumer market with account of the fact that there was no adequate response of producers directed at widening import substitution production.

Analysis of principal trends allows drawing conclusion: although in the 4Q 2009 Russian economy managed to get out of the acute stage of the economic crisis, however unstable character of main indicators, low indicators in the investment and credit sectors, difficult situation observed on the labor market determine limitations in the economic development for short-term period.

Aggregate effect of positive fluctuations on the global market of hydrocarbons and government stimulus measures allowed avoiding Russian economy developing along the most pessimistic scenario which was constructed at the onset of the crisis but had no effect on the fundamental issue of low competitiveness of Russian economy. The economy remains under the effect of factors which conditioned the scale of slump and speed for overcoming acute crisis developments (dependence on world prices of raw materials export, low domestic demand and sluggish development by Russian producers of promising market of consumer, investment and intermediary goods, inadequate financial system and the lack of long-term investments in the economy).

Creation of necessary economic conditions for transition from crisis oriented economic development to the recovery growth envisages implementation of measures directed at modernization of industrial potential, promotion of innovative activity, improvement of human capital.

3.2. Russian Industry in 2008-2009: History of the Crisis According to Industrial Surveys

The section was prepared based on the surveys among managers of industrial enterprises, which are conducted by IET in compliance with the European harmonized methodology monthly, from September 1992 and cover the entire territory of the Russian Federation. The panel is about 1100 companies, which employ more than 15 per cent of total employment in the industry. The panel is biased towards large enterprises in each of the sub-industries. Feedback on questionnaires is 65-70 per cent.

Industrial surveys (IS), among business leaders is a quick way to gather information about the assessment of the situation in their enterprises and the expected (planned) changes the key performance indicators of the enterprise. IS is a relatively new tool of economic analysis. The first survey was conducted by IFO Institute (Munich, Germany) in 1949. Soon afterwards such polls have been held in Great Britain, France and Italy. Since 1962, the EU is making efforts to harmonize (make comparable) the surveys in the countries of the continent.

IS questionnaire has a rather small number of questions (no more than 15-20). The questions are of qualitative rather than quantitative nature. Simple design of questions and answers allows the respondents to fill out the forms quickly and without involvement of other employees or any documentation. It is essential that the respondent in each enterprise should be the Manager was the top level, who has a complete picture of the situation at the enterprise and directly involved in the company management. In 2008 30 per cent of responses were received from the Directors of enterprises, 37 per cent - from the Deputy Directors, 23 per cent - from the leaders of economic departments.

In analyzing the results of industrial surveys a specific derivative index is applied, known as balance. Balance is calculated as the difference between the percentage of respondents given the answer about their business standing as "increasing" (or "above regular" indicators) and the percentage of respondents whose assessment was as a "declining" (or "below regular"). The

resulting difference can express the answers to each question by one number with the sign "+" or "-".

Balance is interpreted as the first derivative or the process rate. If the balance of answers to the question about the expected price change is the sign "+", it means that the average prices in the near future will continue to grow (for example, there dominating the companies, reported an expected increase in their prices). The increase of the balance within a month from +10 to +17 per cent means that average prices industry will grow more intense as the increased prevalence of companies predicting growth. A negative balance means a decrease in average prices (more companies are going to lower their prices). Changing the balance of -5 to -12 per cent interpreted as plans of the intensity of lower prices.

3.2.1. Crisis Statistics or Statistical Crisis

In late 2008 the crisis reached the Russian industry. In December, it was recognized by: the Head of the government, then by the Ministry of Economic Development, and only then by the Russian Statistical Service. The procedure was a bit illogical. In civilized countries, it is usually on the contrary, as the statistical service is the primary source of official data on the state of the economy. Russian sequence of recognition suggests that the domestic statistics is not very reliable, as it seems, it is too heavily dependent on other departments, primarily – on those in charge of the national economy. In the recent sustained economic growth that was not so important because the trend was obvious and there could be doubts only in the intensity of growth, which was insignificant. In 2008 the situation has changed: the growth has been replaced by a downfall, but it was uneven and unpredictable.

And here there was revealed another failure of the Russian industrial statistics - limited set of indicators and low speed output data. As a result, some Ministries, trade unions and employers' associations had to start their own monitoring to understand what is really going on in the industrial sectors, and not be trapped in the preparation of a package of anti-crisis measures. There already appeared the term "crisis monitoring". And this is not only statistics of the crisis, this is a crisis of statistics.

Having discovered in the mid December of 2008 the collapse of the Russian industry, the Russian Statistical Service also decided to start active "crisis monitoring". The Head of the Service announced that the RF Federal State Statistics Service in 2009 will conduct a decade monitoring of a number of key economic indicators in the country. The indicators of such monitoring will be submitted to various government committees, while it is not decided whether the results of the decade's monitoring are to be disclosed. Such a restriction in the dissemination of non-confidential information economy was practiced in the Soviet times and then annoyed only analysts, lacking the necessary statistical data. For businesses, those restrictions did not create any problems, since the decisions on the volume of output, prices, investments and other issues were taken by Ministries and other agencies, and the producers had only to "push through" the required indicators for their performance plan in the offices of government. But with the beginning of market reforms, the situation has drastically changed. The vast majority of the enterprises came out from the government custody and make decisions independently. And to this end, they need a variety of reliable, regular and timely information. One of the sources of necessary information to the company is the Russian Statistical Service, funded from the state budget, i.e., taxes on those same companies. Thus, one of the services of the government, paid from the taxes is provided only to a limited (albeit the most important) group

of consumers (to the government authorities), but not to those for whose money it is created. In November 2008, when the majority of businesses were already facing a decline in demand and were forced to reduce output, a renowned economist said that "there is no crisis, ... the Rosstat statistics gathered by "half a million of people", shows no decline in the industry." Perhaps those words were uttered in the heat of discussions, but they belong to a highly qualified researcher, not the one of the Russian politicians. And it's not his fault, but our common misfortune. As the statistics collects the data that is available, but not those which are needed. But even the information that the companies report to Statistical Services, are not delivered and processed for such a long time, that by the time of their appearance in the government they are so outdated that are more valuable for academic research than for the operational management of the economy. It is extremely time- , resource- and effort-taking to readjust this system.

But even the publication of official statistical data on the Russian industry often induces not the flow of comments about the crisis and the debate about what these indicators mean and whether they are true. Thus, the disclosure of Rosstat data on October 15, 2009 on the dynamics of industrial production in September, provoked such comments: "We were not expecting such a large growth", "Is it true the industry started to exit from the crisis", "Industrial change", the "frontal recovery". The experts were unable to explain the grounds of September upsurge in the Russian industry ("statistics has presented to us one more puzzle"[1]). Doubts about the reliability of official statistics on demand and stocks made less enthusiastic the expectations to consider the stock indicator as a driver of recovery from the crisis. The growth of the global economy and external demand were more often mentioned. There were hopes that anti-crisis measures of the government started to benefit (i.e., reached the business at last). Unpredictable September upsurge sometimes is "written off" to the errors of the Russian Statistical Service. IET surveys as early as on September 29, 2009 allowed to make a conclusion: "the August halt in the dynamics of the Russian industry was successfully overcome in September. Sales have continued to recover, what allowed businesses to move to the most intense growth of production and the very moderate reduction in staff since the beginning of the crisis"[2].

Therefore, the crisis of 2008-2010 has demonstrated the limited capacity of official statistics (sparse set of indicators, low speed) and the benefits of short-term surveys (representative set of indicators, high speed and the ability practically immediately start monitoring of the new, most essential indicators).

3.2.2. The overall dynamics of 2008-2009 crisis

To describe the overall crisis dynamics in the Russian industry there can be used the IET index of industrial optimism (IET IPO)[3], which is published weekly from October 22, 2009.

[1] http://www.dcenter.ru/pdf/2009/kgb_09-36.pdf
[2] http://www.iet.ru/ru/ 208-opros-sentyabr-2009-2.html
[3] The index is assessed as the arithmetic mean of the balances (the difference in the responses) of the four answers of IET market surveys: 1. The actual change in demand, balance =% of growth -% of decrease. 2. Estimates of demand, the balance of assessment = % above the normal rate -% below the standard rate. 3. Assessment of stocks of finished products, balance =% of higher than normal rate -% the rate below normal, the opposite sign. 4. Plans for changes in output, balance =% of growth -% of decline. Balances of the 1-st and the 4-th issues are cleared from the seasonal and calendar factors. The index can be from -100 to +100. In case of positive values the index positive assessments are dominating. Negative values of the index - negative assess-

This index during the economic crisis makes it possible to solve several important problems. First, it allows practically in on-line mode (against extended timeliness and low frequency of official statistics) to get an idea of the domestic industry state. Second, the enterprises participating in the IET surveys is a "middle class" of the Russian industry. They are located throughout the country and are predominantly involved in the manufacturing industries. Information on the status of such enterprises is not always delivered to the authorities and analysts on time and in the relevant scope. Thirdly, the index is estimated on the basis of indicators that have no analogues in the national statistics, but reflecting the most important aspects of the real situation in the Russian industry (demand, inventory, production plans). They very accurately and fully characterize the enterprises performance, as evidenced by a 16-year experience in conducting and analysis of more than 200 surveys. Long-term, personalized and informal relationships with the respondents (90 per cent of them are the Heads of enterprises) create the conditions for obtaining the most objective information on the Russian industry. Therefore, the IET index of industrial optimism gives an idea about the real situation in the Russian industry. The fact that the real situation in our national economy and Russian statistics are not the same thing, is recognized at the highest level (President Vladimir Putin at a meeting with the Minister Alexei Kudrin on August 21, 2006 said: "Statistics and real situation in the economy show…»[1]).

Already the first estimated values of the index showed the signs of crisis in the Russian industry in October 2008 (the index has dropped down to -4.3 points versus +2.0 in September). Only plans for output changes were positive at that time (hopes for growth were dominating) in the Russian industry and not allowed the index to fall below zero indicator. However, there was expressed a prudent assumption is that in November, most likely, they will cease to restrain the index from further decline.

The first estimates of the November (2008) index value (as of November 18, i.e., actually a month before the official recognition of the crisis) has shown a sharp increase in pessimism in the Russian industry. The index value fell down by 33.8 points at once and reached -38.2. There were never such a low value of the index, and in the pre-default period similar values were recorded only in 1995-1996 and in September 1998. The Heads of enterprises gave strong negative assessments of all the components of the index. Russian industry actually fell into crisis. The December index showed further deterioration of the situation, not as catastrophic as it was in November and as predicted by some experts: the index has fallen only by 6 points after the November decline by 26 points. However, the level of pessimism in September 1998 has reached the absolute minimum of the index (as of beginning 1996), only 3 points (*Fig. 1*).

The January index value demonstrated some stabilization of the situation in the Russian industry. As compared with December, the index has grown in January by 2 points and made -32.9. That is, the pessimism in the industry was still great (its scale is comparable only with the 1995-1996 and 1998.), but ceased to grow. In February, the index demonstrated the strengthening trend towards stabilization. In comparison with January, the February Index value improved further by 4.5 points, and compared with the December, the post-default minimum im-

ment of the situation are dominating. Lower values of the index - the deterioration of the situation. The increase in index values – improvement.

[1] See http://www.izvestia.ru/news/news113617.

provement made already 7.5 points. March and April values of the index showed stagnation at the level of previous months at a very low level (*Fig. 2*).

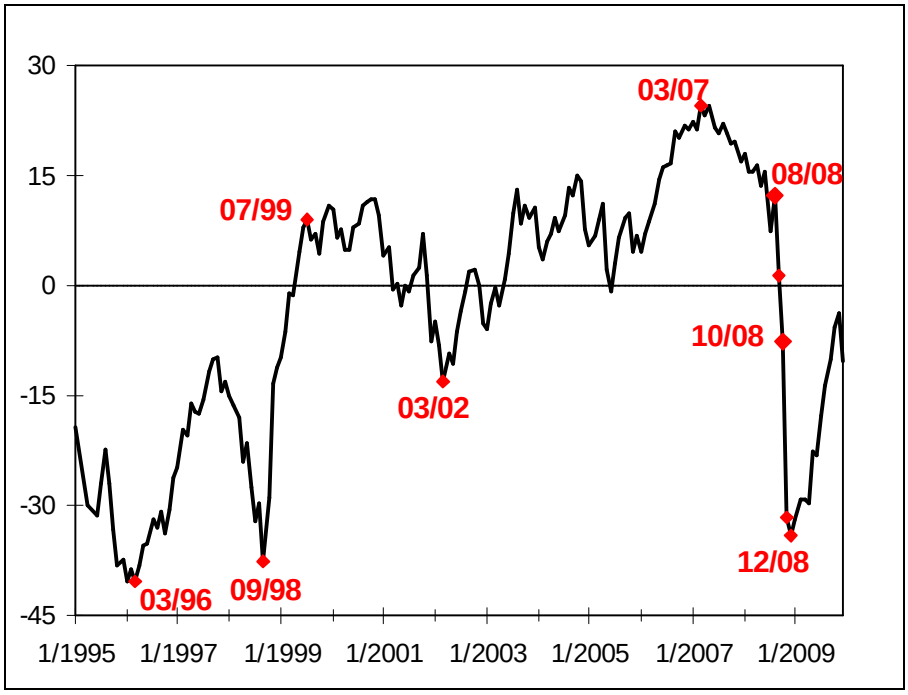


Fig. 1. IET Index of Industrial Optimism, 1995–2009.

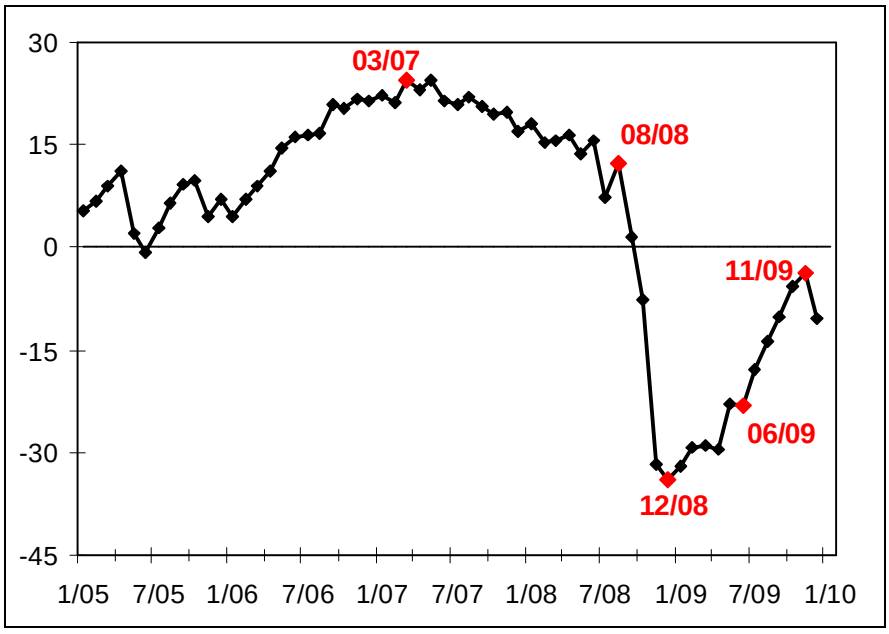


Fig. 2. IET Index of Industrial Optimism, 2005-2009.

But in May, the situation began to improve again. The main reason was the recovery of assessments of the current level of demand and improvement of the assessments of finished

products stock. However, the trend to the pessimism reduction in the estimates proved to be unstable: in June, the index declined by 2 points after the upsurge of the previous month to 6.3 points. From a more profound reduction the index was saved only by a relative improvement in the "output plans." Since July, there has begun the most significant and sustained growth of optimism in the Russian industry, which has nearly dragged the industry from the crisis as early as 2009. In July the crisis minimum (as of December 2008) was exceeded by 16 points. The August index value has exceeded the July level by 3 points and became the next crisis peak (since November 2008). The Russian industry was not in a such good shape in the past ten months. In September, the pessimism has lost another 1.5 points. October was one more month of recovery from the crisis: the index reached its crisis peak of -6,5 item.

In November, the positive trends in Russian industry have disappeared. The November index was equal to October - no significant changes (either positive or negative) trends at the enterprises in November is not registered. The estimates of the December IET index value showed a decrease in optimism of the Russian enterprises in late 2009. The loss of 6 points as compared with the November crisis peak was preserved even in the face of growing output, obtained after cleaning the results from seasonal factors.

However, the first assessments of the industries given by business leaders in January 2010 demonstrate recovery of the situation after the December downfall. The index of industrial optimism returned to the crisis peak, registered in November 2009. Industry is ready to continue recovery from the crisis after the Christmas holidays.

3.2.3. Second half of 2008: beginning of the crisis and the collapse

Let us now consider in detail the dynamics of the most representative array of indicators of the Russian industry since the second half of 2008. Already then the IET surveys results showed a gradual increase in crisis indicators, having resulted in a clear deterioration of the situation in October and a collapse in November.

The first signs of trouble in the Russian Industry surveys have been recorded at the beginning of the second half of 2008. The dynamics of demand and production, assessment of stocks of finished goods stocks and excessive production capacities, forecasts of production and sales showed a growing negative trends in this sector of the Russian economy.

Growing demand for industrial products in mid-2008 remained very low. By all indicators (the original, free from seasonal factors, with the exception of random fluctuations) of sales, the growth rate has dropped to +3 ...+5 balance points, which was the worst value since the end of 2005. This has resulted in the fact that the reduced demand for domestic products became a more significant obstacle to the production growth. In July 2008 its designation as an obstacle increased to 40 per cent, which was the maximum over the previous nine quarters. However, the leader of the "market handicap" in the output growth was still the shortage of human resources.

Under the pressure of demand, the companies were forced to restrain the growth of production. In July, all estimates made on the basis of the surveys indicators showed a slowdown to 12 balance items. It's the worst results of the previous two and a half years, i.e., so slowly the production was not growing since early 2006. The stocks of finished products also confirmed the problems with the sales. The balance of estimates (the difference between the excess of the normal indicator minus below normal indicator) has increased to 14 points and was the maximum over the previous 28 months. The growth rate was caused by reducing the percentage of

responses "below normal" from 15 to 9 per cent, which indicated either the increased delivery of finished goods to warehouses, or the decline of growth prospects for the demand and the revaluation of stocks volume. Both reasons for changing the reserves estimates are extremely negative, because in any case they mean a decrease in the intensity of the output growth.

The slowdown in demand has abolished the lack production capacity in the Russian industry already at the beginning of the third quarter of 2008. For the first time, the lack of production capacity was recorded in the surveys of the second quarter of 2007 and reached 10 balance points at the beginning of 2008. However, later the share of "insufficient" estimates has dropped from 21 per cent to 15 per cent in the background of an increase of the share of "more than enough" estimates from 11 per cent to 18 per cent - the balance again became positive. The demand, therefore, no longer justified the investment efforts of the Russian companies in the recent years. This thesis is confirmed by the statistics of the handicaps to production growth. If in mid-2007 the shortage of equipment hindered the increase in output by 32 per cent of companies (the third place among 10 tracked constraints on growth), in the middle of 2008, it was referred to only by 21 per cent of manufacturers (the 5-th place).

In August, the negative trends have become even more evident. It began an absolute reduction of effective solvent demand for industrial products. So far, though, with the minimum intensity (-2 balance point), but supported by a similar result and after purification from random fluctuations. As a result of the slowing demand, the trend formed in the second quarter of 2007 has reached its logical conclusion. The industrial production growth, according to the surveys, hated to slow down.

However, the relatively long-term and stable negative trends in the dynamics of demand and output enabled enterprises to adapt to them. As a result, the demand satisfaction in the Russian industry in the summer of 2008 has stabilized at the level of 60-63 per cent. A similar situation is observed with the stocks of finished products. Russian enterprises have been able to keep their volumes within a reasonable redundancy, allowing to quickly respond to the new orders. However, in a slowing of demand and production, the estimates of reserves lost their stability and become less optimistic, what is reflecting uncertainty of producers about the sales prospects.

In September of 2008, the situation in Russian industry continued to aggravate. The intensity of demand reduction has reached -13 b.p. and was the worst since mid-2002 (see *Fig. 3*). The absolute decline in demand (i.e., the predominance of responses "declined" over the share of “growth” estimates) was already happening in all sectors except for the food industry. That fact provoked a collapse in the satisfaction of production volume. In September, already 45 per cent of businesses believed the demand for their products was "below normal" (against 34 per cent in August). Such a great dissatisfaction with sales has not been noted since April 2006. An absolute decline in demand forced the industries to stop the growth of production in September.

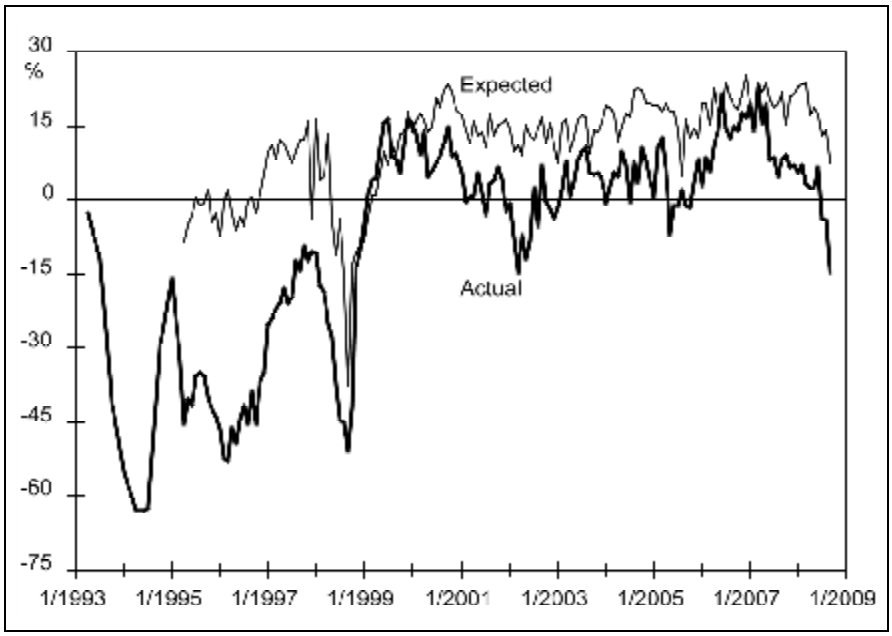


Fig. 3. Changes in the effective solvent demand, cleared from seasonal factors (balance = % growth - % decrease)

Reduced sales forces enterprises not only to restrain production, but also to curb the growth of prices. In September, the balance of change (growth rate), in selling prices has declined (based on initial data) from 18 to 8 points. Cleanup of seasonal factors showed 1.5-fold slowdown and the lowest rate of growth over the previous three years. The second positive point September situation was the assessment of finished products stocks. They did not go beyond the ordinary level of recent values, indicating that accurate policy of producers in this area. Enterprises have been able to withstand such a ratio of actual output, the actual demand and prospects, which did not lead to physical overflow and negative adjustments to estimates of storage stocks. In September 2008, there were no crucial changes in the availability of credits to the Russian enterprises. For 69 per cent of producers it remained normal and the same as in the first and second quarters of 2008.

In October, the situation in the Russian industry has become even worse. Firstly, the intensity (balance) of the reduction in demand for industrial products has reached unprecedented for post-default (since 1998) period values. Such values of this index were recorded only in January, and even not every year. Clearance from seasonal and random fluctuations only slightly adjusted the rate of decline in demand, but has maintained its record values: there was no such intense demand since October 1998. Secondly, the satisfaction of demand in the Russian industry has dropped to 50 per cent, i.e., only a half of the enterprises considered the volume of their sales as normal in the pre-crisis situation. As compared with the absolute maximum (August 2007), a decline of almost 1.5 times and was the worst for the previous 32 months. Thirdly, the production growth has completely stopped. If in September the balance of output changes (after clearance from seasonal factors) still showed a modest positive trend, the October growth was zero. This indicator became the worst one since November 1998 (*Fig. 4*).

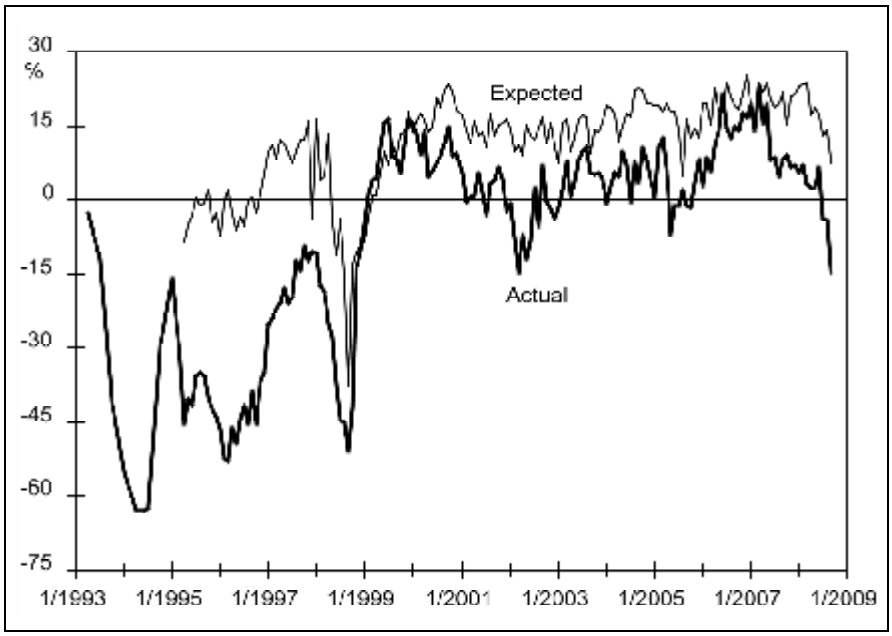


Fig. 4. Changes in Production, Cleared from Seasonal Factors
(Balance =% growth -% Decrease)

In the IV-th quarter of 2008 the structure of interference growth against the industrial production is starting to change. As expected, in the first place there was the "domestic effective demand". It was considered as an obstacle by 45 per cent of companies (growth in comparison with the III-rd quarter was by 9 points). The 2-nd place in the rating was a shortage of current assets. Since two thirds of enterprises have used their credits for replenishment thereof, the credit crunch has increased the prevalence of this interference for the quarter by 8 points, as compared with the absolute minimum (I-st Quarter of 2007) – by 12 points. As a consequence, a sharp (by 13 points per quarter) downfall in the companies' stocks and raw materials were reduced: at the beginning of the IV-th quarter, there were normal stocks only at 63 per cent of the enterprises, which was the worst value over the preceding 11 quarters. The situation was aggravated by the default. For the quarter, their reference in the industry has almost doubled (from 12 to 21 per cent). However, this interference appeared only in the 5-th place, but in early 2008, it was in 8-9-th place.

The third place in terms of interference, i.e., "shortage of qualified personnel", in 41 per cent did not look like disturbing in the IV-th quarter. In other words, at that time the companies considered their employees as a rather valuable resource, and understood that in the recession of the vocational training system and the devaluation of higher education even possible massive dismissals in other sectors of the economy would not allow them quickly to find qualified workers and engineers. The pressure of competing imports was sharing the fifth honored place with non-payment and low export demand, but has also reduced the share of the processing industry to 21 per cent after the absolute maximum (31 per cent), recorded in the third quarter. There were clearly reduced reduction ambitions of the Russian manufacturers, starting with the efforts to reduce costs and monetary disturbances.

Russian enterprises involvement in the crisis occurred relatively smoothly. Several indicators testified for the possibility of "downgrading" for the domestic industry. First, the companies

accurately managed their inventory of finished products. The balance of their assessments remained within the normal for the preceding period corridor values, although not so stable – there was some nervousness. But one could not expect excessive stocks of finished products in the industry.

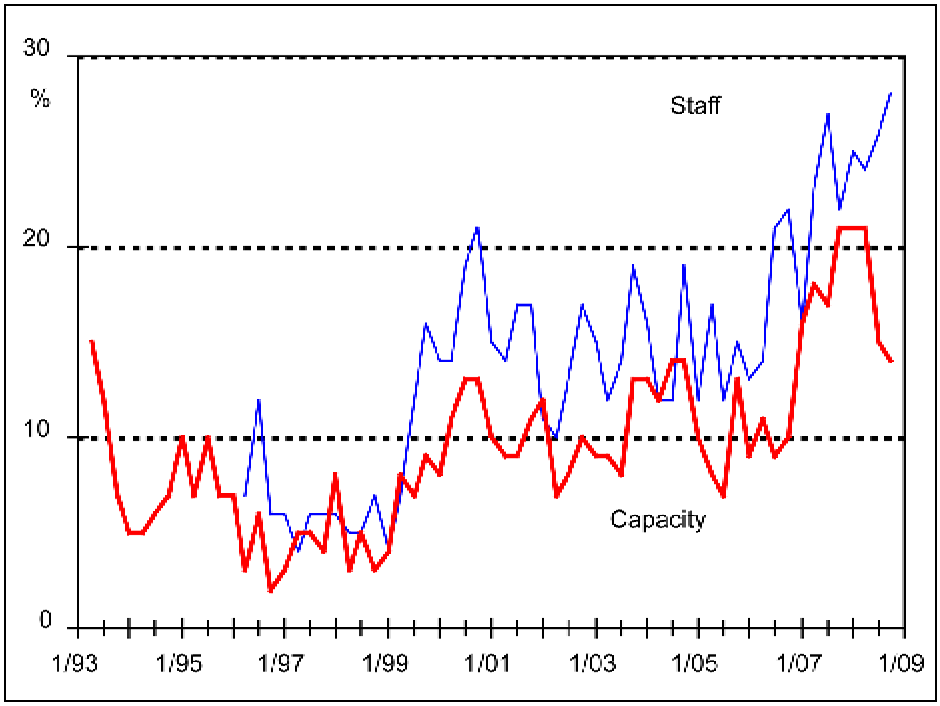


Fig. 5. Proportion of businesses with inadequate facilities and staff

Secondly, there were no sufficient grounds to talk about massive dismissals in the Russian industry in October. To a significant part of the enterprises HR still prevent to increase the output (see above). Assessments of the current staffing levels in view of the expected changes in demand still inspired optimism in the critical situation (see *Fig. 5*). In the domestic industry in October 2008, 28 per cent of businesses consider their staff is insufficient (26 per cent in July and 24 per cent in April) against 10 per cent businesses who think of there is an excess in the staff (after 9 per cent in July and 5 per cent in April). The majority of producers (62 per cent, July - 65 per cent, April - 70 per cent) regard the existing staffing adequate to the anticipated changes in demand.

In November, Russian industry totally drawn into the crisis. Following the sharp decline in sales, companies began to cut down the output, reduce costs and dismiss their staff. However, the storages of finished products were filling, and financial and economic standing of enterprises was deteriorating. Forecasts of the majority of producers were also disappointing: due to credits reduction, the expected significant reduction in demand there was planned a reduction in the output.

The rate of decline in demand for industrial products in November has reached the values recorded earlier only in the 90-th years of the twentieth century. This indicator fell down to -62 balance points, while in August he was +3, and in June +14 points. Clearance of the seasonal factor only slightly adjusted the rate sales reduction: now it is -54 points and is inferior only to

the results in 1994. As a result, the estimates of sales volumes have dramatically changed. They have remained normal for only 26 per cent of enterprises, 71 per cent believed the current demand was "below normal". In August of 2007 (the peak of prosperity for the Russian industry) there were opposite estimates: the demand was normal for 72 per cent of enterprises, and "below normal" for 23 per cent of enterprises.

The downfall in demand forced the industry to reduce output. If in October the intensity to reduce production was minimal (-1 balance point after the seasonal factors clearance), in November this indicator had risen to -41 b.p. Only in 1994, the rate of decline in output exceeded the results in November 2008, however, this reduction in output seemed to be insufficient - the industry started to change to the negative side of inventories assessment. Balance (above-below normal) has worsened over the month by 8 points and made 19 points, which actually was the maximum of the previous five years.

Reduction in demand is providing an increased pressure on producers' pricing. In November, the Russian industry has transferred to an absolute decline in prices. The rate of actual changes in producer prices has reached a minimum record (over 1993-2008 years., based on initial data). After clearance from seasonal factors, the November result was the second for the specified period. More intensively prices were declining only in July 1998. Price estimates of enterprises were also under a fundamental revision. In October, the industry was still planning to increase prices (not so intensive as in July – August, of course), whereas in November, there already began to dominate the intention to lower selling prices. Herewith, the November result in 2008 became a historic minimum for both, the initial and free from seasonal factors data.

The first counter-crisis measures of the government have been ineffective. The massive monetary infusions into the Russian economy did not reach the majority of industrial enterprises. In November, the availability of borrowed funds were sharply decreased. If in September 2008, the normal access to credits had 64 per cent of companies (maximum - 80 per cent was registered in August 2007), the availability of "below normal" - 22 per cent, then only two months later the situation was reversed. In the first crisis month the normal access to the borrowed funds had only 22 per cent of enterprises, "below normal" had already 63 per cent (*Fig. 6*).

Results of December were not so gloomy: the development of crisis in the Russian industry has slowed down a bit after the November downfall. Maintenance of the same intensity of reduction in demand has allowed the businesses to stabilize the rate of reduction in output. The main lever of the fight for the buyer were the prices, the rate of reduction of which has exceeded even the result of the beginning of 1998.

In December, the indicators of the of falling demand intensity has not changed. A certain role in stabilizing the rates of decline in the demand was also played by the pricing policy. In late 2008, the surveys have registered an unprecedented reduction in producer prices. The balance of this indicator fell to -26 points after – November 15, and by -6 in October. Such a high rate of reduction of the actual price was not recorded even in the first half of 1998, and the December plans the reduced prices reached an absolute record over 199 previous surveys.

It did not help in the fight against excessive stocks of finished products. Their estimates have gone beyond the traditional values of previous years – there started to grow surplus savings in the industry. In December, the balance of assessments has grown to +29 points and was the maximum over the previous 13 years.

The situation of the enterprises of real sector and the continuing decline in the availability of credits was aggravated. In December, the normal access to borrowing funds has declined by another 5 points and reached 17 per cent. That's the number of enterprises which regarded as normal credit rate and other credit conditions in the domestic banking system, which has received huge infusions of national liquidity and reporting on the great support of the real sector. Apparently, without of national support of the banks and pressure on them by the government authorities, access to credits would have been even lower.

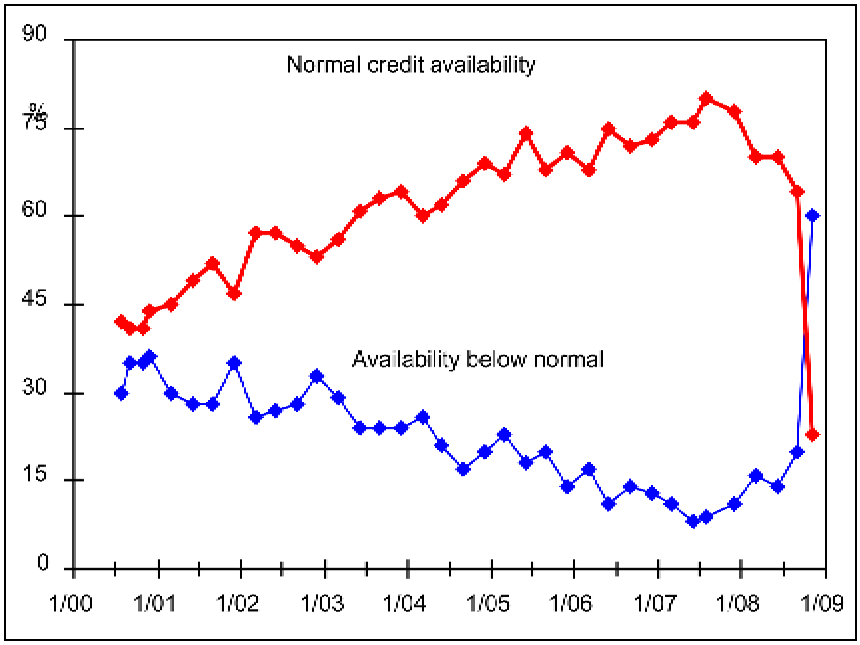


Fig. 6. Credits Availability Indicators

3.2.4. The First Six Months of 2009: Stabilization

Already in early 2009, positive trends started to develop in the Russian industries. Slowing rate in demand has led to the stabilization of satisfaction with sales volumes and allowed businesses to adjust the dynamics of production. A crucial change in price and production policies has restrained further warehouses overstocking. The industry formed an excess of production capacities and personnel, creating a basis for recovery growth.

The rate of decline in demand has slowed down in January to -32 b.p. after -50 b.p. in November. The demand growing dynamics allowed the industry to adjust and the dynamics of output. In January, the decline output reduction rate (upon clearance of seasonal factors) changed from -30 to -10 b.p.

However, the negative signal at the beginning of 2009 was the strengthening of prevailing "insufficient demand" in the rating of barriers to production growth. Low demand was regarded as an obstacle by 67 per cent of enterprises, which is by 21 points more than in the IV quarter of 2008 and by 41 point above the absolute minimum (in the III quarter 2007). Comparable scope of this barrier were recorded in 1996, 1998 and 2002, respectively; the larger ones - only in 1994. The absolute maximum was reached in the mentioning of the lack of export demand, affected by the global nature of the crisis. The weakness of foreign markets pro-

voked a limitation to 36 per cent of the Russian industrial enterprises. The post-default minimum (11 per cent as of the IV-th quarter of 2007) was exceeded by more than 3-fold. Non-payments were still aggravating the situation (third-rank barrier). In the I-st quarter of 2009, they served as an obstacle to 39 per cent of enterprises after 10 per cent in late 2007 - early 2008.

But the monitoring of barriers and detected positive trends as well. The shortage of current assets was shifted to the 2-nd place. However, growth of restraining impact of this barrier in the Russian industry has stopped: after reaching at the end of 2008 the level of 50 per cent mentioning (the maximum over preceding 22 quarters), in January 2009, it was referred as a barrier by 46 per cent of the enterprises. The lack of credits restrained the production of only 18 per cent of enterprises. Competing import has reduced its negative impact on the Russian industry up to 11 per cent, which is nearly 3 times lower than the absolute maximum (31 per cent), recorded only in the III-th quarter of 2008. These were the first confirmed results of exchange rate policy of the RF Central Bank. Shortage of staff at the beginning of the year was regarded as a barrier only by 16 per cent of the enterprises, whereas six months later it was mentioned by 49 per cent of manufacturers, which means a three-fold reduction. The lack of equipment is regarded as a limiting factor of the output growth by 10 per cent of enterprises against 24 per cent in mid-2008 and by 32 per cent of enterprises eighteen months earlier (absolute maximum).

A positive factor at the beginning of the year was stabilization of the situation with industry crediting. Availability of credits, collapsed in November by 40 points at once, has declined in December, only by 6 points, and in January 2009 has increased by 5 points. The normal access to credits at the beginning of the year had 22 per cent of the enterprises.

In February 2009, the positive effects in the crisis situation continued to strengthen. The rates of decline in demand were lower, allowing companies to move to a less intensive reduction of output, and sometimes even to its growth. Enterprises started to change their pricing policy - producers refused to lower prices, and in the forthcoming months were ready to increase them.

Demand continued to fall fairly rapidly, but still not as strong as in November - December 2008 The balance (increase-decrease ratio) increased to -33 points, what was better against "cleared" results of previous months (-51 ...- 45) . Industrial production in February continued to decline, but also clearly not as intensely as in January 2009 and all the more so in December - November 2008. Capacity utilization has shown that in the I-st quarter of 2009, the Russian industry was still significantly falling behind in comparison even with the IV-th quarter of 2008. If in October 2008 the 70 per cent of production capacities were utilized, at the beginning of the new year that indicator fell down to 53 per cent. Such a sharp decline over the quarter was never noted before (see *Fig. 7*).

However, the assessment of stocks of finished goods in February remained at a relatively, but not extremely high level for the past 17 years. In 1994, the surplus was almost 2 times higher, and in late 1995 - early 1996 - about the same; before the 1998 default - 4 times lower.

In February, further positive developments in the banks' crediting to the industry became noticeable. Already 28 per cent of companies could afford to borrow in credit agencies. The growth rate reached 11 points as compared with recent absolute minimum (December 2008).

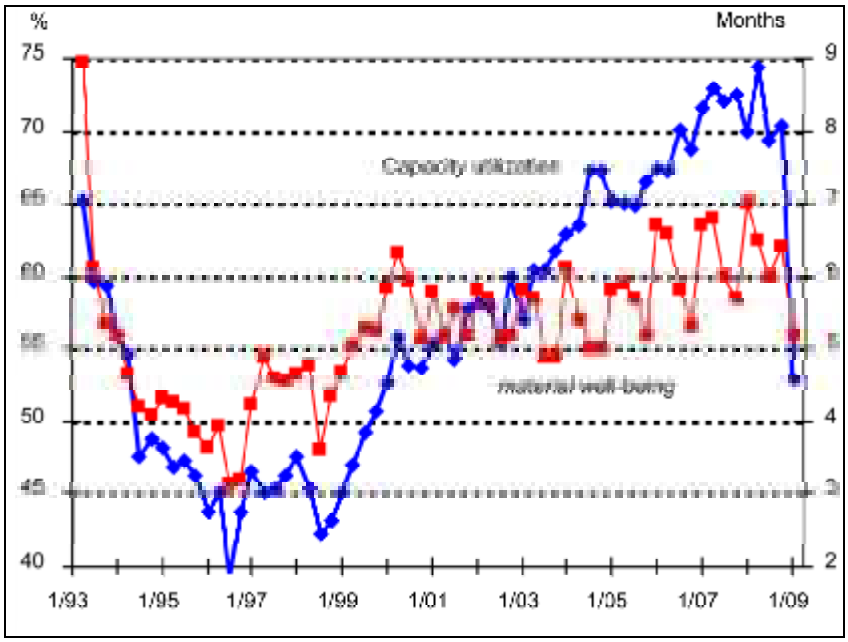


Fig. 7. Capacity utilization rate (%) and security orders (months)

In March, the positive trends of the first months of the year have not been further developed. The dynamics of demand, estimates of sales and stocks of finished products demonstrated that there were no firm foundation for growth in the output of the Russian industry so far. This forced the companies to refrain from more intensive growth of prices and re-extend the practice of dismissals.

In March, demand continued to decline rapidly, but not so intensively as in November - December 2008. Upon clearance of seasonal factors a stabilization of the rate of decline in demand was observed in the I-st quarter of 2009 at the level of -36 ... -34 b.p. In 1998 this indicators was falling to -45 ... -50 points, in 1996 - up to -60. Stabilization of the rate of decline in demand has frozen the estimates sales volumes. In the I-st quarter of 2009 the demand satisfaction was sustained at the level of 23, indicating the Russian enterprises got adapted to the situation existing at that time.

Availability of credits for Russian industrial enterprises in March remained almost unchanged. At that time regular access to borrowed funds had only 24 per cent of producers (versus the crisis minimum in December 2008 – up to 17 per cent). Average indicators of the availability of credits in the I-st quarter of 2009 reflected the banks' sectoral priorities in the real sector in the first months, when the crisis was realized. As one can see from the graph, the positive attitude of banks differs by more than twice, depending on the industry sector of the potential borrower (*Fig. 8.*).

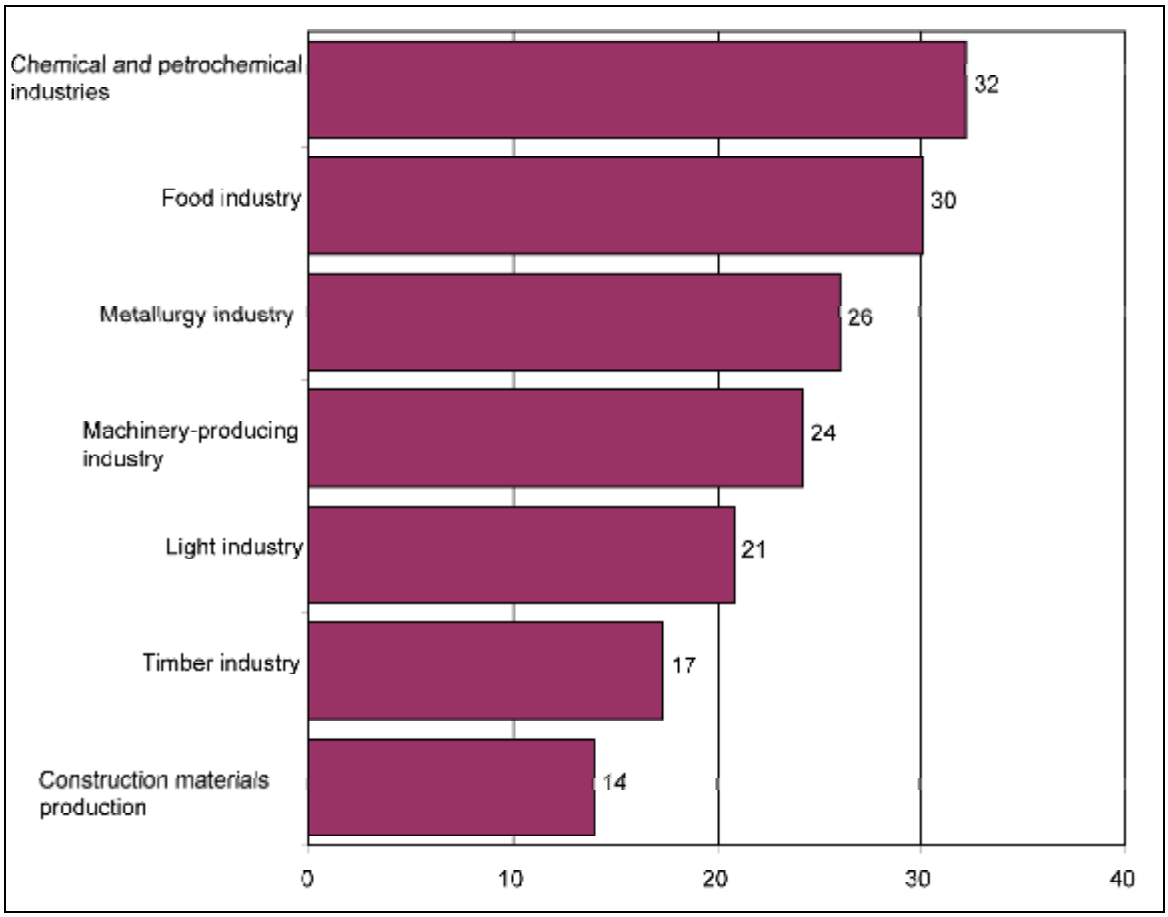


Fig. 8. Regular access to credits by industries in the I-st quarter of 2009, %

A similar pattern was observed in the first months of 2009 and in the banks' attitude to businesses of different scale: the larger the enterprise, the greater the chances of getting credit (*Fig. 9*).

The ability of companies to service already obtained credits can create problems both, to the borrowers and to the lenders. In the industry in general, among businesses with loans (they are taken as 100 per cent), only 60 per cent of borrowers in the 1-st quarter estimated their financial capability as sufficient to perform their already existing credit liabilities to the banks. The leaders in that ranking of reliability were metallurgy (85 per cent of businesses, which regarded themselves able to pay for credits), light industry (80 per cent) and food industry (74 per cent). Most of the problems with the return of loans could arise from banks, providing financing to the construction industry (25 per cent). Machine-building plants were reliable at that time in 52 per cent of cases (*Fig. 10*).

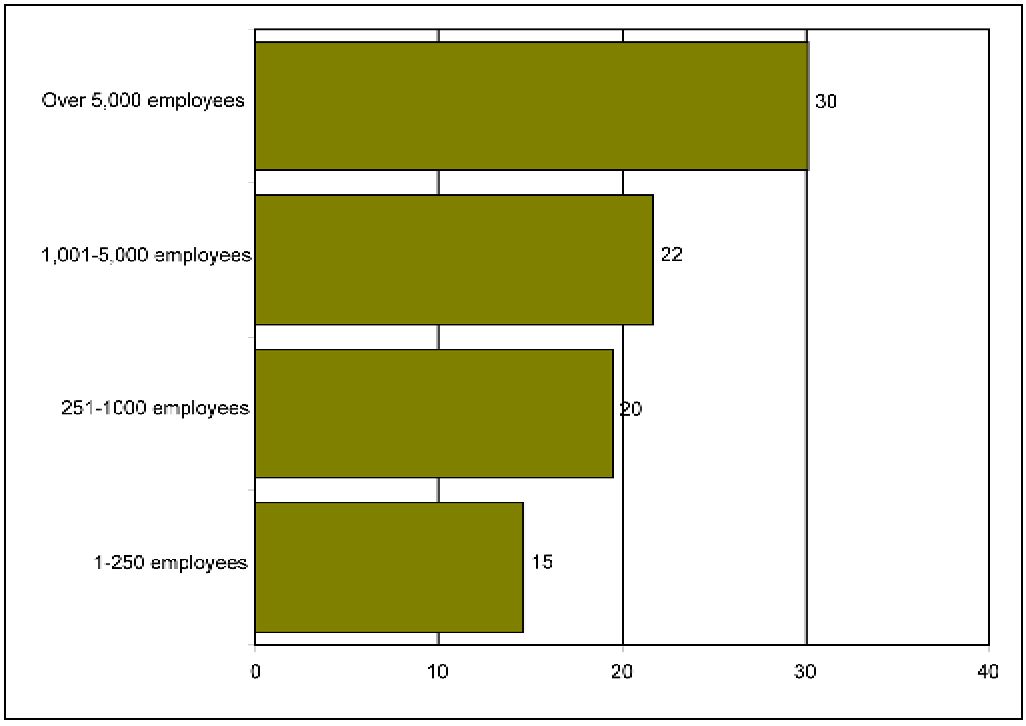


Fig.9. Regular access to credit by size of enterprise in the I-st quarter of 2009, per cent

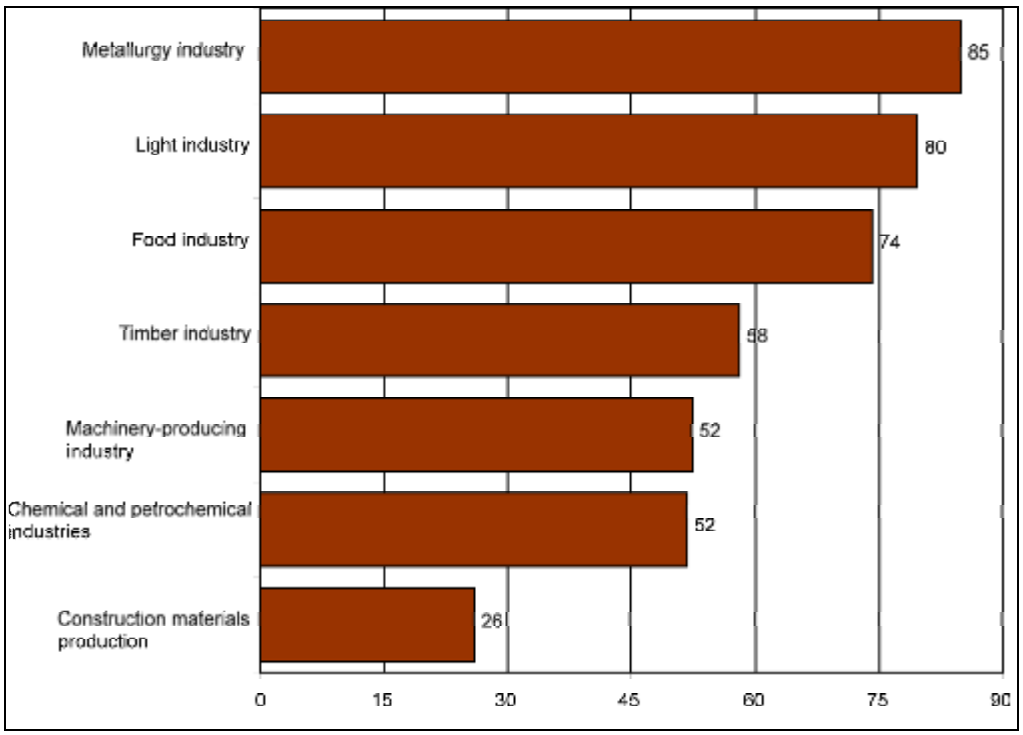


Fig.10. Share of businesses in industries that could pay for credits, %

In April, it became clear that hopes for a quick recovery from the crisis did not come true, - industry again began to get prepared to a more significant rate of demand reduction, output and lower selling prices. At the same time, the emotions from a "hard landing" at the first months of the crisis gave way to sober estimates and attempts to predict the immediate future.

Demand for manufactured goods continued to decline with the same intensity (as in January - March). Estimates of demand in April returned to the levels of December - January. Industry has lost hope of slowing sales decline, which appeared in February - March, and once again was getting prepared to the higher rates demand reduction. The changes in the output, as well as in demand were not so intense, and according to the enterprises estimates, no changes neither in April, nor within the following four months of 2009. As a result, industry has seriously adjusted its output plans for the next two months: estimated rate of decline in manufacturing got worse immediately by 7 points, and returned to the level of December - January. Targeted assessments demonstrated that some optimism of preceding two months (expressed in the gap between production plans and the real demand) started to decrease. In April, 77 per cent of companies planned their output in accordance with the forecasts of demand. In February, there were only 72 per cent of them. The highest correlation to anticipated changes in the output and demand over the entire period of monitoring (88 per cent) was registered in December 2008.

Availability of credits for industrial enterprises has grown in April to 31 per cent. However, changing the credit policy of the banks involved mainly rather large business (exceeding 5,000 employees) enterprises, a free access of which to the of borrowed funds increased to 36 per cent. Small and medium-sized businesses (up to 250 employees) did not feel any changes, rather the opposite: only 13 per cent of companies in this category were in April, the regular access to credits over 16-17 per cent in December – February.

In May, the industry was staying at the bottom of the crisis. Neither positive, nor negative significant changes in key indicators did not happen in May. Demand continued to decline with the same intensity (as in January - April). The intensity of the lower output in May was slightly lower. Production plans of enterprises after clearing of seasonal factors were the interval of -8 ...- 5 b.p., what suggests an adaptation of enterprises to the crisis and the lack of hope for a quick recovery. Capacities utilization also witnessed that the situation with was not aggravating in second quarter of 2009. This indicator in the 1-st quarter fell down to 53 per cent after 70 per cent in October 2008 and by April had risen to 58 per cent.

The intensity of dismissals in the Russian industry by May 2009 was also stabilized (see ***Fig. 11***). The rate of reduction of the number of employees remained at -28 ...- 26 b.p., which is almost twice lower (i.e., better) than the January indicator and equal to the October (2008) indicator. If we exclude the January (2009) downfall of the indicator (which is explained largely by panic, rather than by rational behavior, and seasonal factors), the pace of dismissals in the first months of 2009 and October 2008 were the highest since the monitoring of this indicator in 2003).

In June, the situation in the Russian industry has not actually changed. The initial rate of decline in sales was sustained at the level of in May (-23 b.p.). Clearance from seasonal factors has demonstrated its increase (worsening) by 4 points, but as a result, only returned it to the average value of May 1-st, to the average indicator of the first six months of 2009.

The deterioration of the sales dynamics (a growing reduction rate) has decreased the satisfaction with their volume. After fluctuations in the previous two months, this indicator also re-

turned to the average level of 2009. As a result, 3/4 of Russian enterprises in June were unsatisfied demand for their products. However, the stability index in the background of continuing intensive reduction of sales and total uncertainty about the prospects for the recovery from the crisis was clearly demonstrating the adaptation of enterprises to the crisis. Such stability in the estimates of demand in previous crises was not observed in the Russian industry .

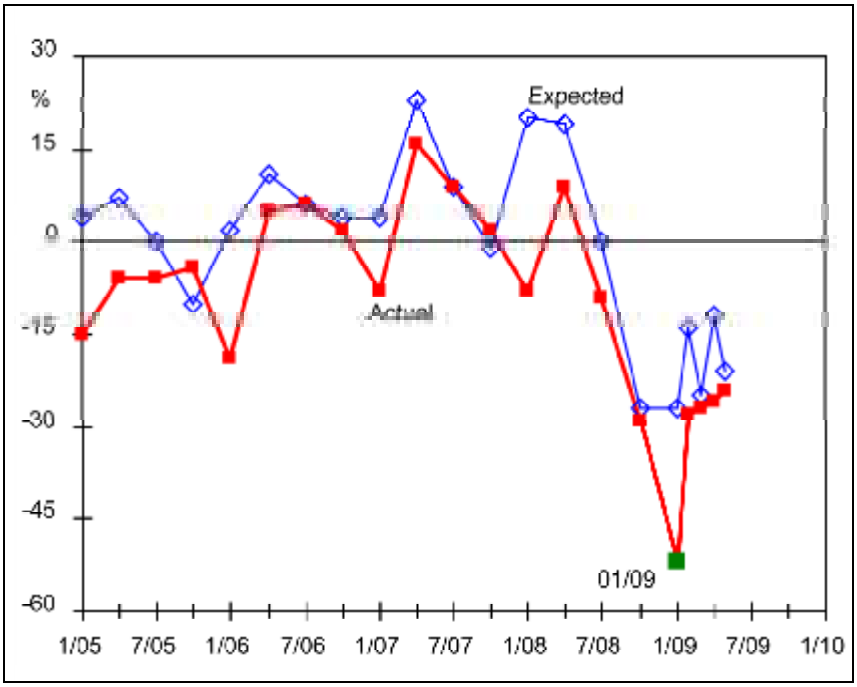


Fig. 11. Changes in employment (balance =% growth - % of decrease)

3.2.5. 2009, Second Semester: an Attempt to Overcome the Crisis

In July the situation in the Russian industry has definitely improved. However, significant positive changes in the dynamics of demand, output, employment and the stock assessments was not found in the Plan for the next few months. This indicated uncertainty about the enterprises' maintaining positive changes in July 2009.

At the beginning of the 2-nd half of the year the rates of decline in demand for industrial products have undergone significant positive changes – over the month the balance, cleared from seasonal factors has improved by 12 points and reached -18 b.p. (See *Fig. 12*). Therefore, the demand continued to decline, but not as intensively as in the IV-th quarter of 2008 and in the 1-st half of 2009. The demand forecasts in July have also improved, but not significantly (only by 3 points), like the actual sales. The apparent improvement in the dynamics of demand has allowed the businesses to make an equally obvious positive changes in the dynamics of the output in July. Cleared from seasonal factors data showed a zero rate of decline in output in July, which was the best level of this indicator since October 2008.

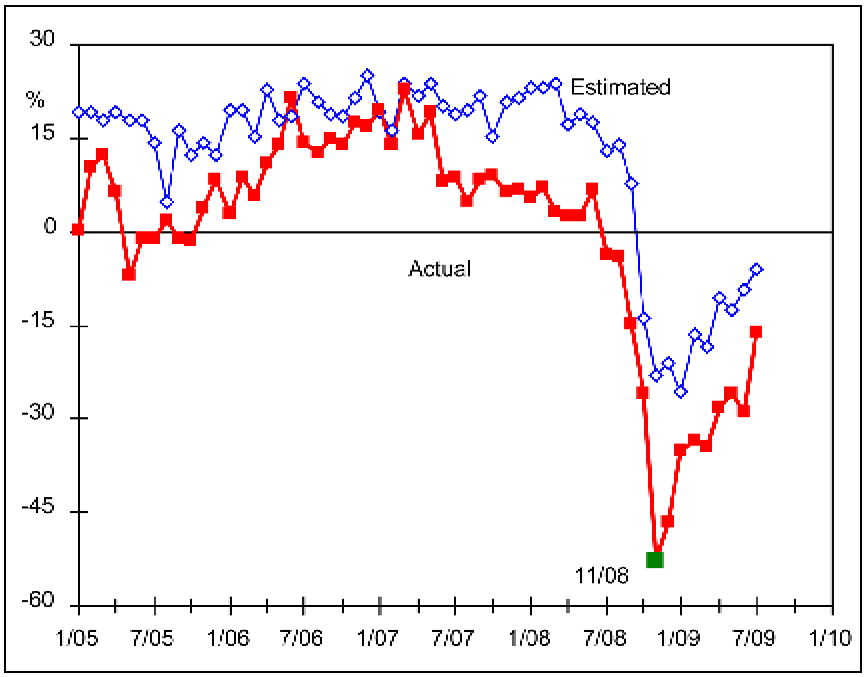


Fig. 12. Changes in effective solvent demand, cleared from seasonal factors (balance = % growth - % of decline)

However, the slowdown in demand reduction was unexpected (or perhaps, seemed to be unreliable), to many of enterprises which could not (or did not take the risk) adjust their production dynamics. As a result, the gap between the changes between the output and demand levels has increased in the Russian industry up to 13 per cent versus 7 per cent in June. The average value of this indicator over the crisis months in November 2008 - June 2009 was 6 per cent. Nevertheless, the majority of enterprises (58 per cent) adequately responded to changes in demand, while 29 per cent of production businesses, by contrast, took the risk to increase the output ahead of sales. Production plans of companies in July were practically unchanged as compared with June and were worse than the actual changes in the output. Such a ratio of planned and actual changes in output over the 17-year-old practice of surveys is infrequent and indicates an uncertainty of producers in the stability of the prevailing rate of the output growth.

Balance assessment of finished products stocks under the scale of "above normal - normal - below normal" has fallen down in July by 7 points and came to the pre-crisis level (*Fig. 13*). Industry, given the sharp slowdown in demand reduction and sustained improvement in forecasts of its changes, has made significant adjustments in the estimates of the warehouse stocks. Thus, by the end of the 1-st half of 2009, the shock of the first months of the crisis in both, psychological and physical terms was overcome (judging from the stocks of finished products).

Availability of credits of the Russian industry in July ceased to grow, but as compared with May (the best month of the crisis) has decreased by 2 points. The change is, of course, insignificant, but sufficient for the conclusion on unimproved situation with industry crediting, despite the persistent and varied efforts of the authorities. But it is wrong to make the conclusion that the industry was suffocating without credits. According to enterprises assessments, the lack of credits in the III quarter was only at the 6-th place (21 per cent of references) among 13 barriers, tracked by IET surveys.

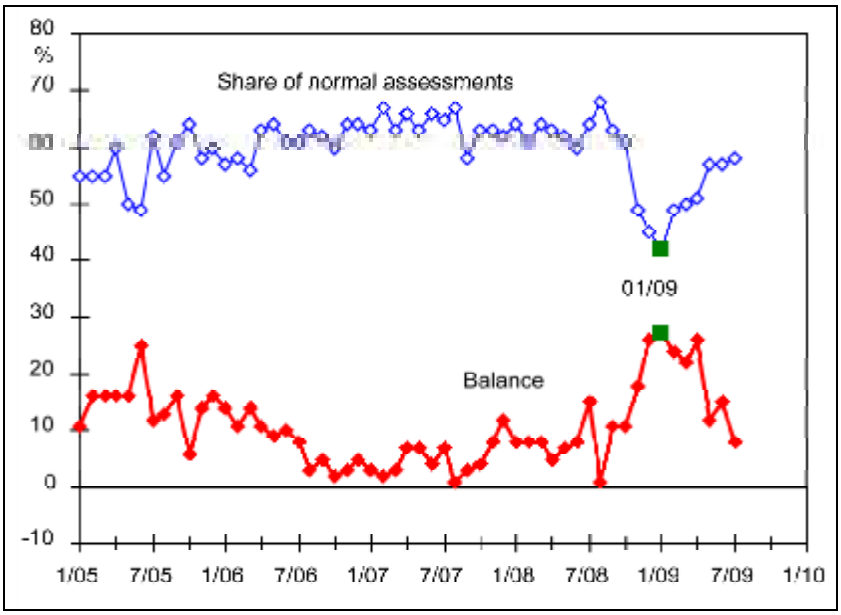


Fig.13. Balance of finished products stocks assessment
(balance = % higher -% below normal)

In the situation of crisis and credit constraints has changed, as well as the structure of the borrowed funds utilization in the industry (see *Table 1*). The most significant changes undergone the investments in production: from 47 to 24 per cent reduction in the use of loans for the upgrading of production, from 30 to 17 per cent - to expand production. Other trends of the funds use either retained their shares, or even increased. There is still 2 / 3 of the enterprises, using loans to replenish working capital like before. Up to 27 per cent has increased the share of credits used for payment of wages, up to 17 per cent - to repay the debts to suppliers and to 7 per cent - to redeem the debt to other banks. Herewith, one fifth of the industrial enterprises has reported the absence loans in July 2009.

Table 1

Trends of Credits Utilization in the Industry (% of Respondents)

	2003	2004	2005	2006	2007	2008	2009
No credits	12	8	10	9	9	9	20
For R&D, know-how, license acquisition	2	6	6	2	1	6	6
For production upgrading	22	31	36	36	36	47	24
For production extension	13	23	24	25	27	30	17
For working capital	66	68	70	62	57	65	66
For sales management	2	1	2	1	1	3	1
For compensations	27	27	22	26	19	19	27
For export contracts	8	7	11	12	7	6	7
For debts redemption to other banks	6	9	7	9	5	5	7
For debts redemption to the suppliers	14	9	11	13	9	11	17

Note. In 2009 the survey was conducted in July.

The main reason for reluctance to take credit or failure to obtain a credit (in case of application to the bank) in mid-2009 was mentioned by a great number of enterprises (see *Table.*

2). On average for the industries it was referred to by a third of enterprises. But the restraining effect of this factor varies considerably by industry. If in the chemical and petrochemical industries, it was the only obstacle for 21 per cent of enterprises, in the light industry - for 39 per cent and in non-ferrous metals - for 46 per cent. Therefore, the pressure on the government on credit refinancing rate provided a different effect in different industries. A second barrier in obtaining credit by a company (banks, of course, in the first turn) felt uncertainty in the enterprises standing. But even here the variety was significant: from 13 per cent in light industry and 15 per cent in the chemical industry to 31 per cent in machine-building industry. To reduce the height of this barrier was much more difficult.

Table 2

For What Reason the Company Decided to Avoid to Take Credit or Failed to Obtain a Credit in 2009

	All industries	chemical and petrochemical industries	Machine-building	Construction materials	Light industry	Food industry
No need for credits	13	16	9	17	31	12
Credit obtained	30	25	25	38	26	51
Too high credit interest	33	21	38	27	39	25
Too short timeframes	9	14	4	10	9	14
Shortage or other problems with credit security	20	27	21	17	17	13
Uncertainty in the company financial standing	24	15	31	20	13	17
Formal grounds of the bank rejection	9	7	12	10	5	10
Other reasons	3	4	3	5	2	10

Source: July (2009) IET survey.

After some positive changes in the July, in August the Russian industry has slightly slowed down. The rate of decline in demand for manufactured goods in August increased (i.e., worsened) by 3 points after the July improvement by 12 points. The increase in the rate of reduction in demand has forced the industry similarly adjusted the rate of decline in production: in August, the production declined by 4 points more intensively than in July, but less intensely than in any other crisis months. The production plans of enterprises, as well as forecasts of demand, in August improved by 6 points at a time, while in February they rose by 2 points every two months. As a result, in August they were for the first months of the crisis definitely positive. Capacities utilization in the III-rd quarter of 2009 was 57 per cent and remained practically unchanged as compared with the II-nd quarter (58 per cent).

The demand, of course, was the most significant and persistent barrier in the industrial growth in 2009 (see *Fig. 14*). The lack of working capital was sustained in the second place in mid-2009, but over the four quarters of the crisis, it lost 9 points. If in the IV-th quarter of 2008, it mentioned by 50 per cent of companies, in the III quarter of 2009 - already by 41 per cent. In the 90-s years of the twentieth century the shortage of working capital was considered as a barrier by 70-80 per cent of the enterprises. Non-payments, which growth analysts feared with the beginning of 2009, have gradually gave way. In January 2009 they were considered as a barrier by 41 per cent of companies, in July - only by 34 per cent. This is, of course, a lot as compared to the 1-st half of 2008, when the non-payments were reported only by 10-12 per

cent of the enterprises, but certainly is small as compared with the 90-s years when they were regarded as a barrier by 70-80 per cent of producers.

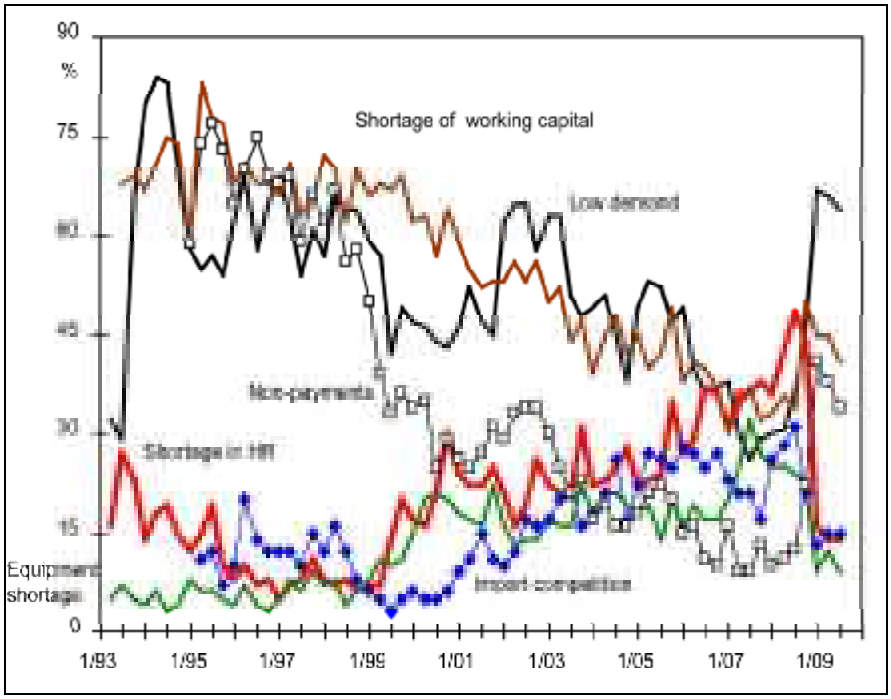


Fig. 14. Barriers in Production Growth

HR shortages, which was leading in the ranting of growth restriction in the output of 5 quarters in 2007-2008 from 36-49 per cent, during the crisis has reduced its restraining effect to 14 per cent and did not change the scale of its prevalence in the Russian industry since 2009.

In August the government managed to turn the trend in crediting the real sector. The share of the normal credit availability assessment increased over the month by 11 points and reached 41 per cent. Particularly sharply improved the banks attitude to the metallurgy and forest industries. At the same time, the companies could reconsider their need for credit.

The lack of equipment (capacities), which was frequently referred to by experts as a barrier from crisis through import substitution was estimated otherwise by enterprises in mid-2009 and in the near (already quite optimistic) perspective. The lack of equipment was mentioned as an obstacle to the output growth in the III quarter of 2009 only by 9 per cent of enterprises. The peak of references (32 per cent) occurred in the III-rd quarter of 2007, but the investment activity has gradually reduced the occurrence of this limitation in the Russian industry up to 22 per cent (October 2008), and the crisis then allowed to reduce the indicator by another 13 points. In the 90-s years the reference to this factor was lowered to 3 per cent. And in connection with the anticipated changes in demand there was formed a relevant stock of facilities in the industry (see *Fig.15*). Since early 2009, though it was slightly decreased (by 6 points), but the balance is still clearly in favor of the rapid growth in output due to unused capacity.

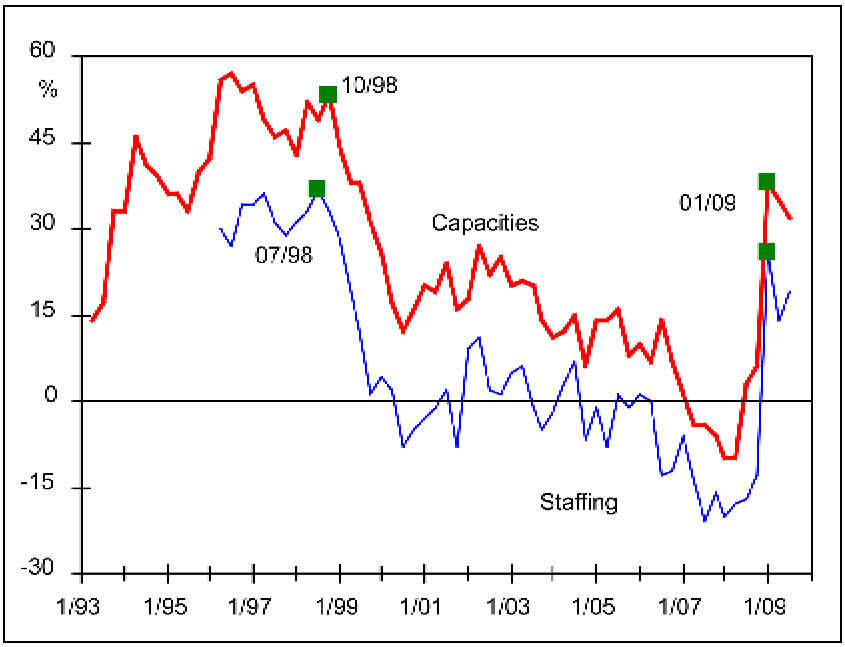


Fig. 15. The balance of Capacity and the Staffing Assessment
(balance = "more than enough" - "less than adequate"

In September, sales have continued to recover, which allowed the enterprises to move to the most intense since the beginning of the crisis increase in production and the very moderate reduction in staff. In September, the rate of decline in the demand has declined (after seasonal factors clearance) by 5 points at a time and the result was the best (i.e., the lowest) from August 2008, when, if you look at the dynamics of the IET index of industrial optimism, Russian industry is starting to shift in the crisis pit. As compared with the minimum of the crisis (November 2008), the rate of reduction in demand has improved by September 2009 by 39 points.

Estimates of demand (sales satisfaction) in September have demonstrated the exit of the Russian industry to a new level of the situation understanding (see *Fig. 16*). For the second consecutive month the demand for its products were regarded as normal by a one third of Russian enterprises. Earlier (over previous eight months of crisis) only a one fourth of producers shared that opinion.

The balance of the finished goods inventories assessment from May to September 2009 make +12 points on average and definitely overcame the level of reasonable sufficiency, typical for 2004 - the first six months of 2006, the period of not very high heating of the Russian industry. The share of enterprises with normal stocks of finished products has overcome the level of the said period. Therefore, the companies have coped with the problem of excessive stocks, and stabilization of their estimates demonstrated that they had no desire to work for the warehouses.

The positive dynamics of demand has allowed the companies to move in September 2009 to the most intense since the beginning of the crisis downfall (in September 2008) in the growth of production. Explicit positive changes in September, was manifested all indicators of the actual output growth in the industry. As compared with November 2008 (the peak of the crisis in the dynamics of the output), by September 2009, that indicator has improved by 56 points and

became definitely positive for the first time: an expressed growth started in the industry, according to the businesses estimates.

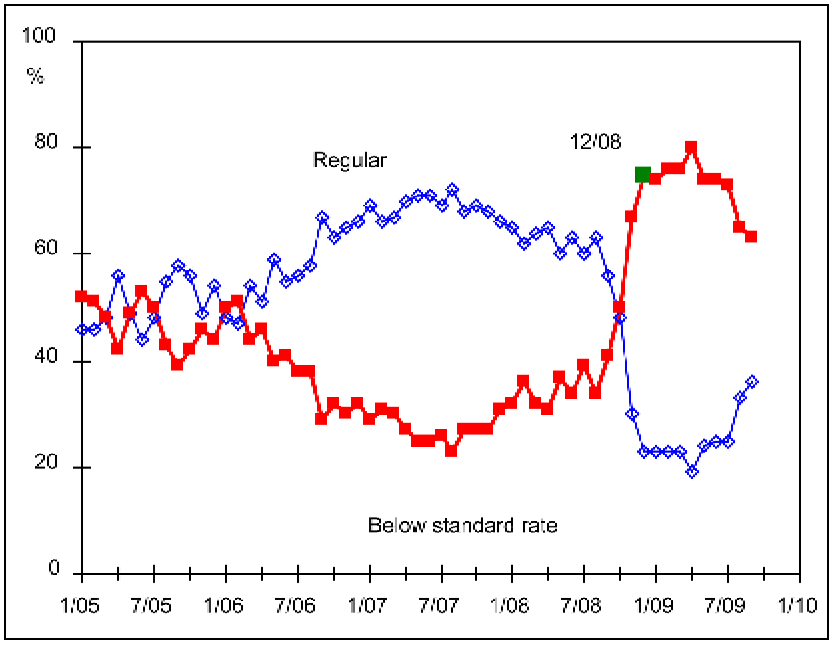


Fig. 16. Dynamics of Effective Demand Growth Assessments

In September, the companies most significantly from February 2009 have adjusted their policies in terms of employment. The intensity of dismissals has been reduced over the month to 9 points and became the most moderate since October 2008. In September, only a quarter of industrial enterprises dismissed their employees, whereas in January 2009, there were more than half of them. The share of reports of recruitment has increased to 12 per cent and became a record peak since July 2008.

In October, the Russian industry has continued to recover from the crisis. There was a positive dynamics in the actual changes in sales, production, employment, stocks assessment of finished.

The demand reduction has slowed down in October (+6 percentage points after seasonal factors clearing) and indicators have reached the level of July - August 2008. Then the demand (and probably, the industry in general) was a step away from the collapse of September - November. Over those three months the rate of change in sales (as per the balance responses of the survey statistics) has lost 50 points. The Russian industry has not faced such a collapse in demand even in the 90-s years of the twentieth century.

It took 11 months to overcome such crisis, which, incidentally, looks very nice, if we recall the gloom forecasts of winter-spring 2009 forecast. The demand estimates, after stabilizing in August – September have been improved in October by 5 points and become positive - for the first time since the crisis start hopes sales were definitely prevailing in the industry.

In October, the growth rate of output after clearance of seasonal factors has increased by another 4 points and made the next crisis record (but with a plus sign): so intensely the output of the Russian industry was not growing since the June 2008 Capacities utilization in industry in the IV quarter increased to 60 per cent and was the highest for the crisis quarters of 2009. In

October, the intensity of dismissals in the Russian industry has continued to decline and as a result became the most moderate since July 2008. Improving this indicator in October as compared with the January crisis value (largely alarmist) amounted to 42 points, and as compared with the more reasonable (i.e., not in so scaring) level of February - 18 points.

Regular access to credits for businesses in October rose to 48 per cent and for the first time during the crisis exceeded the share of businesses estimating credits availability as "below normal". It seems that the banking sector is beginning to believe in the recovery of the Russian industry from the crisis and started to increase its lending, but still under fairly stringent terms. The minimum proposed interest rate was in October, an average of 18 per cent per annum, but it has declined over the month only by 0, 4 percentage points. To small and medium enterprises credits were offered under 19 per cent per annum, with an increase off business scope the rate is decreased to 14-15 per cent per annum.

In November, the progressive dynamics of the main indicators of industry was suspended. The dynamics of demand for the fourth time this year demonstrated the slow-down of a positive trend of recovery from the crisis after undoubtedly positive changes in October. This time, the rate of sales reduction increased by 2 points (in August – by 1 in June - by 3, in March - by 1 point), which is already familiar and more than modest value. Estimates of demand in November, has undergone a significant negative change. Upon clearance from seasonal factors, the rate of anticipated changes in sales showed a decrease (by 4 points) in November for the first time within the previous 6 months.

The growth rate of output, as well as the rate of reduction in demand have changed in November for the worse. Baseline data showed slowing down by 10 points at once and nearly suspended growth of production. The data cleared from seasonal factors showed slowing growth in the output growth by 4 points, but still the growth of production was maintained. The production plans of enterprises declined by 6 percentage points. However, it was the first deterioration in the plans since the crisis beginning in November 2008. Hopes for growth industrial output growth were still large, but there was less confidence The more intense decline in sales and slower growth in output led in November to an increase in the intensity of dismissals in the industries. The rate of layoffs has increased from -11 to -15. estimates of changes in the number of employees have decreased in November by 9 points and also became worse over the previous three months.

By the end of the crisis year 2009 there formed the new trends in the companies' plans regarding the productivity of workers and in estimates of this factor. The average year data show a lack of positive impact of the crisis on business plans to increase productivity. The share of enterprises, which were planning to change the ratio of output and employment in favor of higher returns during 2009, dropped to 27 per cent. This value fits well the trend established in 2005 and is characterized by a gradual decrease in the intensification of labor in industry. The rapid growth of the economy and escalating shortage of personnel fully explain this trend. But 2009 is the year of crisis, which in the first stage was often compared to the 1998 crisis. Then the share of enterprises intending to change the ratio of production output and employees in favor of increasing productivity, reached a maximum value (40 per cent on average in annual terms and 46 per cent in the I-st quarter of 1998). It would seem that 2009 should provide a similar pressure on the Russian industrial enterprises. But this has not happened. And the reason is obvious - active (sometimes even too much) counteracting of unemployment from the authorities of all levels. Now It is not a secret to anybody that the relevant authority (according

to the size of the enterprise) exerted any pressure to minimize the dismissals of employees. It did not happen In 1998: the companies were left to themselves and were forced to get out of the situation by all means of their own capabilities.

In November 2009 the tendency of enterprises to increase productivity has dropped to historic minimum. Only 16 per cent of industrial enterprises were planned to change the ratio of output and employment, which would lead to increased productivity. Previous anti-record (19 per cent) was recorded back in 1993. The overwhelming majority of producers (74 per cent) had to plan the suspension of the currently existing performance, and everybody is aware of its level t is in Russian industry. The companies were estimating the situation with production output quite adequately. In October 2009, when the optimism of the enterprises has reached the crisis maximum, suddenly (at first glance, of course) there occurred a prevailing dissatisfaction with productivity in the industry. It rose to the level of April, one of the hardest months of the ending year.

In December, companies managed to consolidate the positive results of the previous months, but could not do better. At the end of the year this resulted in the reduced demand, deterioration finished products stocks estimates and growing pessimistic of all estimates before the of All-Russian New Year holidays.

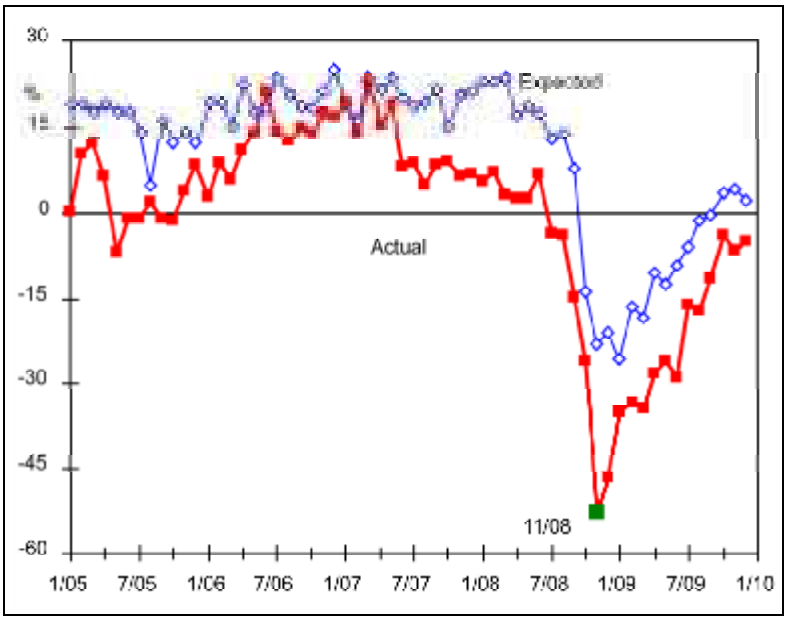


Fig. 17. Changes in effective demand, cleared from seasonal factors
(balance =% growth -% decrease)

The intensity of reduction in demand in December remained at the level of October - November, i.e., the company did not notice any progress in this indicator in the IV quarter of 2009. The demand continued to decline, although not so intensively as in the II or III quarters of the crisis year (see *Fig. 17*). As a result, sales satisfaction was unable to stay at the new level and returned to the level of August - October, when sales of their products satisfied only one-third of enterprises and two thirds regarded it as "below normal". Estimates of stocks of finished products also returned to the medium indicators (and it is quite normal for a year of crisis), the levels of May - October.

The cleared from seasonal factor data on the dynamics of production showed in late 2009 the sustained rate of growth of output at the average level of +11 b.p. That is, production volume in September – December was growing, and quite explicitly and faster than ever during the current crisis. Companies' production plans in anticipation of All-Russian New Year holiday were declining for two consecutive months and lost during this time 11 points of optimism upon clearance from seasonal factors. As compared with initial assessments, the loss amounted to 28 points, and as a result, the December balance of output plans for 2009 was the closest to the November-December balance of 2008 (the peak of the current crisis) and worse than all other points of observation since August 1994. Even in August - September 1998 (peak of the previous crisis) the original output plans of businesses were more optimistic. Most likely, now the situation is affected by slow recovery from the crisis in the January holidays.

Positive trends in personnel policy of enterprises, existing in September – November, were suspended at the end of the year. In December, the producers have reported the most intense over 11 months of the year, staff dismissal (January appears to have been a panic exception). Over the last month, the intensity of layoffs in the industry increased by 2 times.

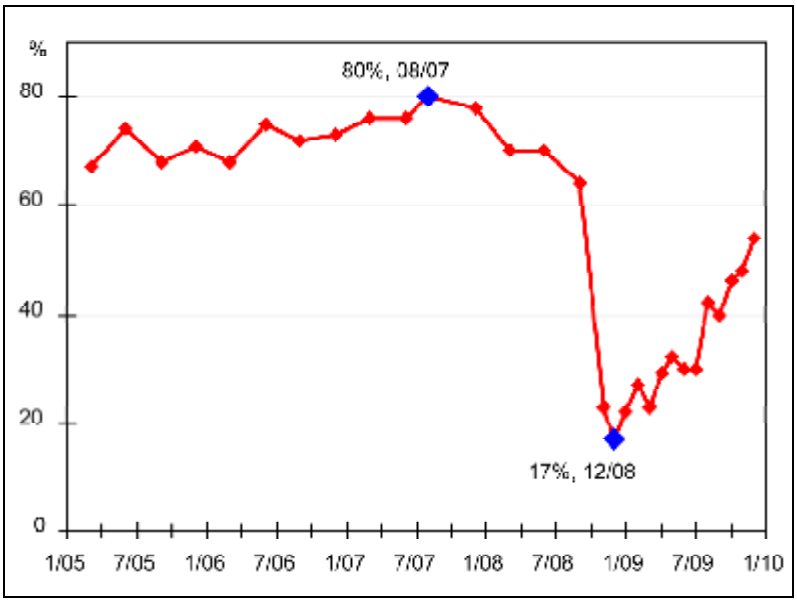


Fig. 18. Share of enterprises with normal access to credits

By the end of the crisis, the normal availability of credits to industrial enterprises increased to 53 per cent, slightly less than the level it reached in pre-crisis September (63 per cent). The crisis minimum (17 per cent, December 2008) has been already exceeded 3-fold (see *Fig 18*). Therefore, the industry crediting was definitely restoring over the year - not, perhaps, as fast as businesses and government wished, but the positive trend is evident.

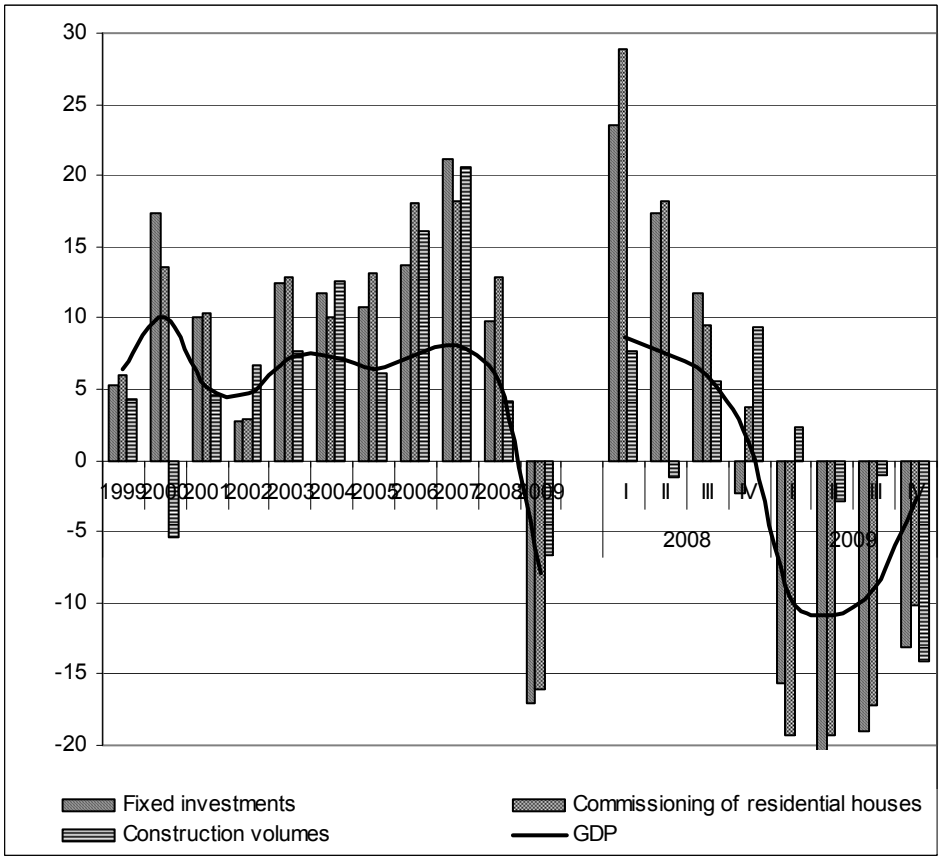
But in early 2010, Russian industry continued to recover from the crisis. The January sales dynamics and assessment of demand allowed businesses to maintain growth in production and demand estimates, backed up by a portfolio of orders, indicate the formation of the most popular expectations for recovery from the crisis. In January 2010 the industry for the first time during the current crisis, expressed a desire to abandon dismissals and start to employ the personnel.

3.3. Real Sector Investments

3.3.1. Domestic Fixed Investments

Fixed Investments Movement: General Trend

Slowdown in the economic activity has resulted in a new situation in the investment sector. Through 2008 a gradual downward trend in the investment growth was observed which coupled with the global financial crisis and from November 2008 was followed by a drastic turning point in behavior: for the first time since 2000 the investment upturn trend got to the negative territory. In the 4Q 2008 fixed investments constituted 97.7% of the same period of the preceding year. In 2009 downward trend in fixed investments took a more acute form: fixed investments shrank by 17.0%, where GDP contraction stood at 7.9%. The fall in the fixed investment volume in the small business sector over the year exceeded 25%. Downward trend in the investment sector predetermined the features of technological and reprocessing activity in the economy as a whole and across the types of economic activity, as well as the process of financing investment expenditures.



Source: Federal service of state statistics

Fig. 1. Rates of Growth of GDP, Fixed Investments, Construction Volumes and Commissioning of New Residential Houses in 2000–2009, and quarter-on-quarter 2008–2009, in % to corresponding period of the preceding year

Positive trend in construction of industrial and infrastructure facilities coupled with the downward trend in commissioning of residential housing was characteristic of 2009. In 2009 commissioning of agricultural facilities went up by 46.8%, in the industrial sector – 11.8% in comparison with a year ago. It is worth noting that in spite of rather rigid financial constraints, commissioning of industrial facilities in public health sector went up by about 1.7fold (*Table 1*).

Table 1

Commissioning of Buildings across Types in 2007–2009

	Total floor space, mln square m			In % to a year ago	
	2007	**2008**	**2009**	**2008**	**2009**
Buildings commissioned	91.0	93.8	89.8	103.1	95.7
Of which:					
Residential	73.5	77.1	72.8	104.9	94.4
Non-residential	17.6	16.7	17.0	94.9	101.8
Of which:					
Industrial	2.2	2.2	2.5	100.0	111.8
Agricultural	1.5	2.0	2.9	133.3	146.8
Commercial	7.9	6.3	6.2	79.7	97.0
Educational	1.9	1.8	1.0	94.7	56.4
Public health	1.1	0.9	1.5	81.8	169.9
Other	3.0	3.5	0.9	116.7	27.4

Source: Federal service of state statistics

Downward trend in commissioning of residential housing was observed from the 2Q and by the end of 2009 constituted 6.7%. Attention should be paid, first, to the reduction in net investment volumes in residential housing construction in comparison with January-September 2008 by 74.8 bn Rb and, second, to the decline of the investment in residential housing construction in fixed investments structure in January-September to 6.7% against 7.6% for the same period a year ago.

One more peculiarity of the investments structure was increased share of expenditures on construction of buildings and facilities in fixed investments structure in 2009 to 55.8% (by 4.1 percentage points more that for the same period of the preceding year) under the reduction in the share of expenditure on machines and equipment to 31.2% against 33.4% in 2008. Let us point out that against the background of sharp downturn in domestic production of capital goods, investments in imports and in purchasing of machines, equipment and means of transport (without small business and informal economy) in 2009 came to 371.8 bn Rb or 20.7% of the overall volume of investments in machines, equipment and means of transport against 20.0% in previous year. In other words, in the first half we observed positive trend in purchases of imported equipment and machinery coupled with sharp scaling back of their domestic production. In the 3Q production curtailment of production of domestic capital goods was accompanied by a downturn in the investments in imported equipment and machinery, and in the 4Q against the background of change in the ration of domestic and import prices and slowdown of the recession, an increase in the share of domestic machinery and equipment in the types structure of fixed investments was observed.

Table 2

Structure of Fixed Investment across Types of Major Assets in 2008–2009 (without small business and informal economy), in % to total

	2008	Of which			2009	Of which		
		I quarter	I half year	January-September		I quarter	I half year	January - September
Fixed investments – total	100	100	100	100	100	100	100	100
Of which across types of major asserts:								
Residential housing	7.5	8.1	7.8	7.6	6.0	6.0	6.0	6.1
Buildings and facilities	52.4	48.5	49.9	51.3	55.8	51.6	54.4	54.8
Machines, equipment, means of transport	33.0	34.5	34.1	33.6	31.2	32.2	30.7	31.1
Other	7.1	8.9	8.2	7.5	7.0	10.2	8.9	8.0

Source: Federal service of state statistics.

Changes in the Investment Structure across Sources of Funding

Investment structure against sources of financing was also subjected to notable changes. Rather sharply contracted the share of proprietary funds of organizations in the investments' volume (by 2.8 percentage points in 2009 against a year ago). Correspondingly the share of raised funds in the investment structure went up. The share of investments from revenues shrank most dramatically (from 18.5% in 2008 to 14.8% in 2009). In its turn, the role of budget funds is growing in the structure of borrowed funds directed to fixed investments: in 2009 1240.8 bn Rb of fixed investments were funded from the budget (21.5% of the overall volume of investments in the economy), of which the federal budget funded 622.9 bn Rb (10.8%) and budgets of the subjects of federation – 546.6 bn Rb (9.5%). The federal budget funding directed at investments increased by 1121.1 bn Rb. This fact has to a certain extent offset contraction of the investment from the budgets of the constituent entities of the Russian Federation by 166.6bn Rb and budgets of other levels of government authority – by 14.4 bn Rb (*Table 3*).

Table 3

Structure of Fixed Investments across the Sources of Financing, in % to total (without small business and informal economy)

	2008	2009
Fixed investment – total	*100*	
Of which across sources of financing:		
Net worth	39.5	36.3
Of which:		
Income	18.5	14.8
Borrowed funds	60.5	63.7
Of which:		
Bank loans	11.8	9.4
Including foreign banks	3.0	2.8
Borrowed funds of other organizations	6.2	10.7
Budgetary funds:	20.9	21.5
Federal budget	8.0	10.8
Budgets of the subjects of the Russian Federation and local budgets	11.3	9.5
Other	21.2	21.9
Including funds obtained for share participation in construction	3.5	2.3
Including funds of the population	1.9	1.0
Foreign investment in the overall volume of fixed investment	4.3	4.6

Source: Federal service of state statistics.

State demand for domestically produced goods and services was maintained by means of the implementation of planned investment projects in the field of transport, telecommunica-

tions, etc. realized within Federal Targeted Program (FTP) and Federal Targeted Investment Program (FTIP), as well as by way of large infrastructure projects of the Investment Fund. In the wake of the crisis the government stimulated investments in the economy by means of the implementation of technological federal targeted programs whose investments were either maintained at the planned level or reduced insignificantly.

In compliance with the List of construction sites and projects for the federal government needs approved by the RF Government edict of 31 December 2008 № 2058-p and included in the federal targeted investment program for 2009, the state envisaged allocation of public funds for 2444 construction sites, construction projects and various events with planned commissioning of 1186 projects.

In October 2009 the List of construction sites and projects of the federal targeted investment program was amended in accordance with applications submitted by principal administrators of the federal budget funds and caused by revisions in the budget allocations, as well as bringing names of government customers, developers, construction sites and projects and other parameters of construction sites and projects in line with registration documentation. According to data as of 1October 2009 in compliance with the amended List government investments were envisaged for 2666 construction sites, projects and events and commissioning of 1412 projects.

In 2009 projects construction and realization of events included in the federal targeted investment program (FTIP) with account of optimization of the volume and structure of expenditure of the federal budget were to receive 708.0 bn Rb from the federal budget, of which for financing the projects included in the state defense order – 158.4 bn Rb. For financing the projects included in the federal targeted programs the government planned to allocate 503.2 bn Rb, of which 99.9 bn Rb were planned to direct to the state defense order.

With account of introduced amendments, in 2009 the total volume of budget allocations on construction projects and implementation of measures included in the federal targeted investment program (FTIP) amounted to 601.2 bn Rb, of which directed to financing projects in the federal targeted program – 298.9 bn Rb, on construction projects and implementation of measures outside of the FTIP in 2009 – 197.8 bn Rb. The volume of funds directed to the financing of special assignments included in the state defense order constituted 104.5 bn Rb or 17.4% of the overall volume of the FTIP (of which within the planned part of the FTIP – 62.7 bn Rb, outside the planned part – 41.8 bn Rb.

According to the preliminary data of the Federal service of state statistics, construction sites and projects of the FTIP (excluding special assignments included in the state defense order) which are being monitored by the Federal service of state statistics the level of budget allocations in January-December 2009 constituted 317.1 bn Rb or 63.2% of the annual limit.

In 2009 construction sites and projects of FTIP which were monitored by the Federal service of state statistics received budget allocations in the amount of 317.1 bn Rb. As of 1 January 2010 1715 projects were financed in full, and 597 projects were in the state of technical readiness in the range between 51.0% and 99.9%.

Considerably higher than on the whole across construction sites and projects reserved for the state needs the annual limit of state capital investments was financed in agro industrial complex (80.3%) and transport complex (79.4%). In case of the special complex budget allocations were financed up to 62.3% and in case of the social complex to the extent of 51.6%. On average across Russia for January-December 2009 nearly 90.2% of the overall volume of funds was allocated using all sources of funding. Special complex was financed in full

(100%) and the social complex was financed at the level of 87.0%, and the industrial production complex – at the level of 91.7%.

Table 4

Projects Envisaged by the Targeted Investment Program and the Volume of State Capital Investments in 2009 г. (exclusive of construction sites and projects included in the state defense order)

	Number of projects in 2009		Commissioned in January-October 2009		Limit of state capital investments for 2009		Financed from the federal budget in 2009	Total investments out of all sources of funding 2009
	Total	In-service dated in 2009	Full capacity	In part	Total	Of which from the federal budget		
	Units						*Bn Rb*	
Total	**2643**	**1413**	**212**	**67**	**527.1**	**501.7**	**317.1**	303.9
Of which:	289	127	13	7	203.1	197.2	156.6	148.9
Transport complex								
Agricultural complex	425	261	50	22	12.2	11.7	9.4	9.3
Special complex	351	189	32	6	19.9	19.1	11.9	12.6
Social complex	1427	730	102	32	265.7	249.7	128.8	123.2
Other projects	151	106	15	–	26.2	24.0	10.4	9.8

Source: Federal service of state statistics

North-Western, Urals, Siberian and Privolzhsky Federal Okrugs have received more than average amount of funds allocated for construction sites and projects of the FTIP. In the Central, Sothern, and Far-Eastern Federal Okrugs disbursement of budget capital investments has been significantly lower than the average mark (*Table 5*).

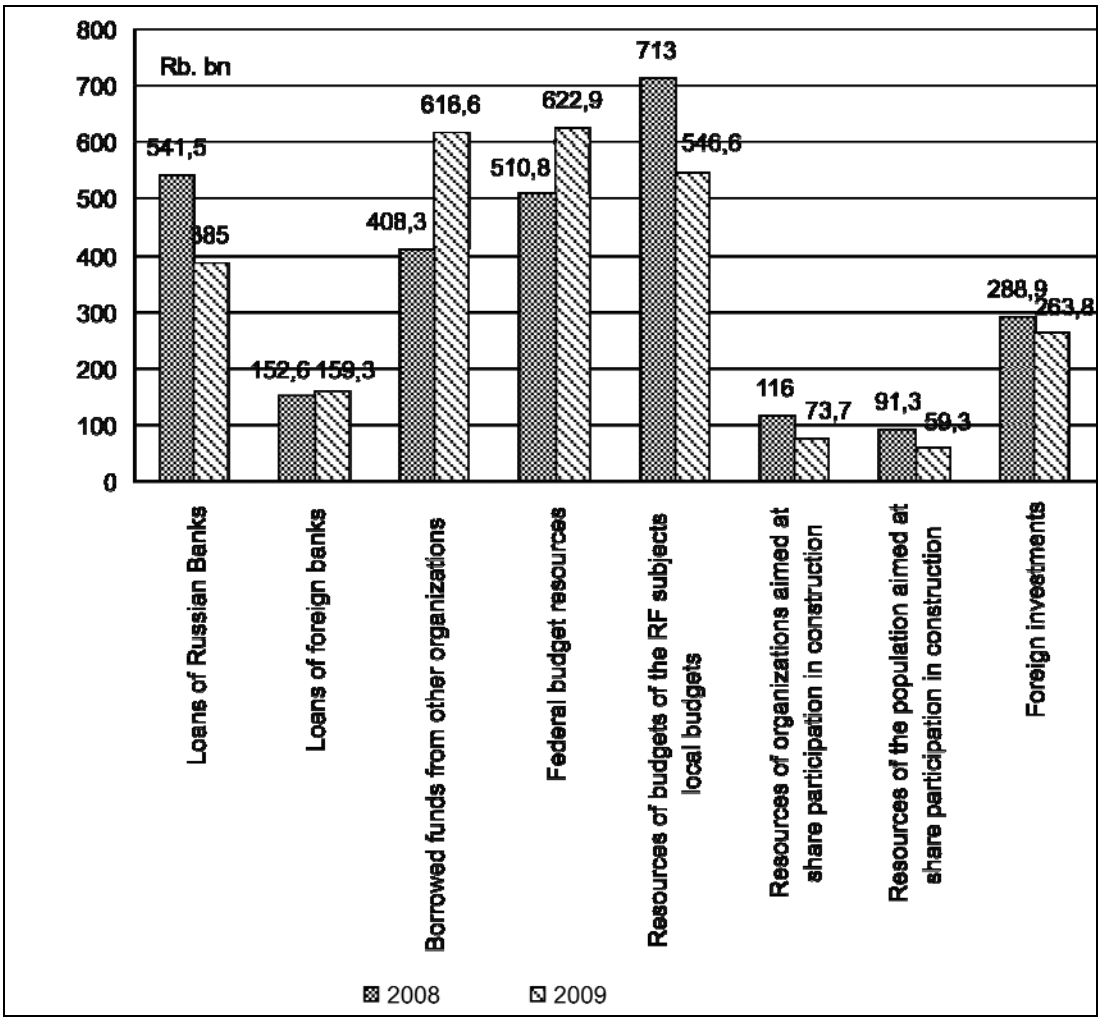
Table 5

Disbursement of Funds on Construction Sites and Projects for the Federal Needs

	Limit of appropriations from all sources, bn Rb	Limit of state investments per year, bn Rb	Actually disbursed from all sources of funding	
			Bn Rb	in % to limit per year
Russian Federation	527.1	501.7	303.9	57.7
Central Federal Okrug (FO)	218.3	217.7	90.8	41.6
North-Western FO	90.6	76.6	67.6	74.7
Sothern FO	69.8	69.0	45.3	64.9
Privolzhsky FO	22.8	21.7	16.0	70.3
Urals FO	6.6	5.9	6.5	98.0
Siberian FO	31.6	30.3	24.4	77.1
Far-Eastern FO	87.4	80.5	53.3	61.0

Source: Federal service of state statistics.

Contraction of domestic market and downturn in the revenues of the economy predetermined, as was mentioned earlier, drastic reduction in the volumes and share of the proprietary funds of enterprises and organizations in the structure of the sources of financing fixed investments. In 2009 net worth of large and medium-size enterprises directed to the investments amounted to 2092.0 bn Rb against 2506.6 bn Rb a year before. Acute shortage of net worth was offset by the bank loans and borrowed funds. In 2009 out of 3765.5 bn Rb of borrowed funds 694.1 bn Rb or 18.4% were bank loans (*Fig. 2*).



Source: Federal service of state statistics.

Fig. 2. The Structure of Borrowed Funds directed to Financing Fixed Investments in 2008 and 2009, in bn Rb

The structure of bank loans in the sources of financing fixed investments were subject to significant changes. If in 2008 the share of foreign banks loans amounted to 22.0% of the overall amount of bank loans, then in 2009 this mark went up to 29.3%. Foreign banks loans in 2009 in comparison with a year ago went up by 4.3% at net fall of domestic banks loans directed to fixed investments by 156.5 bn Rb (decrease by 29.3% against the level a year before). As a result, the share of foreign investments in the overall volume of fixed investments increased to 4.6% and constituted 263.8 bn Rb.

This trend was formed against the background of upward trend in capital outflow and contraction of foreign investments. According to preliminary data provided by the Central Bank of Russia, in 2009 net outflow of private capital amounted to USD 52.4 bn against USD 132.8 bn a year ago. Foreign investments in the Russian economy in 2009 stood at USD 81.9 bn (79.0% to 2008), of which direct investments – USD 15.9 bn (58.9% to the level a year ago) (*Table 6*).

Table 6

Net Inflow/Outflow of Private Sector Capital, according to balance of payments data, in bn USD

	Net inflow/outflow of private sector capital, total	Of which:	
		Net inflow/outflow of capital by banks	Net inflow/outflow of capital by non finance enterprises and households
2007	**82.4**	**45.8**	**36.6**
2008	**–132.8**	**–56.9**	**–75.8**
I quarter	–23.7	–9.9	–13.7
II quarter	40.7	22.1	18.6
III quarter	–19.3	–13.5	–5.8
IV quarter	–130.5	–55.6	–74.9
2009 (estimate)	**–52.4**	**–32.5**	**–19.9**
I quarter	–35.1	–6.8	–28.3
II quarter	4.5	–5.8	10.3
III quarter	–33.4	–27.6	–5.8
IV quarter (estimate)	11.6	7.7	3.8

Source: Central Bank of Russia

Shortage pf proprietary resources and negligible role of the domestic banking sector in fixed investments preconditioned wider circle of borrowing companies. In 2009 the volume of borrowed funds directed into fixed investments (insurance and investment companies, trade enterprises, etc.) constituted 616.6 bn Rb and by 231.6 bn Rb exceeded the volume of the domestic banks' loans in the structure of financing of fixed investments.

The global financial crisis defined the behavior of the investors in the market of residential housing construction. In 2009 net decline in the resources directed both by the organizations and the population to the share participation in construction. In 2009 the share of funds directed to the share participation in construction amounted to 2.3%, of which the funds of the population – 1.0% against correspondingly 3.5% and 1.9% in 2008.

Investment Restructuring across Types of Economic Activity

By the end of 2009 fixed investments structure in the economy as a whole was affected by drastic exacerbation of contraction in the investments in agricultural sector (75.2% 2008), in commerce (75.7%), in the communication sector (66.6%), and transactions with real estate (70.8%0 (*Table 7*).

Investment activity in the infrastructure sector serves as an indicator of the potential for the future growth due to its orientation for the solution of subsequent issues. Dip in the investments in the development of railway transport by 21.0% against a year ago sent a warning signal. Net reduction in the investments has very negatively impacted associated productions of capital goods. Upward trend in the movement of the investments in the transportation was backed by an increase in the volumes of finding of priority projects in the development of the pipeline transport. Investments in the pipeline transport in comparison with 2008 went up by 1.54fold, and their share in the fixed investments structure in the economy as a whole went up by 5.2 percentage points to 11.8%.

Due to the contraction of the domestic market, investments in the retail sector against 2008 went down at 28.8%, in the wholesale sector – at 13.2%, and in car dealerships – at 34.7%.

Restructuring of the fixed investments across types of economic activity in industry in 2009 was dictated by contraction in the investment activity in the extraction sector at 11.7%, manufacturing industries – at 21.8%, and in the production and distribution of electricity, gas

and water – at 0.2% against the 2008 level. The share of investments in industry in the overall volume of fixed investments constituted 42.2% and went up by 1.3 percentage points in reference to 2008.

Table 7

Fixed Investments Structure across Types of Economic Activity (excluding small business and informal economy)

	2008	2009
Total	*100*	100
Of which across types of economic activity:		
Agriculture, hunting and forestry	3.8	3.3
Industry	40.9	42.2
Extraction of natural resources	16.1	16.8
Of which, extraction of fuel and energy natural resources	14.7	15.5
Manufacturing industries	16.1	15.3
Production and distribution of electricity, gas and water	8.7	10.1
Construction	2.6	2.8
Wholesale and retail sector; automotive maintenance, motorcycles, household goods and personal items	3.1	2.4
Transport	19.6	23.0
Communication	5.2	5.2
Financial activity	1.3	1.3
Transactions with real estate, lease and provision of services	12.9	9.6
Education	2.2	2.0
State governance and state defense, compulsory social security	2.2	2.3
Public health and provision of social services	2.6	2.5
Delivery of other utility, social and personal services	3.1	2.9

Source: Federal service of state statistics.

In the extraction of fuel and energy resources contraction of investments against 2008 constituted 22.2%. Although it is worth noting that with the increase of the world prices commercial production of fuel and energy resources in 2009 went up to 29.2% against 24.7% a year ago.

The share of manufacturing industries in the fixed investment structure on the whole of the economy in 2009 amounted to 15.3%, and in the fixed investments in industry – 36.2% which is 3.2 percentage points below the 2008 mark. Investment activity in the manufacturing industries was ensured by the increase in the investments in the production of petroleum products (135.8% against 2008 mark). Among industries with the deepest investment slump are chemical production (74.2% against 2008), food processing (75.6%), manufacture of leather and footwear (65.7%), textile manufacture (82.4%), and cellulose and paper (63.2%).

Small investment demand for capital goods and construction materials coupled with underutilization of production capacities have led to a contraction in the investments in metallurgical production by 29.1% and production of metal goods - by 32.6% against 2008.

Analysis of behavior and structure of investments demonstrate reduction of as it is small share of investments in machine building. Change in the investments in machine building was mainly dictated by a contraction of investments in manufacture of means of transport by 26.9% against 2008 and in manufacture of machines and equipment – by 30.6%. Considering age, technological and reproduction structure of fixed capital slow investment rates in machine building industry remain a factor which slows rates of development of industries which manufacture final and intermediary products.

In 2009 major factors which hampered the investment activity in industry were insufficient demand for goods and products, high interest rates, as well as ambiguity of economic situation and prospects for economic development (*Tale 8*). The share of enterprises which pointed

out to the shortage pf proprietary funds as a constraint of economic activity remained high. However, at the same time, it remained at the average levels recorded for recent five-six years.

Table 8

Ranging of Organizations across Factors Limiting Investment Activity, in % to overall number of organizations

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Small demand for goods and products	10	21	14	10	15	21	17	11	18	29
Shortage of proprietary funds	41	53	68	66	60	65	63	59	63	66
Expensive commercial borrowing	47	35	31	31	30	31	28	27	26	36
Complicated mechanism for obtaining loans for the implementation of investment projects	39	31	24	23	17	17	12	14	15	19
Investment risks	35	33	27	26	24	25	28	29	27	23
Unsatisfactory state of the technical base	18	19	14	14	12	9	8	8	7	7
Low return on fixed investments	8	14	10	18	11	14	13	12	8	10
Ambiguity of economic situation in the country	49	35	29	19	20	18	14	11	33	48
Inadequate normative-legal base regulating the investment processes	36	30	22	17	21	17	13	18	10	10

Source: Federal service of state statistics

Under the 2009 level of utilization of production capacities and investments, fixed investments as in the previous years were directed to the replacement of worn-out equipment and machinery. According to findings of business surveys of the investment activity of organizations 64% of the overall number of organizations specified that reason. Under the contraction of demand a natural reaction of producers was to reduce the nomenclature of output which was followed by stagnation in job creation. Loss of interest on the part of enterprises to pursue the policy of production costs and energy saving looked very threatening in the wake of the crisis. Finally, this fact provoked growth of production costs and earnings delusion of services and products. The situation was aggravated by the lack of motivation to improve technical and technological production characteristics. In this connection, replacement of work-out equipment was due to solution of current or short-term issues of enterprise functioning and was not oriented to long-term perspective.

In spite of the fact that the lion's share of fixed investments in 2009 was directed at procurement of machines and equipment, the high level of long-life performance and worn-out state of the equipment and machinery remain one of the principal factors determining low efficiency of production, capital and utilization of labor. For instance, the share of buildings and facilities which are over 20 year constitute 28%, the share of machinery and equipment of the same age amounts to 14% and means of transport – 6% in the companies engaged in the extraction of mineral resources, manufacturing industries companies, those engaged in production and distribution of electricity, gas and water in 2008. Average age of machines and equipment in metallurgy, manufacture of means of transportation and equipment, production of cellulose, wood pulp, paper, carton and their products does not exceed the average age across the companies under survey.

Table 9

Ranging of Organizations across Fixed Investments Objectives (findings of the investment activity surveys, in % to the overall number of organizations)

Fixed investments objectives	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Expansion of production capacities with permanent nomenclature of products	42	35	35	36	33	28	31	27	29	29
Expansion of production capacities with expansion of nomenclature of products	34	26	28	27	33	38	36	39	39	27
Automatization and mechanization of current production process	51	51	46	51	53	51	51	53	51	45
Introduction of new manufacturing technologies	41	43	42	39	40	46	47	44	42	33
Reduction of primecost of the output	42	41	39	39	47	49	46	48	46	39
Energy saving	39	39	37	38	44	49	44	48	43	35
Replacement of worn-out equipment and machinery	56	73	68	71	70	73	72	73	70	64
Job creation	30	17	17	16	21	25	21	21	22	16
Environment protection	48	51	40	46	46	50	50	49	46	36

Source: Federal service of state statistics.

At the same time, note positive trends in the structure of fixed investments.

Table 10

Ranging of Organization across Types of Purchased Fixed Assets, in % to the overall number of organizations

	2009	2010 projection
Machines and equipment		
Complexes and manufacturing lines	58	56
Individual plants	54	50
Means of transport	49	46
Computer technologies and mechanical and automatization equipment	62	57
Telecommunications equipment	38	36
Other	32	27

Source: Federal service of state statistics.

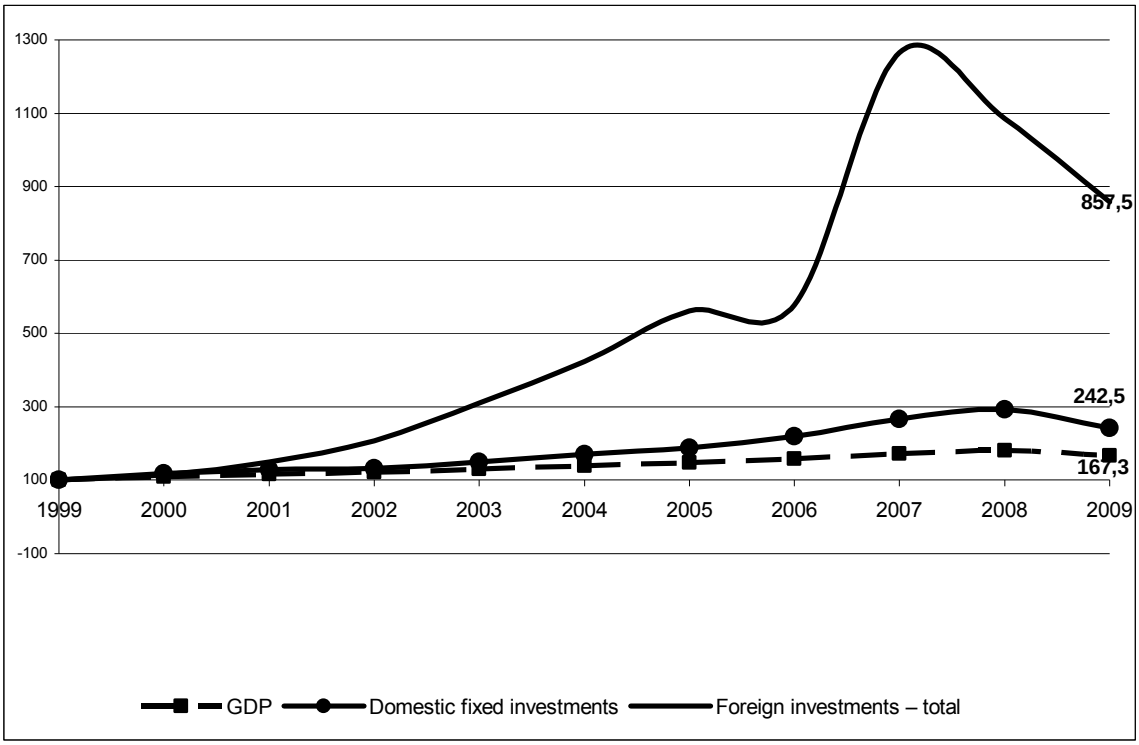
Investment in the new technological lines and complexes has been growing on the back of the decline in the replacement of machines and equipment which fully corresponds long term purposes of modernization and reconstruction of industrial production and fosters manufacture of competitive high-tech products. This trend is paramount due to the fact that the majority of companies in 2009 – 87% of all companies subject to survey - purchased new machines and equipment of domestic origin and only 37% - imported. Such shift in priorities will undoubtedly influence positively the domestic market of investment-intensive goods.

3.3.2. Foreign investment

Over the last ten years in the Russian economy dominated the trend according to which foreign investments grew faster than domestic investments. Significant outrunning rates of growth of the overall volume of foreign investments in comparison with domestic investments movement were due to structural features. Major share of foreign investments in the Russian economy constitute “other type of investment” which are ranged by type of financial tool as: loans and credits; commercial credits; credits obtained from indirect investors, in particular, from international financial organizations (World Bank, International Monetary Fund, International bank for reconstruction and development, European bank for reconstruction and development); credits from foreign governments under guarantees of the RF Government, etc.

On average, for the period 2000-2008 the share of direct investments stood at about 26% of the overall volume of foreign investments, the portfolio investments – 2%, and other – 72%.

The rates of growth and the volume of foreign investments in the Russian economy peaked in 2007. That year the volume of foreign investments doubled against the level of a year ago. In 2007 the volume of direct investments reached USD 27.9 bn which exceed the volume of investments received for two preceding years. Sustainable growth of direct investments came on the back of a surge in tied commercial credits and loans from direct investors. For the year 2007 increment in other investments exceeded USD 50 bn which, undoubtedly, affected the national financial indicators. At the same time, the stock market remains a zone of high risks which conditioned instability of behavior of the portfolio investments. Contraction in the volume of portfolio investments, the lion's share of which constitute investments in shares, during 2000-2004 was interrupted by a somewhat revival recorded in 2005and surge in growth by 7fold in 2006 with slowdown of the movement to 131.8% in 2007. Dramatic upsurge in activity of foreign investors turned to a sluggish behavior in 2008. At the end of 2008 the volume of foreign investments in Russian economy in comparison with 2007 declined by 14.8%. Downward trend in foreign fixed investments continued over entire 2008 and remained in 2009.

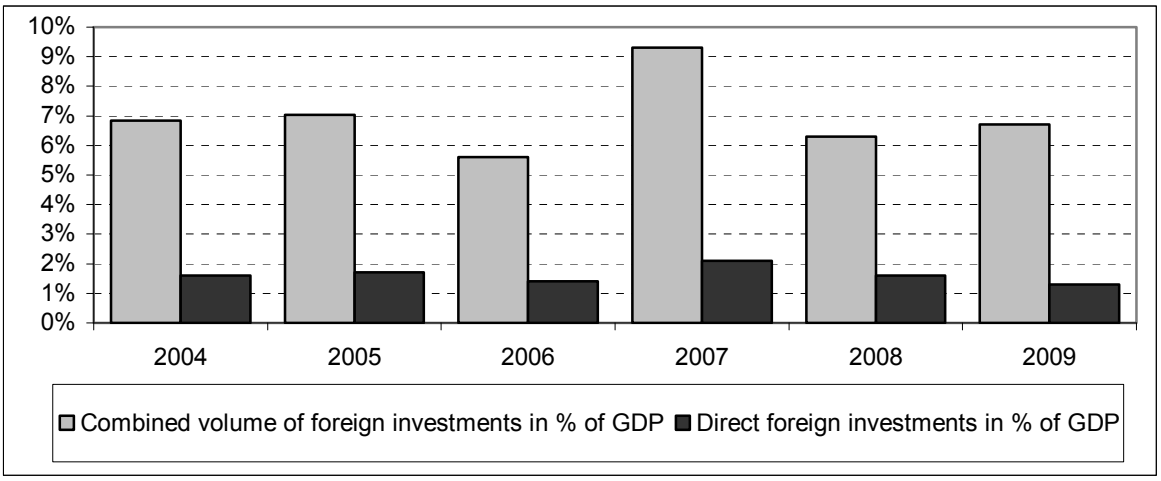


Source: Federal service of state statistics.

Fig. 3. Indices of the Physical Volume of GDP, Domestic Fixed Investments and Foreign Investments in 1999–2009, in % to 1999

Although insignificant decline in the volume of foreign investments was recorded in the 4Q 2008, crisis developments in the investment sector were clearly revealed in the 1Q 2009 when the volume of foreign investments in the Russian economy dipped by 30.3% against the

same period of 2008 and by 2.3fold in comparison with the preceding quarter. Global unfavorable situation on the hydrocarbons market and on other raw material resources markets along with instability reported on the global stock markets provoked by the onset of 2009 the outflow of foreign investments from the Russian market. In the 1Q 2009 the amount of transferred profit obtained by foreign investors coupled with repayment of loans and interest payment on those loans was comparable with the amount of foreign investments received over this period. Furthermore, for the first time in the last decade Russia's investments abroad exceeded the volume of foreign investments in the Russian economy. This trend continued in the 2Q and in the 3Q 2009. In the 4Q 2009 Russian investments abroad constituted only 46.5% of the amount of foreign investment in Russian economy for this period. Increase of interest rates on credits, high investment risks, contraction of domestic demand, unfavorable global marker environment conditioned low level of the investment activity.



Source: Federal service of state statistics.

Fig. 4. Level of Inflow of Foreign Investments in Russian Economy in 2004-2009 (in % of GDP)

Initial decrease of sovereign credit ratings of Russia due to the global financial crisis took place in December 2008 when international credit ratings agency S&P lowed sovereign rating of Russia from BBB+ to BBB, with negative projection for the credit rating. According to S&P "decrease of sovereign credit rating reflects the risks connected with the sharp contraction of currency reserves and other investment flows, which have resulted in increasing costs and difficulties with access to external financing." For the same reason Fitch lowed the credit rating of Russia from BBB+ to BBB in February 2009 with negative projection of the rating. In August 2009 Fitch confirmed the credit rating fixed in February 2009. In its press-release S&P in September 2009 noted that decided not to change sovereign ratings of Russia. Given reason were continued risks for the Russian economy.

Moody's did not lower credit rating of Russia following S&P and Fitch and confirmed in the end of 2008 its positive projection for the RF promissory notes and deposits, limiting to reviewing projection from positive to stable (in July 2008 Moody's increased Russia's credit rating from Baa2 to Baa1 with positive projection for the rating). In the end of October 2009

Moody's announced that the sovereign credit rating of Russia will remain in the near future within A3-Baa2 and considers as insignificant chances for its decrease.

In 2009 as a whole foreign investments are estimated to stand at USD81.9 bn or 79.5% against 2008.

The highest dip in net indices (at USD11.1 bn) and relative (at 41.1%) in 2009 was recorded in the direct investment segment. Other investments carried out on repayable basis shrank at USD10.2 bn. At the same time, contributions to the authorized capital at the end of 2009 fell at 49.7% to USD8.0 bn. Loans from foreign joint owners went down at 34.2% to USD 6.4 bn. Thus, the share of loans obtained from foreign joint owners in the structure of direct foreign investments in Russia went up from 36.2% in 2008 to 40.5% in 2009 and the share of contributions in the authorized capital decreased from 58.8% to 50.3%.

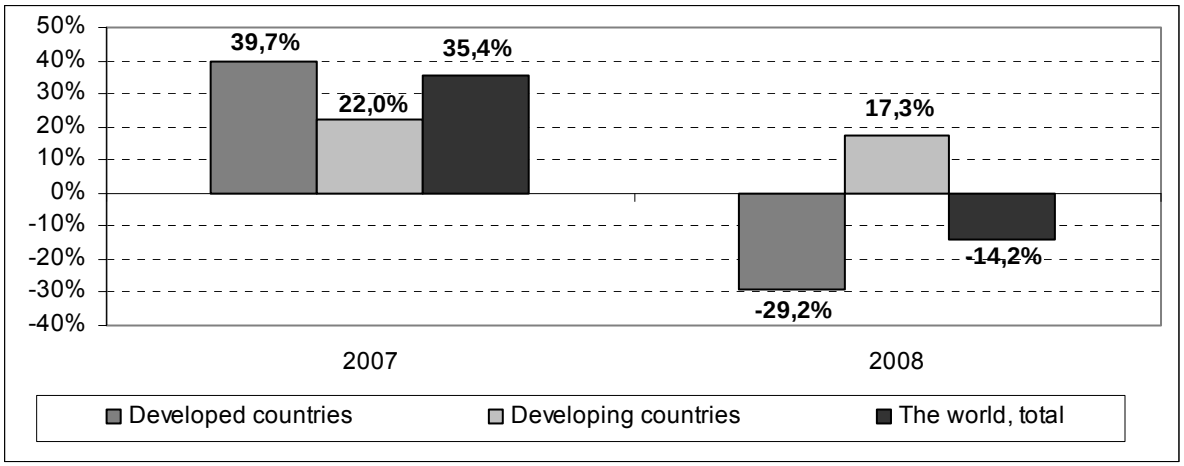
Table 11

Volume and Behavior of Investments Received from Foreign Investors in the Russian Economy, across types of investments

	Mln USD				In % to preceding year			
	Total	Direct	Portfolio	Other	Total	Direct	Portfo-lio	Other
2005	53 651	13 072	453	40 126	132.4	138.8	136.3	130.5
2006	55 109	13 678	3 182	38 249	102.7	104.6	700.0	95.3
2007	120 941	27 797	4 194	88 950	219.5	203.2	131.8	232.6
2008	103 769	27 027	1 415	75 327	85.8	97.2	33.7	84.7
2009	81 927	15 906	882	65 139	79.0	58.9	62.3	86.5

Source: Federal service of state statistics.

According to UNCTAD "World Investment Report 2008", the volume of attracted direct foreign investments in 2008 Russia took 5th place in the world (2007 – 9th, 2006 – 10th, 2005 – 15th) and among developing countries Russia took 2nd place behind China (2005 – 3rd). According to the data represented in the report, in 2008 Russia attracted 4.1% of direct global foreign investments (2007 – 2.8%) due to significant reduction in the inflow of direct foreign investments in developing countries.



Source: UNCTAD, "World Investment Report 2008".

Fig. 5. Adjustment in the Influx of Direct Foreign Investments in 2007–2008

According to the UNCTAD report contraction of the combined volume of direct foreign investments in the world was recorded gradually starting with the 1Q 2008. In January-March 2009 decrease in the combined direct foreign investments in the world according to estimate constituted 44% against the 1Q 2008. At the same time, it was noted that for the same period the fall of direct foreign investments was recorded in 70 out of 96 countries. In the developed countries influx of direct foreign investments in the 1Q 2009 fell in relation to peak marks recorded in the 4Q 2007 by more than 3fold. In the developing countries peak volumes of direct foreign investments were recorded in 1Q 2008. At the end of the 1Q 2009 their reduction constituted about 40%. Later than anywhere else (starting with the 3Q 2008) the fall of direct foreign investments was recorded in the East European and CIS countries. Decrease of net indices in the East European and CIS countries was much deeper in comparison with combined index and with the data for the developed and developing countries. However, in relative terms at the end of January-March 2009 direct foreign investments in relation to maximum indices of the 2Q 2008 dipped by about half. In the segment of portfolio investments in the Russian economy in 2009 a decrease was noted by 37.7% in comparison with 2008. At the same time, decrease in the investments in shares and stock which constituted the lion's share of the portfolio investments (2007 – 95.5% of the volume of portfolio investments, 2008 – 79.6%, 2009 – 42.9%).

The volume of other investments in 2009 went down in relation to the corresponding period of 2008 by 13.5%. The share of commercial credits in the structure of other investments at the end of 2009 remained at the level of 2008 and constituted 21.4% (2008 – 21.5%). According to terms of attracted loans, the share of loans exceeding six months remained at the level of 67.9% (2008 – 68.1%).

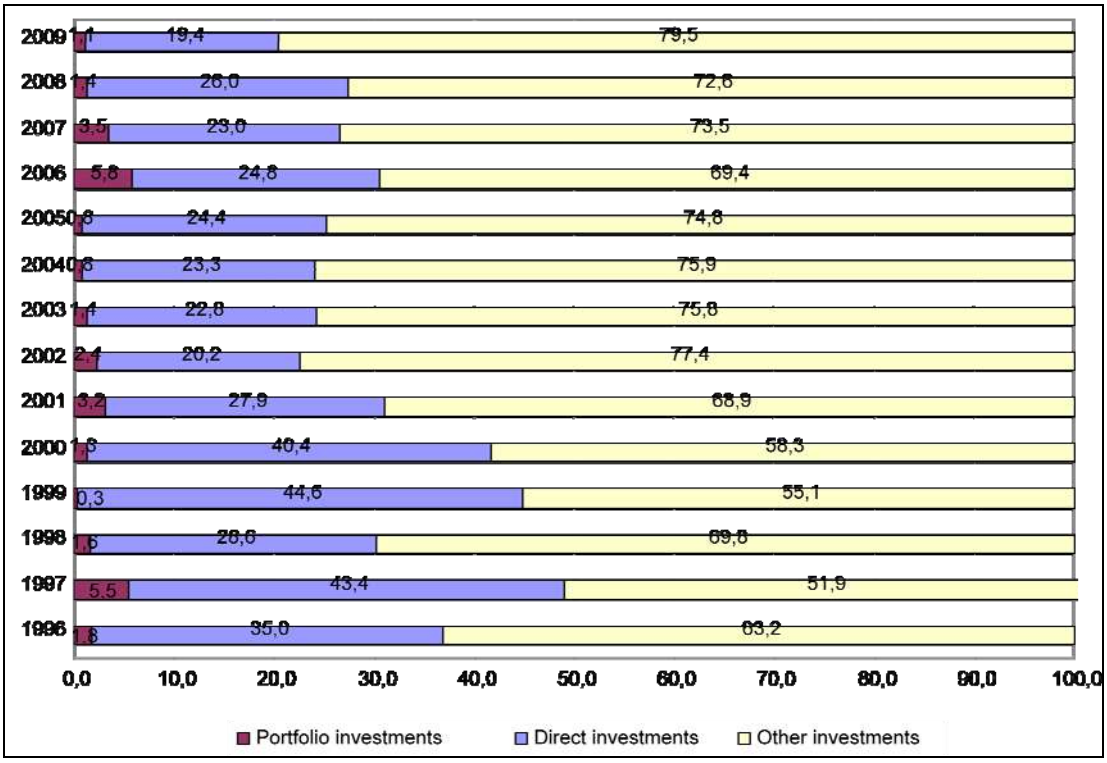
Thus, in comparison with the preceding year, in 2009 the structure of foreign investments in the Russian economy was subject to certain amendments.

In 2009 foreign investments in industry went down by about one third and constituted 40.3% of the overall volume of foreign investments in the Russian economy. After twofold reduction of investments in commerce in 2008, in 2009 foreign investment in commerce dropped by 4.7%, at the same time their share in the overall volume of foreign investments went up to 27.5%. 2009 has brought back a positive trend in foreign investment in transportation and communication sectors following their downturn by 27.5% a year ago. Foreign investment in the pipeline transportation in 2009 amounted to USD 9.0 bn and exceeded the level of the successful 2007 by 3.2fold. Dynamic growth of foreign investment in the communication sector in 2009 by 5.1fold in comparison with preceding year not only totally offset a fall recorded in 2008 but also ensured expansion of the investment potential by 20% against 2007. As a result, the share of transportation in the structure of foreign investment in 2009 went up to 12.1% against 3.4% in 2008 and 2.8% in 2007, and communication, correspondingly, to 4.5% against 1.3% and 2.7%

The global crisis which was triggered by the housing bubble in the United States has sizably affected the real estate sector. Many countries recorded two-digit rates of price slump annualized in the real estate. All that has led to a downturn of the investors' interest to Russian real estate sector. In 2009 foreign investment in real estate contracted by about half.

Foreign investment in industry at the end of 2009 compared with 2008 recorded a fall by 16.7% in the extraction of minerals (in 2008 decline amounted to 28.7%). Foreign investment in manufacturing industries went down by 34.5% (2008 posted investments growth in manufacturing industry by 6.2%) Investment in the food processing industry declined by 40.0%, in

chemical industry – 37.6% and constituted USD 2.4bn and USD 1.6 bn correspondingly. Under unfavorable world market price trends on metals foreign investment in metallurgy in 2009 contracted 3.2fold constituting USD 4.5 bn compared with the same period a year ago.



Source: Federal service of state statistics.

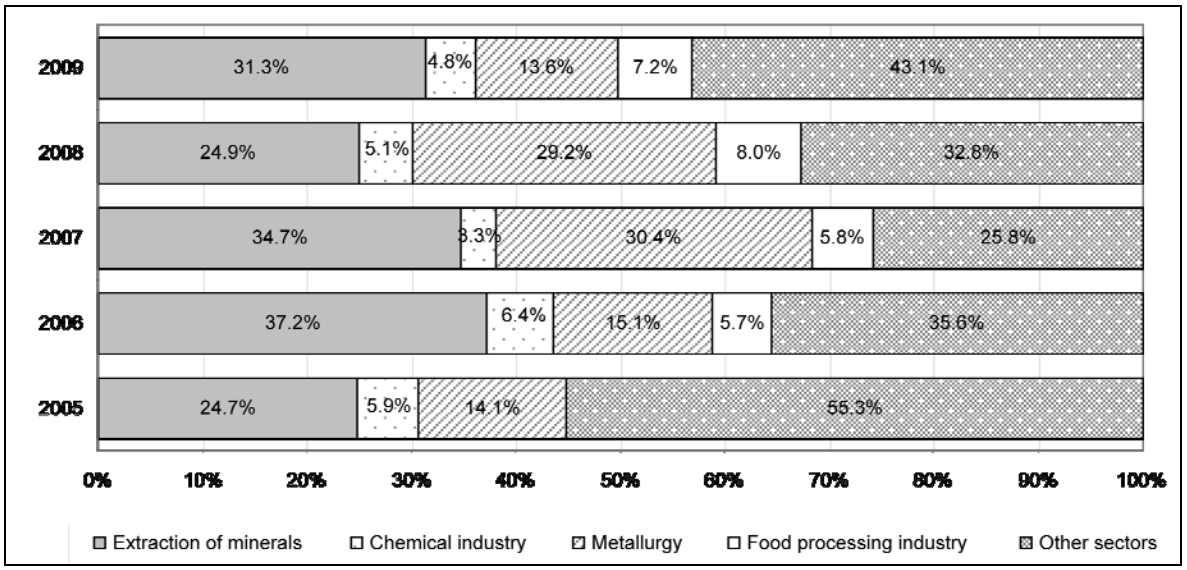
Fig. 6. Structure of Foreign Investments in the Russian Economy in 1996–2009, in % to total

Table 12

Volume, Behavior and Structure of Foreign Investment in the Russian Economy across types of economic activity in 2007–2009

	In mln USD			In % to preceding year			In % to total		
	2007	2008	2009	2007	2008	2009	2007	2008	2009
Total	120941	103769	81927	219.5	85.8	79.0	100	100	100
Industry	50 163	49 704	32 980	203.9	99.1	66.4	41.5	47.9	40.3
Transportation and communication	6 703	4 861	13 749	126.5	72.5	282.8	5.5	4.7	16.8
Wholesale and retail sector; maintenance of motor transport, motorcycles, household appliances and personal items	47 310	23 905	22 792	361.4	50.5	95.3	39.1	23	27.8
Transactions with real estate, lease and services provision	8 414	15 378	7 937	140.3	182.8	51.6	7	14.8	9.7
Financial activity	4 450	4 977	2 658	94.7	111.8	53.4	3.7	4.8	3.2
Other sectors	3 901	4 944	1 811	274.7	126.7	36.6	3.2	4.8	2.2

Source: Federal service of state statistics



Source: Federal service of state statistics. Data on foreign investment in food processing industry for 2005 are missing.

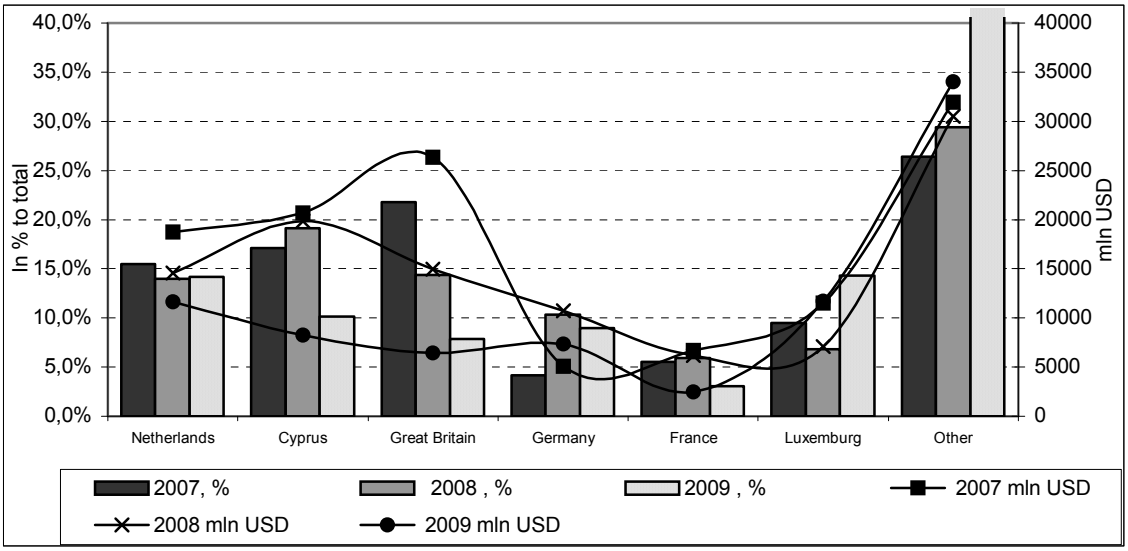
Fig. 7. Structure of Foreign Investments in Industry in 2005–2009

Direct and portfolio investments in industry decreased in 2009 compared with 2008 by 44.1% and 41.2%. Other investments in industry also went down by 29.5% against a year ago. Thus, the share of other investments in industry went up from 71.1% in 2008 to 75.6% in 2009, the share of direct and portfolio investment for the same period declined from 26.6% and 2.3% to 22.4% and 2.0% correspondingly.

The structure of foreign investments across types of economic activity in industry was subject to adjustments. In the extraction of minerals sector direct investments went down by 36.2% to USD3.2 bn which resulted in contraction of their share in cumulative investments in this sector at the end of 2009 at 30.7% (2008 – 40.2%). The share of other investments in the extraction sector which posted reduction at the end of 2009 by 7.2% (to USD6.8 bn) went up to 65.8% (2008 – 59.0%).

In manufacturing industry in 2009 major part of investments also fell to the share of other investments which compared with 2008 went down by 35.5% constituting in the cumulative indices of the investments in manufacturing industry 80.6% (2008 – 81.9%). Foreign direct investments in manufacturing industries for the period under consideration went down by 30.7%. The share of direct investments in manufacturing industries went up at the end of 2009 to 18.5% (2008 – 17.5%).

The Netherlands and Luxemburg have preserved their positions as large exporters of capital in the geographical structure of foreign investment in the Russian economy in 2009. In 2009 Luxemburg invested the largest amount USD 11.7 bn (14.3% of the overall amount of foreign investment in the Russian economy for the given period), the Netherlands invested USD 11.6 bn (14.2%). China became the third largest investor whose investments at the end of 2009 amounted to USD 9.8 bn. At the same time, the US did not get into the first ten largest exporters of capital to Russia at the end of 2009.



Source: Federal service of state statistics.

Fig. 8. Geographic Structure of Foreign investments in Russian Economy in 007–2009

In 2009 the largest growth of investment was posted from Japan – by 3.5fold against 2008 (to USD3.0 bn), investments from Luxemburg went up by 65.7%. At the same time, investments from Cyprus went down by 2.4fold, Great Britain – 2.3fold, France – 2.5fold, Ireland – 3.9fold. Investments from the Netherlands went down by 20.0%, Germany – by 31.3%. Changes in the investment movement have resulted in the changes in the geographical structure of foreign investments in the Russian economy.

As of the end of 2009 cumulative foreign capital exclusive of monetary and credit regulatory agencies, commercial and savings banks, inclusive of ruble investments evaluated in USD constituted USD 268.2 bn which exceed by 1.4% corresponding parameter as of beginning of the year. The negative fact is that direct cumulative investments for the year fell by USD 13.4 bn. However, contraction of cumulative direct investments was posted in the 1Q 2009 (at USD27.2 bn, or by 22.2% for quarter). In the 2Q of preceding year cumulative foreign direct investments on the contrary went up and increased for half year by USD14.0 bn (at 14.7%).

At the end of 2009 Cyprus, the Netherlands, Luxemburg, Great Britain and Germany are among leader in the overall volume of cumulative foreign investments at the end of 2009. Their share constituted 59.1% (2008 – 70.3%). At the same time, the share of the first five investor-countries in the segment of portfolio investments went up to 85.0% (2008 – 75.3%), in the structure of direct and other investments it went down to 61.8% and 55.3% (2008 – 73.4% and 57.6%).

Table 13

Cumulative Foreign Investments across Major Investors

	Cumulative as of 01.01.2010 mln USD				Adjustment to 01.01.2009, %			
	Total	Direct	Portfolio	Other	Total	Direct	Portfolio	Other
Ireland	9 212	415	5	8 792	95.3	86.5	1250.0	95.8
Germany	19 226	7 834	14	11 378	110.3	107.7	53.8	112.4
France	8 622	2 182	29	6 411	90.4	113.2	2900.0	84.2

	Cumulative as of 01.01.2010 mln USD				Adjustment to 01.01.2009, %			
	Total	**Direct**	**Portfolio**	**Other**	**Total**	**Direct**	**Portfolio**	**Other**
Great Britain	23 585	3 625	2 327	17 633	76.5	78.0	99.5	74.0
Cyprus	49 128	33 547	1 835	13 746	86.3	82.4	106.2	953.3
Netherlands	48 619	29 065	4 280	15 274	104.9	80.9	10439.0	147.2
Luxemburg	37 157	1 185	273	35 699	108.0	97.4	100.0	108.5
Other countries	72 677	31 169	1 495	40 013	120.3	113.5	268.4	88.2
Total	**268 226**	**109 022**	**10 258**	**148 946**	**101.4**	**89.1**	**182.3**	**109.1**

Source: Federal service of state statistics.

In the structure of foreign investment accumulated at the end of 2009 other investments prevail. They constitute 55.5%. The same parameter for foreign direct investment constituted 40.6%.

In 2010 according to projections of the RF Ministry of Economic Development the upward trend in foreign investments in the Russian economy will continue. For instance, at the end of December 2009 S&P revised its projection of the credit rating of Russia from negative to stable, thus confirming the currency rating at the level BBB. At the end of January 2010 Fitch has also preserved Russia's rating at the level of BBB revising projection on rating from negative to stable.

3.4. Oil and Gas Sector

Oil and gas sector remains the backbone of the Russian economy and produces the lion's share of the state budget revenues and of the trade balance. Acute oil price fluctuations which took place on the free market, reduction in demand for gas, as well as objective fall in the oil and gas extraction in Russia, cuts in their production on the old existing oil deposits and significantly larger costs required for the development of the new deposits especially in the undeveloped regions which lack any type of infrastructure had main impact on its development in 2009.

3.4.1. Dynamics of the World Prices for Oil and Gas in 2008–2009

In 2009 the world prices for crude oil remained under the effect of the global financial and economic crisis. In 2008 world prices for crude oil reached an exceptionally high level which exceeded 100 USD/bbl. In July 2008 average monthly price for crude oil exceeded 130 USD/bbl and reached its historical maximum both in the nominal and real terms. As a result of slump of prices at the end of the year, average price for oil constituted 97.7 USD/bbl (Brent) in 2008. Comparable level of prices in real terms was noted only in 1979-1980 when the average annual price for Brent in real terms (2008 prices) soared to 94.1-96.6 USD/bbl under rated value of 31.6-36.8 USD/bbl. For comparison it is possible to note that in 1998 the average annual price for Brent in real terms (2008 prices) constituted only 17.3 USD/bbl (12.7 USD/bbl in rated value) and on average in 1990s – 26.9 USD/bbl.

Principal drivers for price growth were: incremental demand for petroleum due to high rate of growth of the world economy, in particular, of the economies of China, India and other countries of Asia, conservative policy of OPEC in relation to the increase of oil production by its member countries, as well as sluggish growth of oil production of non-OPEC producers. Serious factor which contributed to the increase of the world prices for crude oil was a considerable inflow of speculative capital in the futures markets. Profound effect on the dynamics of the oil production during recent years was produced by the fall of growth rates in the oil production in Russia and fall of production volumes from oil deposits in North Sea. In September-December 2008 slowdown of growth rates of the world economy, reduction in de-

mand for oil by the industrially developed countries and outflow of the investment capital from the futures markets determined a slump in the world oil prices (*Table 1*). According to the data provided by the International Energy Agency of OECD, in the fourth quarter 2008 reduction in demand for oil in the OECD countries reached 5.1% against the corresponding period of the preceding year (*Table 2*).

Amid sharp reduction in the world oil prices in the second half of 2008, OPEC took a number of decisions aimed at cutting petroleum production in order to preserve oil prices at the stable level. In September 2008 OPEC took a decision to stick to the oil production quota at the level of September 2007 adjusted by the incorporation of Angola and Ecuador to the cartel but without Iraq and Indonesia[1] which would have resulted in the cut of production volumes by 520 thousand barrels per day in comparison with July 2008. In October 2008 OPEC took a decision to further cut its production by 1.5 million barrels per day in relation to the level of September 2008 starting with November 2008. However, amid a reduction in demand for oil by the industrially developed countries and due to onset of the economic recession, as well as failure to fully meet commitments taken by the OPEC member countries regarding production cuts, these decisions failed to exert any influence on the free market. In December 2008 OPEC took a decision to cut production from 1 January 2009 by further 4.2 million barrels per day in relation to the level of September 2008.

In 2009 contraction in demand for crude oil by the industrial countries due to the global financial and economic crisis was compensated by the growth in demand by the developing countries, first of all by China[2], as well as by the production cuts by the OPEC member-states and by some other oil producing countries (Norway, Great Britain and Mexico). In the following months of the year positive effect on the dynamics of crude oil prices was produced by the recovery of economic growth posted by the leading industrially developed nations. As a result, world prices for crude oil went up from 40 USD/bbl in December 2008 to 73-77 USD/bbl in November-December 2009. In these circumstances at the conferences of OPEC which took place in March, May, September and December 2009 decisions were taken aimed at preserving production quotas for oil determined by the member-states and effective from 1 January 2009. In 2009 average price for Urals on the free market (European) averaged 61.0 in 2009 or 65% in relation to the average price level of the last year.

Table 1

World Prices for Oil in Nominal Terms in 2000–2009 (USD/bbl)

	2000	2001	2002	2003	2004	2005
Price for Brent, Great Britain	28.5	24.4	25.0	28.8	38.2	54.4
Price for Urals, Russia	26.6	23.0	23.7	27.0	34.5	50.8
OPEC reference basket of crudes	27.6	23.1	24.3	28.1	36.1	50.6

	2006	2007	2008 I quarter	2008 II quarter	2008 III quarter	2008 IV quarter	2008
Price for Brent, Great Britain	65.2	72.5	96.7	122.5	115.6	55.9	97.7
Price for Urals, Russia	61.2	69.4	93.3	117.5	113.2	54.1	94.5
OPEC reference basket of crudes	61.1	69.1	92.7	117.6	113.5	52.5	94.1

[1] Indonesia has recently become net exporter of crude oil. In 2008 Indonesia announced about its withdrawal from OPEC and from 2009 it is no longer a member of this organization.

[2] Crude oil consumption by China in 2009 went up by 7.2% in comparison with 2008

	2009 I quarter	2009 II quarter	2009 III quarter	2009 IV quarter	2009
Price for Brent, Great Britain	45.0	59.1	68.4	75.0	61.9
Price for Urals, Russia	43.7	58.1	68.0	74.3	61.0

Source: IMF, OECD/IEA, OPEC.

Table 2

World Petroleum Consumption in 2008 (in % to the same period a year ago)

	2008 I quarter	2008 II quarter	2008 III quarter	2008 IV quarter	2008
World – total	1.1	0.9	–0.5	–2.7	–0.3
OECD countries	–1.6	–1.8	–4.6	–5.1	–3.3
Of which:					
North America	–3.3	–3.6	–7.5	–5.9	–5.1
Europe	0.4	0.7	0.4	–1.6	0.0
APR	0.0	–0.6	–4.9	–8.9	–3.6
Countries outside OECD	4.7	4.4	4.7	0.4	3.6
Of which:					
Asia (exclusive of the countries of Middle East)	5.7	2.8	3.5	–1.5	2.6
	2009 quarter	**2009 II quarter**	**2009 III quarter**	**2009 IV quarter**	**2009**
World - total	–3.4	–2.5	–0.7	0.4	–1.5
OECD countries	–4.9	–6.2	–3.5	–3.0	–4.4
Of which:					
North America	–5.1	–6.2	–1.3	–2.4	–3.8
Europe	–2.5	–5.6	–6.8	–5.0	–5.0
APR	–8.6	–7.2	–3.5	–0.7	–5.1
Countries outside OECD	–1.4	1.8	2.7	4.7	2.0
Of which:					
Asia (exclusive of the countries of Middle East)	–1.3	4.6	6.1	9.2	4.6

Source: OECD/IEA.

Monthly dynamics of the world price for crude oil in 2008 was marked by its sustainable growth right down to July 2008 when the crude oil price maximum was reached and by a slump of prices starting from August 2008. By the end of the year the price for Russian crude oil on the free market dipped to 39.9 USD/bbl, i.e. it declined by more than threefold in relation to the July level. In 2009 monthly dynamics of the world oil price was defined by rather stable growth. At the same time, during last months of the year crude oil price steadily exceeded 70 USD/bbl (see *Table 3* and *Fig. 1*). Depreciation of the US dollar exchange rate in relation to other currencies affected the dynamics of crude oil prices.

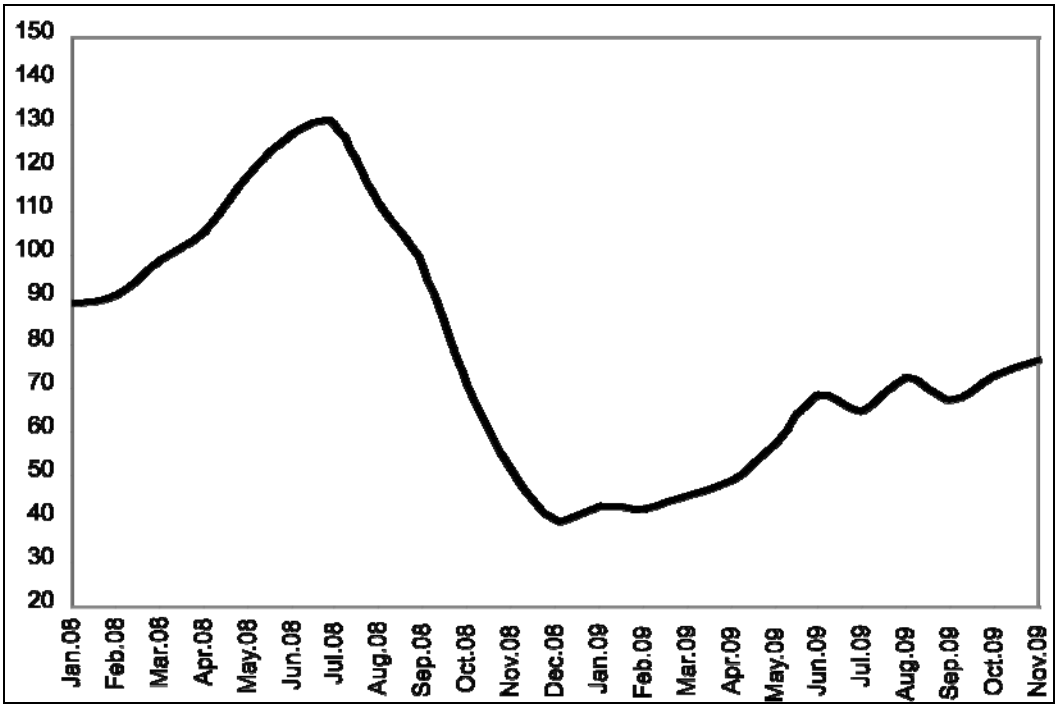
Revival of the world economy holds out a hope for maintaining of rather favorable for the Russian oil producers level of crude oil prices in the future. For instance, according to the latest IMF forecast the world crude oil price in 2010 will constitute on average 76.5 USD/bbl, and in 2011 – 82 USD/bbl. The US Department of Energy provides similar forecast. The RF Ministry of Economic Development and Trade is expecting a lower level of world crude oil prices (*Table 4*). Scenario with crude oil prices below 60 USD/bbl (conservative scenario) is considered, however, as less feasible one.

Table 3

World Prices for Crude Oil in 2008–2009 (USD/bbl)

	2008 January	2008 February	2008 March	2008 April	2008 May	2008 June
Price for Brent, Great Britain	92.0	95.0	103.7	109.0	122.7	132.4
Price for Urals, Russia	89.4	91.4	99.2	105.7	118.8	128.1
	2008 July	2008 August	2008 September	2008 October	2008 November	2008. December
Price for Brent, Great Britain	133.2	113.0	98.1	71.9	52.5	40.4
Price for Urals, Russia	130.1	111.9	97.5	70.8	51.5	39.9
	2009 January	**2009 February**	**2009 March**	**2009 April**	**2009 May**	**2009. June**
Price for Brent, Great Britain	43.6	43.1	46.5	50.3	57.5	68.6
Price for Urals, Russia	43.2	42.5	45.3	48.9	57.1	68.4
	2009 July	**2009 August**	**2009 September**	**2009 October**	**2009 November**	**2009 December**
Price for Brent, Great Britain	64.6	72.8	67.4	72.8	76.7	74.3
Price for Urals, Russia	64.6	72.2	67.2	72.7	76.3	73.9

Source: OECD/IEA.



Source: the RF Ministry of Economic Development and Trade.

Fig. 1. Price for Urals in 2008–2009 (USD/bbl)

Table 4

Forecasts of World Prices for Crude Oil (USD/bbl)

	Date of publication of forecast	2010	2011
IMF: average world price for crude oil	26.01.2010	76.5	82.0
US Department of Energy: average price for oil imported to the US	12.01.2010	76.9	80.5
RF Ministry of Economic Development and Trade: price for Urals	30.12.2009	69	74
		65	70
		58	59

Source: IMF, U.S.DOE/EIA, the RF Ministry of Economic Development and Trade.

Prices for Natural gas on the free market, as a rule, are determined on the basis of the alternative to gas energy products such as gasoil/diesel oil and heating oil, which price levels depend on the level of world oil prices. That is why world prices for natural gas follow the world oil prices with certain lag. Price for Russian gas on the European market and the oil price reached its peak in 2008 and in 2009 also dipped (*Table 5*).

Table 5

World Prices for Crude Oil and Natural Gas in 2002–2009

	2002	2003	2004	2005	2006	2007	2008	2009
Average world oil price, USD/bbl	24.5	28.89	37.76	53.4	64.3	71.1	97.0	61.8
Price for Russian gas on the European market, USD/thousand cubic meters	96.0	125.5	135.2	212.9	295.7	293.1	473.0	318.8

Source: IMF.

3.4.2. Dynamics and Structure of Production and Processing in the Oil and Gas Sector in 2008–2009 and during Preceding Period

Growth of oil production in Russia in the first half of 2000s was due to the extension of its export capacity, and in particular due to construction of the Baltic pipeline system and the use of the railway transport system, and to the intensification of the development of existing oil deposits and capital expenditure expansion by the oil companies due to growth of world oil prices. In the following years rates of growth of crude oil production declined sizably. Where in 2002-2004 increment in oil production reached 8.9-11% annually, then in 2006-2007 annual increment constituted only 2.1%, and in 2008 for the first time over recent years there was a cut in oil production. This is an obvious sign of depleted resources needed for production enhancement by means of intensification of development of existing oil deposits and indicates the need to undertake urgent measures at developing new oilfields.

In 2009 growth in oil production in Russia recovered, although its increment was relatively low: in relation to a year ago increment in crude oil production averaged 1.2% (*Table 6, 7*). Positive effect on the dynamics of the oil production was produced by several new large oil deposits which were put into operation (in the north of European part of Russia and in Eastern Siberia), devaluation of the exchange rate of the ruble and coming into effect of a number of amendments to the RF Tax Code designed to reduce tax burden in the oil sector, stimulation of enhanced development of existing oilfields and development of the new oil deposits.

In the first half of 2000s intensive growth of production (on average by about 9% of annual increment) against the background of sluggish growth of primary processing (about 3% annually on average) has resulted in reduction in the refined oil's share of its production volume (from 53.5 to 42.5%). On the contrary, in 2005-2008 rates of increment of primary oil refining constituted 3.2-6.2% annually under the rates of increment of oil production at 2.1-2.1% in 2005-2007 and its decline by 0.7% in 2008. As a result, the share of refined oil in its production volume went up from 42.5% in 2004 to 48.4% in 2008. The volume of refined oil somewhat dipped (by 0.4%) in 2009. At the same time, processing depth of the crude oil during recent years was growing exceptionally slowly and in 2009 constituted only 72%; meanwhile in the leading industrially developed countries it comes up to 90-95%. Effectiveness of oil refining and quality of oil products produced in Russia as before remains significantly lower the world level.

Table 6

Production and Processing of Crude Oil in the Russian Federation in 2000–2009

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Oil production including gas condensate, mln t	323.2	348.1	379.6	421.4	458.8	470.0	480.5	491.3	488.5	494.2
Primary oil refining, mln t	173	179	185	190	195	208	220	229.0	236.3	236.0
Share of oil refining in its production, %	53.5	51.4	48.7	45.1	42.5	44.3	45.8	46.6	48.4	47.8
Processing depth of oilstock, %	71	71	70	70	71	71.6	71.9	71.7	72.0	72.0

Source: Federal service of state statistics, RF Ministry of Energy.

Table 7

Production of Crude Oil, Oil Products and Natural Gas in 2000–2009 (in % to preceding year)

	2000	2001	2002	2003	2004
Crude oil, including gas condensate	106.0	107.7	109.0	111.0	108.9
Primary oil refining	102.7	103.2	103.3	102.7	102.6
Gasoline	103.6	100.6	104.9	101.2	103.8
Diesel oil	104.9	102.0	104.7	102.0	102.7
Heating oil	98.3	104.2	107.1	100.3	97.8
Natural gas	98.5	99.2	101.9	103.4	101.6
	2005	**2006**	**2007**	**2008**	**2009**
Oil, including gas condensate	102.2	102.1	102.1	99.3	101.2
Primary oil refining	106.2	105.7	103.8	103.2	99.6
Gasoline	104.8	107.4	102.1	101.8	100.5
Diesel oil	108.5	107.0	103.4	104.1	97.7
Heating oil	105.8	104.5	105.2	101.9	100.8
Natural gas	100.5	102.4	99.2	101.7	87.9

Source: Federal service of state statistics.

In 2009 Rosneft, LUKOil, TNK-BP, Surgutneftegas and Gazprom were the largest petroleum producers in the country. The share of these five companies constituted 77% of the overall oil production in Russia. The share of medium size companies (Tatneft, Slavneft, Russneft and Bashneft) amounted to 14.2% of the overall oil extraction. The share of other producers which number over 100 small oil producing organizations accounted for only 5.3% (*Table 8*).

Distinctive feature of the recent years was the increased role of state companies in the oil sector which was due to takeover of private companies. In 2004 Rosneft took over major oil producing enterprise of YUKOS – Yuganskneftegas, and in 2005 Gazprom bought control of the Sakhalin-2 project which was implemented by foreign investors under the production sharing agreement. In 2007 the share of state companies in the oil sector went up when Rosneft bought control of the remaining oil producing and oil refining assets of YUKOS, which was declared bankrupt in 2006.

As a result of redistribution of assets in the oil sector, Rosneft has become the largest oil company in Russia, and the share of state (in the federal ownership) companies in the overall oil production has come up to 32%. For comparison it is possible to note that in 2003 the share of Rosneft and Gazprom in the overall oil production amounted only to 7.3%

Table 8

Structure of Oil Production in 2007–2009

	Oil production in 2007, mln t	Share in overall production, %	Oil production in 2008, mln t	Share in overall production, %	Oil production in 2009, mln t	Share in overall production, %
Russia – total	491.3	100.0	488.5	100.0	494.2	100.0
Rosneft	110.7	22.5	113.8	23.3	116.3	23.5
LUKOil	91.4	18.6	90.2	18.5	92.2	18.7
TNK-BP	69.4	14.1	68.8	14.1	70.2	14.2
Surgutneftegas	64.5	13.1	61.7	12.6	59.6	12.1
Gazprom + Gazprom neft	45.8	9.3	43.4	8.9	41.9	8.5
Of which:						
Gazprom	13.2	2.7	12.7	2.6	12.0	2.4
Gazprom neft	32.6	6.6	30.7	6.3	29.9	6.1
Tatneft	25.7	5.2	26.1	5.3	26.1	5.3
Slavneft	20.9	4.3	19.6	4.0	18.9	3.8
Russneft	14.2	2.9	14.2	2.9	12.7	2.6
Bashneft	11.6	2.4	11.7	2.4	12.2	2.5
NOVATEK	2.6	0.5	2.7	0.6	3.3	0.7
PSA operators	13.8	2.8	12.0	2.5	14.8	3.0
Other producers	20.7	4.2	24.1	4.9	26.0	5.3
State companies total: Rosneft+ Gazprom+ Gazprom neft	156.5	31.9	157.2	32.2	158.2	32.0

Source: RF Ministry of Energy, author's calculations.

Gazprom has traditionally dominated in the field of gas production. At the same time, as long as decline in gas production was mainly due to Gazprom, its share in the overall gas production dipped to 77.5% in 2009 (*Table 9*). In such a case proportion of oil companies in gas production went up (to 10.6%), of NOVATEK (to 5.5%) and PSA operators (to 3.1%).

Table 9

Structure of Gas Production in 2007–2009

	Gas production in 2007, bn cubic meters	Share in overall production, %	Gas production in 2008, bn cubic meters	Share in overall production, %	Gas production in 2009, bn cubic meters	Share in overall production, %
Russia – total	654.1	100.0	664.9	100.0	596.4	100.0
Gazprom + Gazprom neft	551.9	84.4	553.1	83.2	466.6	78.2
Of which:						
Gazprom	550.1	84.1	550.9	82.9	462.3	77.5
Oil companies	56.9	8.7	54.8	8.2	63.5	10.6
NOVATEK	28.5	4.4	30.8	4.6	32.8	5.5
PSA operators	6.7	1.0	8.5	1.3	18.3	3.1
Other producers	10.1	1.5	17.6	2.6	15.2	2.5
State companies – total: Rosneft + Gazprom + Gazprom neft	568.9	87.0	566.1	85.1	484.0	81.2

Source: RF Ministry of Energy, author's calculations.

Reduction in the growth rates of crude oil production is due to first of all objective deterioration of its production conditions. Considerable part of producing fields have reached the stage of declining production (brown fields), and the new oil deposits in the majority of cases are marked by worse mining-and-geological and geographic parameters, their development requires excessive capital, maintenance and transportation costs.

Sharp cut in gas production in 2009 (by 12.1% in comparison with preceding year) was due to a reduction in domestic and foreign demand (due to economic recession and relatively

warm weather conditions), as well as to forced cut in gas supplies to Europe at the beginning of 2009 due to conflict with Ukraine. In January-November 2009 export of natural gas dipped by 19.1% in relation to the corresponding period of the preceding year (at the same time gas supplies outside of CIS dipped by 27.7%).

3.4.3. Dynamics and Structure of Petroleum and Gas Export

Against the backdrop of oil production decline in 2008 there was a somewhat cut in crude oil export volume, however, growth of oil export resumed in 2009 (*Table 10*).In 2009 net export of crude oil and petroleum products amounted to 370.1 mln t or went up by 3.45 in comparison with preceding year. The proportion of net export of crude oil and petroleum products in the overall oil production came to 74.9%. Net export of crude oil in 2009 constituted 49.8% of its production volume. The share of export in fuel oil production in January-November 2009 amounted to 81.5%, diesel oil – 59.0%, gasoline – 12.9% (for comparison: in 1999 the share of export in gasoline production constituted 7.2% and in 2005 – 18.5%, in 2006 – 18.3%, in 2007 – 17.1% and in 2008 – 12.5%).

In 2009 a decline in import of petroleum products was observed, the share of import for coverage of domestic demand also dipped. In 2009 the share of import in gasoline stock constituted only 0.5% (for comparison: in the first half of 1998 proportion of import in gasoline stock amounted to 8.7%, in 2008 – 0.7%). For diesel oil and fuel oil this indicator amounted to 0.3-0.4%.

Table 10

Export of Crude Oil, Petroleum Products and Natural Gas from Russia in 2002–2009 (in % to preceding year)

	2002	2003	2004	2005	2006	2007	2008	2009 11 months
Oil – total	113.9	117.8	115.0	98.4	98.0	104.0	94.0	102.0
Of which:								
Countries outside CIS	109.9	118.9	116.3	99.1	98.0	104.8	92.6	103.3
To CIS countries	137.3	112.4	108.3	94.9	98.0	99.4	102.6	94.8
Petroleum products – total	118.5	103.6	105.5	117.9	106.3	108.0	105.0	105.4
Of which:								
Countries outside CIS	119.1	102.6	104.9	119.1	104.5	107.6	102.0	107.4
To CIS countries	102.8	132.3	117.9	94.6	148.8	115.3	152.2	85.2
Gas –total	102.4	102.0	105.5	103.7	97.6	94.6	101.8	80.9

Source: Federal service of state statistics.

In 2009 in spite of the reduction in demand for crude oil in Europe due to economic recession, Russia managed to increase its volume of oil export in natural terms. This was due to a fall in oil supplies by some other petroleum producers – Norway, Great Britain, the OPEC countries. In Norway and Great Britain this was due to objective fall of oil production as a result of depletion of producing fields, in the OPEC countries – accomplishment of commitments taken by cartel aimed to reduce petroleum production volumes by the cartel member countries.

At the same time, in 2009 gas export volume sharply dipped. In January-November 2009 gas export shrank by 19.1% compared to the corresponding period of the previous year due to considerable reduction in supplies to Europe. As a result, proportion of net export in gas production fell from 28.3% to 25.3% in 2009.

Table 11

Ratio of Production, Consumption and Export of Petroleum and Natural Gas in 2000–2009

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009 (estimate)
Oil, mln t										
Production	323.2	348.1	379.6	421.4	458.8	470.0	480.5	491.3	488.5	494.2
Export – total	144.5	159.7	187.5	223.5	257.4	252.5	248.4	258.4	243.1	248.0
Export to countries outside CIS	127.6	137.1	154.8	186.4	217.3	214.4	211.2	221.3	204.9	211.7
Export to CIS countries	16.9	22.7	32.7	37.1	40.1	38.0	37.3	37.1	38.2	36.3
Net export	138.7	154.7	181.3	213.4	253.2	250.1	246.1	255.7	240.6	246.2
Domestic consumption	123.0	122.9	123.5	129.8	124.2	123.1	131.2	124.1	130.4	124.1
Net export in % to production	42.9	44.4	47.8	50.6	55.2	53.2	51.2	52.0	49.3	49.8
Petroleum products, mln t										
Export – total	61.9	70.8	75.0	78.4	82.1	97.0	103.5	111.8	117.9	124.3
Export to countries outside CIS	58.4	68.3	72.5	74.9	78.0	93.1	97.7	105.1	107.6	115.6
Export to CIS countries	3.5	2.5	2.6	3.5	4.1	3.9	5.8	6.7	10.3	8.7
Net export	61.5	70.5	74.8	78.2	81.4	96.8	103.2	111.5	117.5	123.9
Oil and petroleum products, mln y										
Net export of crude and oil products	200.2	225.2	256.1	291.6	334.6	346.9	349.3	367.2	358.1	370.1
Net export of crude and oil products in % to oil production	61.9	64.7	67.5	69.2	72.9	73.8	72.7	74.7	73.3	74.9
Natural gas, bln cubic meters										
Production	584.2	581.5	594.5	620.3	634.0	636.0	656.2	654.1	664.9	596.4
Export – total	193.8	180.9	185.5	189.3	200.4	207.3	202.8	191.9	195.4	158.1
Export to countries outside CIS	133.8	131.9	134.2	142.0	145.3	159.8	161.8	154.4	158.4	114.5
Export to CIS countries	60.0	48.9	51.3	47.3	55.1	47.5	41.0	37.5	37.0	43.6
Net export	189.7	176.8	178.3	180.5	193.5	199.6	195.3	184.5	187.9	150.6
Domestic consumption	394.5	404.7	416.2	439.8	440.5	436.4	460.9	469.6	477.0	445.8
Net export in % to production volume	32.5	30.4	30.0	29.1	30.5	31.4	29.8	28.2	28.3	25.3

Source: Federal service of state statistics, RF Ministry of Energy, Federal Customs Service, author's calculations.

Amid somewhat increase in the share of oil products, export of crude oil still prevailed in the structure of petroleum export and was accounted in 2009 for 66.5% of the overall export of oil and petroleum products. Fuel oil which is used in Europe for further processing and diesel oil constituted major share in the export of petroleum products. Major proportion of energy resources (in 2009 – 85% of oil, 93% of petroleum products and 72% of gas) was exported to non-CIS countries.

Table 12

Net Export of Petroleum Products in 2002–2009

	2002	2003	2004	2005	2006	2007	2008	2009 (estimate)
Net export of petroleum products, mln t	74.8	78.2	81.4	96.8	103.2	111.5	117.5	123.9
Share of petroleum products in net export of oil and oil products, %	29.2	26.8	24.3	27.9	29.5	30.4	32.8	33.5

Source: Federal service of state statistics, Federal Customs Service, author's calculations.

Analysis of dynamics of Russia's oil export over a prolonged time interval indicates increase in the share of petroleum products, which proportion went up from 18.2% to 33.5% in 2009 (*Table 12*). Amid drastic reduction in domestic petroleum consumption (according to our calculations, it slumped from 269.9 mln t in 1990 to 124.1 mln t in 2009, i.e. more than

twofold) proportion of net export of oil and petroleum products in the oil production went up during this time interval from 47.7% to 74.9%.

Represented data bear record to a significant strengthening of export orientation of the oil and gas sector in comparison with the pre-reform period. However, one should bear in mind that it is due not only to the increase in absolute export volumes, but to a significant contraction in domestic demand for oil resulting from the market oriented reforms implemented in the Russian economy. During the year preceding the global financial and economic crisis of 2008-2009, amid fast economic growth volumes of domestic oil consumption were sufficiently stable which speaks for a reduction in the oil intensity of Russia's GDP.

In 2008 the rise of world prices for crude oil determined appreciable income growth recorded in the oil and gas sector (*Fig, 2, 3*). Ultimate proceeds from export of oil and major types of petroleum products (gasoline, diesel oil and fuel oil) in 2008 came to USD 228.9 bn, which by 38.8% exceeds the volume of earnings from export of oil and oil products recorded in 2007 and represents an all-time high level for the entire post-reform period (*Table 13*). For comparison it is possible to note that the minimal level of receivables from export of oil was observed amid slump of world prices for crude oil observed in 1998, when export receipts constitute only USD 14 bn.

Table 13

Proceeds from Export of Oil and Oil Products in 2000–2009 (USD/bn)

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009 11 months
Proceeds from export of oil and major types of oil products	34.9	33.4	38.7	51.1	74.6	112.4	140.0	164.9	228.9	126.0

Source: calculated on the data provide by the Federal service of state statistics.

In 2009 a lower level of world prices for crude oil by contrast to the preceding year determined sizable contraction in export revenues. Ultimate proceeds from export of crude oil and oil products (gasoline, diesel oil and fuel oil) in January-November 2009 came to USD 129 bn or to 58% vis-à-vis the corresponding period of last year (*Table 14*).

Table 14

Receipts from Export of Oil and Oil Products in 2008–2009 (USD/ bn)

	2008 I quarter	2008 II quarter	2008 III quarter	2008 IV quarter	2009 I quarter	2009 II quarter	2009 III quarter	2009 October-November
Receipts from export of oil and major types of oil products	53.2	64.4	68.9	42.4	25.6	30.6	39.2	30.6

Source: calculated on the data of Federal service of state statistics.

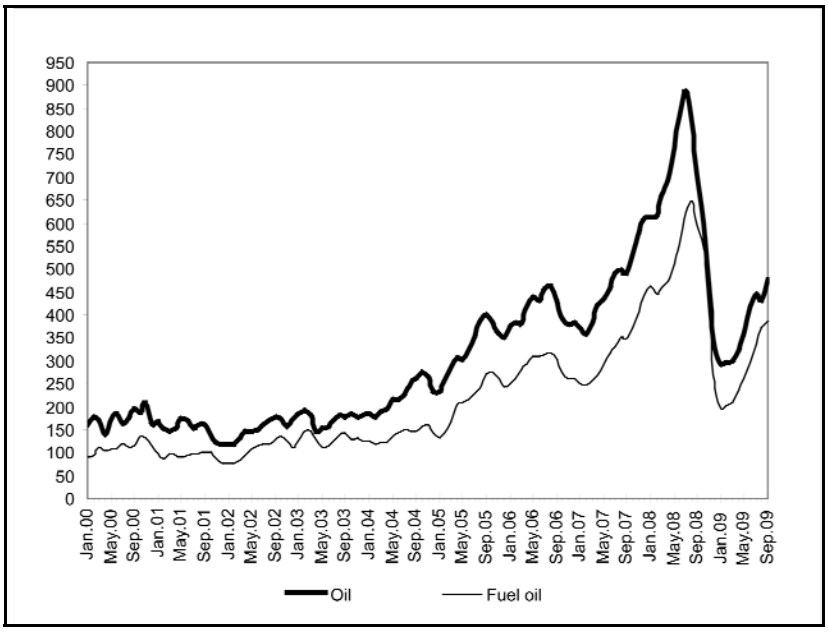
Table 15

Value and Proportion of Export of Fuel and Energy Commodities in 2005–2009

	2005		2006		2007		2008		2009	
	USD bn	%*	USD bn	%*	USD bn	%*	USD bn	%*	USD bn	%*
Fuel and energy commodities – total	154.7	64.1	196.9	65.4	225.6	64.0	321.1	68.6	201.1	66.7
Of which:										
Oil	83.8	34.7	102.3	34.0	121.4	34.4	161.2	34.4	100.6	33.3
Natural gas	31.4	13.0	43.9	14.6	44.8	12.7	69.1	14.8	42.0	13.9

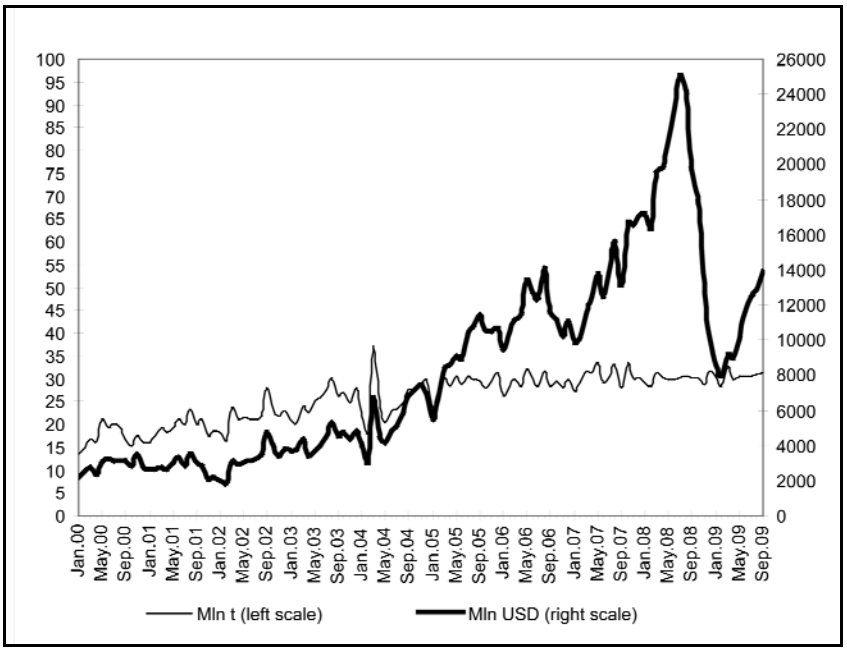
***** In % to overall volume of Russia's export.

Source: Federal service of state statistics.



Source: calculated on the data of Federal service of state statistics.

Fig. 2. Average Prices of Export of Oil and Fuel Oil in 2000–2009 (USD/t)



Source: calculated on the data of Federal service of state statistics.

Fig. 3. Export of Oil and Oil Products in Physical and Value Terms in 2000-2009 (mln t, USD mln)

Under the impact of the rise of world prices for crude oil and natural gas, the share of fuel and energy commodities in Russia's export in 2008 accounted to 68.6%, of which crude oil represented 34.4% (*Table 15*). In 2009 the share of fuel and energy commodities in Russia's

export somewhat declined, however remained high as before (66.7% of which crude oil – 33.7%).

3.4.4. Dynamics of Prices for Energy Commodities on Domestic Market

In 2008 in response to the growth of world oil prices notable increase in prices for oil and oil products on the domestic market was observed. In summer 2008 producers' prices on oil, gasoline, diesel oil and fuel oil reached record high values for the entire after-reform period. In July 2008 average domestic price for oil (producer's price) in dollar terms reached 410.2 USD/t, and average price of gasoline – 810.3 USD/t. In September-December 2008 in response to a decline in world oil prices and the devaluation of the ruble exchange rate, a slump in domestic prices for oil and oil products (producers' price) in dollar terms was observed. However, in 2009 in response to the rise of world oil prices, they greatly resurged and exceeded the level of the end of 2008. (*Table 16, Fig. 4,5*). At the same time, domestic prices for oil in Russia as before remain notably lower than the world oil price level. Price gap between world and domestic oil prices is due to the export customs duty and additional transportation costs of export. Oil price on the domestic free market (market's segment where oil is sold not by transfer prices) during recent years actually is formed on the basis of its free market price with the deduction of export customs duty and export costs.

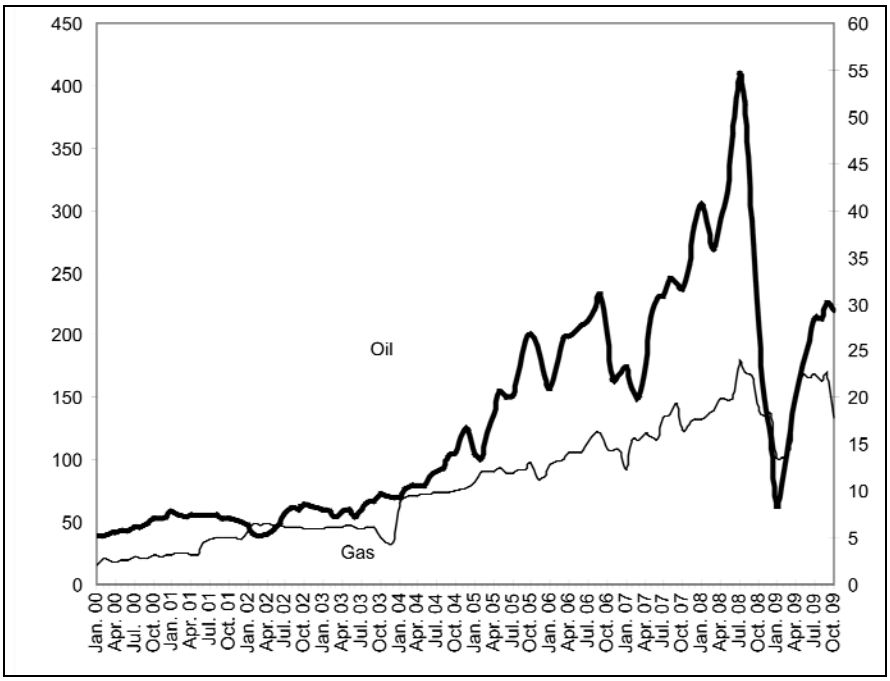
Table 16

Domestic Prices for Oil, Oil Products and Natural Gas in USD Terms in 2000–2009 (average producers' prices, USD/t)

	2000 December	2001 December	2002 December	2003 December	2004 December	2005 December
Crude oil	54.9	49.9	60.7	70.1	123.5	167.2
Gasoline	199.3	151.5	168.8	236.9	333.1	318.2
Diesel oil	185.0	158.5	153.8	214.3	364.3	417.0
Fuel oil	79.7	47.1	66.1	66.0	69.4	142.7
Gas, USD/thousand cubic meters	3.1	4.8	5.9	4.4	10.5	11.5
	2006 December	**2007 June**	**2007 December**	**2008 June**	**2008 July**	**2008 December**
Crude oil	168.4	230.3	288.2	360.4	410.2	114.9
Gasoline	416.5	491.7	581.2	763.6	810.3	305.1
Diesel oil	426.1	442.0	692.5	850.7	902.8	346.5
Fuel oil	148.8	181.6	276.5	337.2	392.8	125.0
Gas, USD/thousand cubic meters	14.4	15.6	17.6	20.0	23.8	18.1
	2009 January	**2009 March**	**2009 June**	**2009 September**	**2009 October**	**2009 December**
Crude oil	62.2	122.9	194.7	225.9	219.5	219.3
Gasoline	244.3	318.8	481.5	593.2	576.2	457.4
Diesel oil	306.2	343.1	382.1	388.2	380.6	394.8
Fuel oil	107.2	145.9	210.8	265.8	257.6	250.8
Gas, USD/thousand cubic meters					17.9	16.9

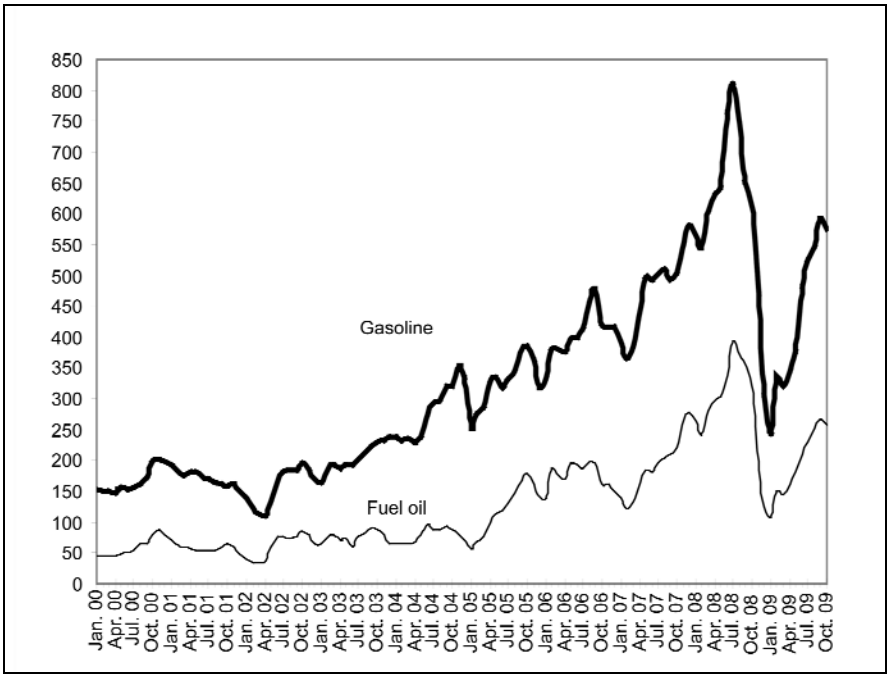
Source: calculated on the data provided by the Federal service of state statistics.

So far domestic prices for gas remain under the government control. In the coming years gradual rise of domestic prices for gas to the level which ensures profitability of its marketing on domestic and on external markets has been envisaged. Price gap between the world and domestic prices for gas in this case will reduce; however, domestic prices for gas will remain below the world level (the difference is equal to export customs duty and transportation costs for export).



Source: calculated on the data provided by the Federal service of state statistics.

Fig. 4. Average Producers' Prices for Crude Oil and Natural Gas in USD Terms in 2000–2009 (USD/t – left scale, USD/thousand cubic meters- right scale)



Source: calculated on the data of Federal service of state statistics.

Fig. 5. Average Producers' Prices for Gasoline and Fuel Oil in USD Terms in 2000–2009 (USD/t)

3.4.5. Features of Tax Regulation in Oil and Gas Sector in the Wake of the Crisis

Some amendments to the RF Tax Code came into effect in 2009. They were directed at the reduction in tax burden on the oil sector and stimulation of crude production. Tax system based on the unified specific oil extraction tax which was effective since 2002 did not take into consideration real differences which existed in the conditions of oil extraction due to mining-and-geological features of oil deposits, their location, as well as the stage of their production. As a result, the oil extraction economic effectiveness deteriorated regarding the high-cost deposits, termination of production ahead of schedule. At the same time, commissioning of the new high-cost oilfields was getting more difficult. It was especially true of undeveloped regions with lacking infrastructure.

Drawbacks inherent to the unified rate for oil extraction tax have determined the search for scenarios with different tax rates depending on mining-and-geological conditions which specify real conditions for oil extraction. The tax system was amended with new elements since 2007:

1. Rate-reducing coefficient for depleted deposits at over 80% has been introduced. Coefficient is calculated on the basis of the formula and changes from 1 (under depletion at 0.8) to 0.3 (under depletion at 1 and more)

2. For the new oil deposits of the Eastern Siberia oil and gas province on the territory of the Republic of Sakha (Yakutia), Irkutsk oblast and Krasnoyarsk Krai tax holidays for the oil extraction tax have been applied. For this type of oil deposits zero oil extraction tax rate has been fixed before oil extraction volume reaches the volume of 25 mln t at the subsoil block on condition that the development timeline does not exceed 10 years or during 10 years in case of licenses for the right to use subsurface mineral resources both for geological study (prospecting and exploration) and production from the date of state registration of the license.

3. Zero oil extraction tax rate has been determined for deposits with super heavy crude oil.

Adopted amendments were aimed at stimulating development of depleted and new oil deposits. Differentiation of oil extraction tax with the account of the level of depleted resources allows extending development timeline of depleted deposits and ensures additional revenues both from oil extraction tax (levied at the reduced rate) and from other types of taxes (profit tax, export duties, etc.). Reduction in the rate for the oil extraction tax in case of new oil deposits in the Eastern Siberia oil and gas province has allowed stimulating the development of the deposits of this region.

At the same time, adopted amendments envisaged that the benefits with respect to oil extraction tax for the new and depleted oil deposits can be obtained solely in case of application of the direct metering method (accounting) of the oil production volume at the subsoil block. In case of the depleted deposits this provision notably restricted the sphere of application of tax benefits due to the fact that there is no direct metering of oil production on the majority of these oilfields (license blocks). As a result, application of this benefit has a very limited character, i.e. the task of stimulating and extending the development of depleted deposits has found a very limited solution.

Adopted amendments have not found a full solution for the tax stimulation of the development of new high-cost deposits which do not belong to Eastern Siberia oil and gas province, i.e. located in other regions and on the continental shelf. In the majority of cases the new Russian oil deposits are characterized by negative mining-and-geological and geographic parameters. Their development requires higher capital investment, maintenance and transporta-

tion costs. At the same time, current tax system failed to ensure necessary reduction in tax burden for the development of such deposits which held back investments in the new projects. Commissioning of the new high-cost oil deposits especially in the undeveloped regions with undeveloped or lacking infrastructure required improvement of the current tax system, and the implementation of special tax policy ensuring required incentives for the investment into oil production.

In 2008 in order to stabilize oil production amendments into the RF Tax Code were developed and adopted. These amendments were aimed at the reduction of tax burden on the oil sector, stimulation of enhanced development of operating deposits and development of the new ones in undeveloped regions and on the continental shelf. These amendments entered into force from 1 January 2009. From the point of view of impact on the oil production economic effectiveness the following ones are the most important:

1. Depletion coefficient Кц formula which reflects dynamics of the world oil prices and is applied to the base rate of the oil extraction tax, the exemption minimum has been raised from 9 USD/bbl to 15 USD/bbl (*Table 17*). Such modification of the depletion coefficient formula has resulted in a sizable reduction in the oil extraction tax rate. In the heat of 2009 reduction in the oil extraction tax rate by means of formula modification constituted about 12%. This reduction in the uniform oil extraction tax rate cuts tax burden on the oil sector and allows oil companies to get more revenues, increases investment yield from the development of new deposits, stimulate more enhanced development of depleted deposits.

Table 17

Oil Extraction Tax Rate in 2002–2009

	2002	2003	2004	2005	2006	2007	2008	2009
Basic rate of oil extraction tax Rb/t	340	340	347	419	419	419	419	The formula 419
Coefficient of world price dynamics (Кц)	(Ц-8)хР/252				(Ц-9)хР/261			(Ц-15)хР/261

Note. Ц – average for the tax period price level for Urals in USD/bbl; Р – average for the tax period USD exchange rate to the Ruble determined by the Central Bank of the Russian Federation.
Source: RF Tax Code, Federal law № 151-FZ of 27 July 2006, Federal law № 33-FZ of 07 May 2004, Federal law № 126-FZ of 08 August 2001.

2. Requirement to apply direct metering method for oil production on specific subsoil block has been removed in case of set oil extraction tax benefits on deposits with high depletion level and on the deposits located in Eastern Siberia oil and gas province (within borders of the Republic of Sakha (Yakutia), Irkutsk oblast and Krasnoyarsky Krai. Applicability of existing benefits regarding oil extraction tax, first of all rate-reducing coefficient for depleted deposits, were significanty restricted by the requirement to use the direct metering method for extracted volume of oil. Due to the fact that implementation of technical undertakings to secure direct metering method of oil extraction on the depleted deposits in the majority of cases was economically inefficient, this did not allow applying existing tax benefits and led to untimely closure of production and subsequent loss of crude

Application of benefits for oil extraction tax on the basis of current metering system of oil production for separate subsoil blocks allows spreading these benefits to all depleted oil deposits which will ensure extension of their production period, supplementary oil extraction and extra tax receipts.

This also allows securing application of oil extraction tax benefit (tax holidays) for the new small fields located in the Eastern Siberia oil and gas province and other regions entitled to

the benefits. Implementation of direct metering of oil production on such oil fields is economically inefficient and in the event of the absence of such oil extraction tax benefit they will remain untouched.

At the same time, it should be noted that where the current metering method of oil production is implemented, oil companies tend to maximize the volume of produced crude oil by means of manipulation (distorting accounting) when distributing the volume of produced oil across separate license blocks. In this connection, government authorities face a daunting task to establish rigorous control over reliability of such data

3. For the fields located in Nenetz autonomous okrug (north of Timano-Pechora oil and gas province) and the Yamal peninsula in Yamalo-Nenetz autonomous okrug, zero oil extraction tax rate is fixed for the production period up to the accumulated volume of oil extraction reaches 15 mln t on the subsoil block or for the time interval of 7 years for the licenses for the right to use the subsoil resources for the purposes of exploration and production or for the period of 12 years in case of the licenses for the right to use natural resources simultaneously for geological prospecting (study and exploration) and production of natural resources staring from the date of state registration of corresponding license. For the subsoil blocks located there, licenses for the right to use subsurface mineral resources were issued prior to 1 January 2009 and the level of depletion does not exceed 0.05 zero oil extraction tax rate is effective up to the moment when accumulated volume of oil extraction reaches 15 mln t or during 7 years starting with 1 January 2009.

4. For the RF continental shelf oil fields located to the north of the Northern Pole zero oil extraction tax rate has been determined for the period up to the moment when accumulated volume of oil extraction reaches 35 mln t or for the time interval of 10 or 15 years starting with the date of state registration of the license depending on the type of the license for the right to use subsurface mineral resources. For the subsoil blocks located there, licenses for the right to use subsurface mineral resources were issued prior to 1 January 2009 and the level of depletion does not exceed 0.05 zero oil extraction tax rate is effective up to the moment when accumulated volume of oil extraction reaches 35 mln t or during 10 years starting with 1 January 2009.

5. For the field located in the Sea of Azov and in the Caspian Sea zero oil extraction tax rate has been determined for the period prior to the moment when accumulated volume of oil production reaches 10 mln t or for the time interval of 7 or 12 years starting from the date of state registration of the license depending on the type of the license for the right to use subsurface mineral resources. For the subsoil blocks located there, licenses for the right to use subsurface mineral resources were issued prior to 1 January 2009 and the level of depletion does not exceed 0.05 zero oil extraction tax rate is effective up to the moment when accumulated volume of oil extraction reaches 10 mln t or during 7 years starting with 1 January 2009.

In order to provide additional incentives for the development of Eastern Siberian oil fields the government has determined zero export customs duty rates effective from 1 December 2009. It is envisaged that these rates will be effective only a limited period of time. Furthermore, amendments to the RF Tax Code have been developed regarding tax holidays for the oil extraction tax effective for the deposits located in the Black Sea and Okhotsk Sea (for the Black Sea fields – up to 20 mln t of accumulated volume of oil production or for the period of 10 or 15 years depending on the type of the license for the right to use subsoil mineral resources; for the Okhotsk fields up the 30 mln t of accumulated volume of oil production or for the period of 10 or 15 years).

Gradual reduction of the tax burden effective for specific regions is characterized by excessive costs required for the development within the framework of the current tax system seems to be justified because it allows ensuring required investment yield in the development of the new deposits. At the same time, the mechanism of tax holidays which is rather simple from the tax administration point of view is rather imperfect. All deposits of specific region (shelf) are subject to a unified averaged approach which does not account differences in characteristics and costs required for the development of certain field of the given region.

Moreover, on the relatively small oil fields oil production under regular development rate during tax holidays will remain sizably below the determined production limit, tax holidays create incentives for the rapid development aimed at exempting from taxation the maximum volumes of oil production. It may result in the contraction of tax revenues and in the fall of the quality of final oil extraction. .

The problem of development of small fields remains unsolved. As a rule, their development is connected with high production costs per a ton of crude oil. In the new regions benefits for the oil extraction tax effective for small fields in many cases remain insufficient, and in case of old oil producing regions benefits for small fields are not envisaged.

Ad valorem rate for the oil extraction tax is a more flexible tax tool as compared with the specific tax rate. Crude oil price at its production site, in other words, oil sale price minus transportation costs represents the tax base in case of ad valorem rate for the oil extraction tax. This allows to directly account at the time of taxation differences in transportation costs determined by geographic location (as well as difference in sale price determined by the quality of oil and supply routs). High transportation costs represent one of the important factors leading to cost increase of deposits development in promising regions (for instance, in Eastern Siberia). Furthermore, growth of Transneft's tariffs in this case is offset for the oil producers by a reduction in tax payments because transportation costs are removed from the tax base.

In case of ad valorem rate to the oil extraction tax needed to preserve progressive dependence of tax burden on the oil price there should be progressive dependence of tax rate on the price for Urals. In this case, on the one hand, tax burden in relative terms will be growing together with the oil price; on the other hand, advantage of the ad valorem rate will be effective. At the same time, it is necessary to determine reduced rates for the oil extraction tax in case of the new production regions and for the small oil fields in order to take into account higher capital and production costs for taxation purposes.

Additional profits tax (APT) represents a better form of oil production taxation. Due to the fact that all mining-and-geological and geographic parameters of the oil field finally tell on the obtained profit volume, such an approach ensures automatic differentiation of tax burden depending on specific conditions of oil production. Under such approach not only gross revenue is taken into account but production costs on a specific field as well. As a result, there are no economic barriers for the development of oil fields with high capital, production and transportation costs.

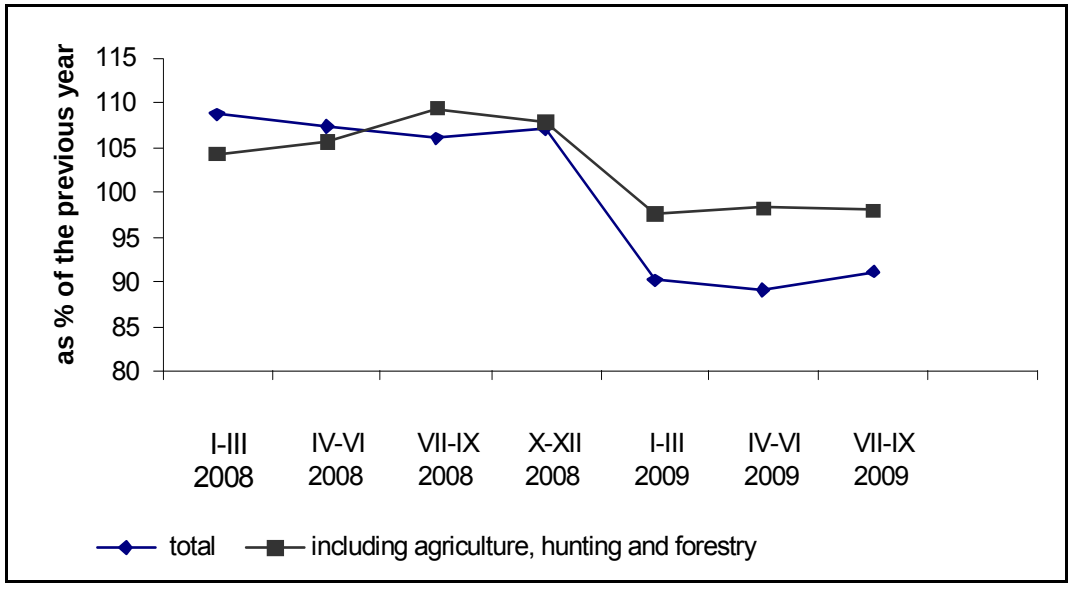
Additional profits tax (APT) has a number of advantages vis-à-vis oil extraction tax. In contrast with the oil extraction tax, APT is based on the additional incomes indicators and P-factor which objectively reflect actual economic efficiency of specific oil field development. In the even of highly profitable projects the use of APT will ensure progressive resource rent extraction for the state budget. Simultaneously, conditions for the implementation of low profit projects are improved.

Use of APT for the new fields will ensure automatic bringing of tax burden in line with the development conditions of specific deposits. Application of such tax regime will allow creating necessary conditions for the development of new oil fields with excessive capital investments, high production and transportation costs.

3.5. Russian agrifood sector: performance and trends in the crisis period

3.5.1. General outline of agricultural performance

Due to its specifics agriculture is very inert and cannot promptly respond to the changing environment. As a result the signs of crisis appear therein later and the after-crisis recovery goes slower than in other sectors of the economy. Some sub-sectors may need years to restore. The diagram (*Fig. 1*) shows that as different from the economy at large the GDP in agriculture, hunting and forestry continued growing till the third quarter of 2008. Beginning from the fourth quarter a sharp drop took place in all sectors but in agriculture it was not so deep – 2% versus the general 10%.



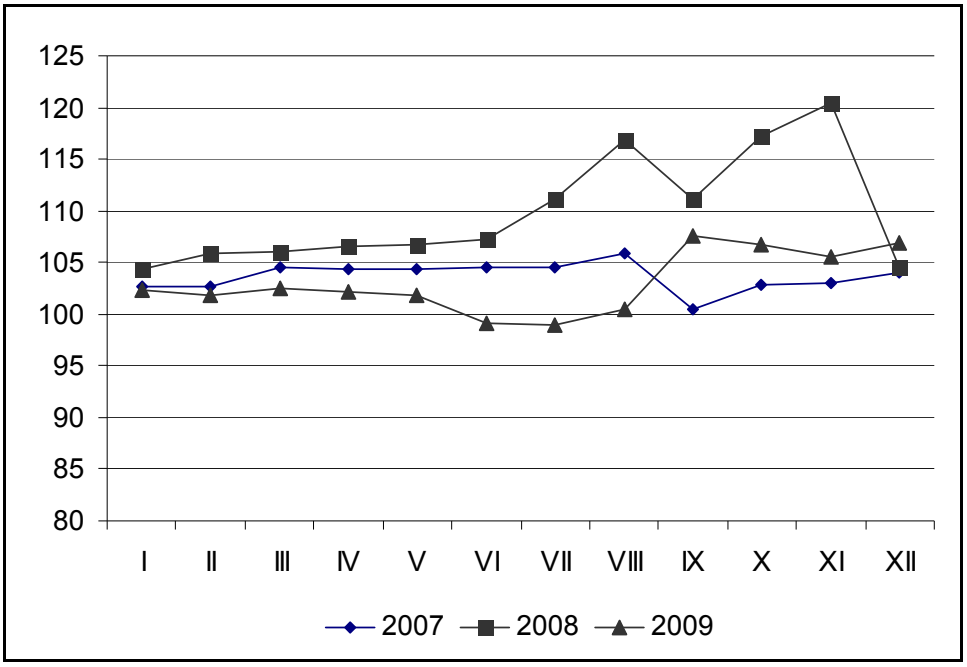
Source: Rosstat, http://www.gks.ru/bgd/free/B09_00/IssWWW.exe/Stg/d12/2-1.htm

Fig. 1. Gross domestic product in market prices, as percent of the previous year

Crisis developments in the Russian economy could well be observed in the second half of 2008 but the farm sector's annual performance was then better than in 2007. 2008 was recognized as one of the most successful years in terms of agricultural production beginning from the 1990s. Despite the lowering of grain prices in 2008, a good basis for 2009 crop was laid in autumn: the winter grain acreage expanded by 5% as compared with 2007, the share of lands fertilized with organic and mineral fertilizers increased up to 6.2% and 44% of the total planted area, respectively. Still, the area of under-winter plowing decreased by 2% conditioning smaller spring crop acreage in 2009.

From November 2008 agricultural production started to demonstrate a downward trend (*Fig. 2*) and fell to its lowest level in August 2009. The good crop harvested in September 2009 reverted this trend: in the fourth quarter of 2009 the increase of production exceeded

6%. This helped to finish the year with 1.2% increase over the 2008 indicators (in 2008 the annual production increase amounted to 10.8%).



Source: Rosstat.

Fig. 2. Agricultural production in the pre-crisis and crisis periods
(as percent of the corresponding period previous year)

2009 was not favourable in terms of weather conditions. This factor can account for the lowering of yields (from 1% for sunflower seeds to 12% for corn) of all major agricultural crops in corporate farms. The growth of gross output of vegetables was provided entirely by household plots whose increase of production exceeded the respective decline in corporate and individual private farms. Larger output of potatoes was also mostly due to the expansion of household production (*Table 1*).

Table 2

Gross output of basic crops, million tons

	Annual average			2005	2008	2009
	1986-1990	1991-1995	1996-2000			
Grain (weight after primary processing)	104.3	87.9	65.2	78.2	108.2	97.0
Potatoes	35.9	36.8	34.5	37.3	28.9	31.1
Vegetables	11.2	10.2	11.4	15.2	13.0	13.4
Sunflower seeds	3.1	3.1	3.3	6.4	7.3	6.4
Sugar beets	33.2	21.7	14	21.4	29.0	24.8

Source: Rosstat.

The above data show that the output of crops whose production is concentrated in corporate and individual private farms has slightly fallen while the output of crops produced primarily by household plots has increased. The latter growth should not inspire much optimism since as different from data about the output of corporate and individual private farms there is no statistical information about the actual output of households. Statistical agencies estimate

their output by means of carrying out sample surveys in a limited number of household farms and then extrapolating these data to 29 million of such farms. In this case a minor increment of potato and vegetable productivity or area planted (sometimes by less than 0.01 hectares) in surveyed farms transforms into a great increase when extrapolated to the whole country.

In spite of the crisis the dynamics of livestock production in 2009 remained positive (*Table 2*). The data on output of meat in slaughter weight is lacking but according to estimates in 2008 it was about 5.96 million tons, in 2009 – not less than 6.35 million tons.

Table 3

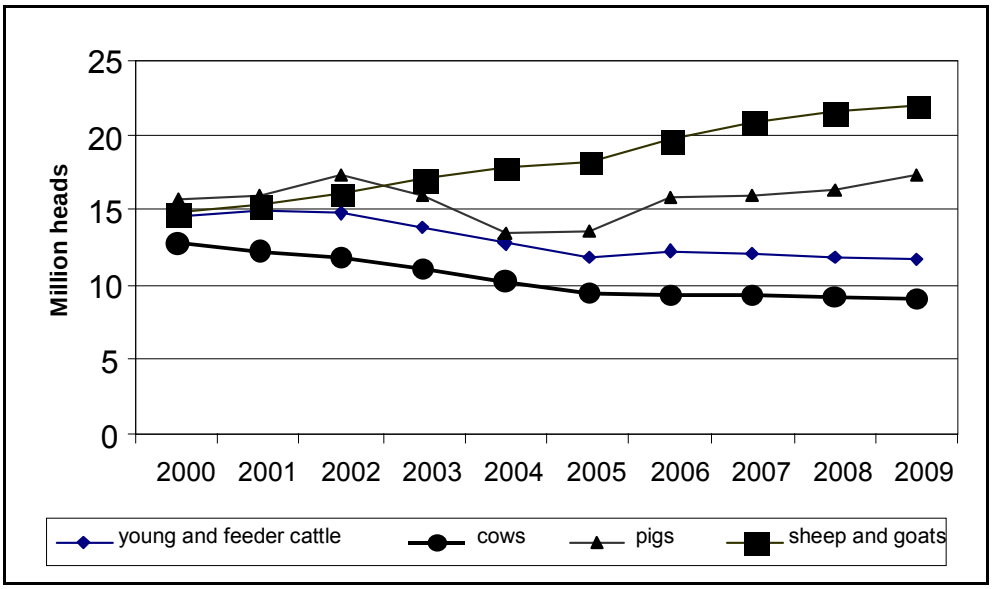
Output of basic livestock products in all types of farms

	1986-1990	19991-1995	1996-2000	2005	2006	2007	2008	2009
Livestock and poultry, million tons slaughter weight	9.7	7.5	4.7	4.9	5.2	5.7	9.3* (5.96)	9.9* (6.35)
Milk, million tons	54.2	45.4	33.6	31.1	31.4	32.2	32.4	32.6
Eggs, billion pieces	47.9	40.3	32.8	37.1	37.9	37.88	37.8	39.4

* - live weight.
Source: Rosstat.

Beginning from 2005 the share of household farms in livestock production fell from 52% to 48.3%. It is currently approximately the same as the share of corporate farms (48.1%). In 2009 the output of livestock products in households remained at the 2008 level. The reduction of their share in the total output is due to the growing production of pork, poultry meat, milk and eggs in corporate farms. Its increase there ranged from less than 1% (milk) to 7% (red and poultry meat). One can assert that bigger government support to agriculture in the pre-crisis and crisis years (2006-2009) whose beneficiaries are primarily corporate farms helps them to sustain the recession.

The dynamics of basic livestock inventories is shown at *Fig. 3*. Cattle population is shrinking despite government support to livestock producers. The trend is the same both for feeder young stock and for the dairy herd. Meantime the number of pigs, sheep and goats in 2009 continued to grow (by 6.7% and 0.9%, respectively). The dynamics of livestock population depends on its distribution between different types of producers: the higher share of corporate farms - the bigger annual swings. In its turn it's determined by the structure of livestock inventories: in corporate farms the share of short-cycle species is larger than in household farms. The share of cattle kept by households is growing: from 1990 to 2008 it increased from 17.3% to 47.3%, in 2009 – up to 47.7%. They also keep about 78% of goats and slightly less than one half of sheep. The population of pigs and poultry is concentrated in corporate farms (65.7% and over 72%, respectively). The growth of households' share in livestock population is due not to the increase of inventories but to their slower (sometimes by percent or less) decline as compared with corporate farms.

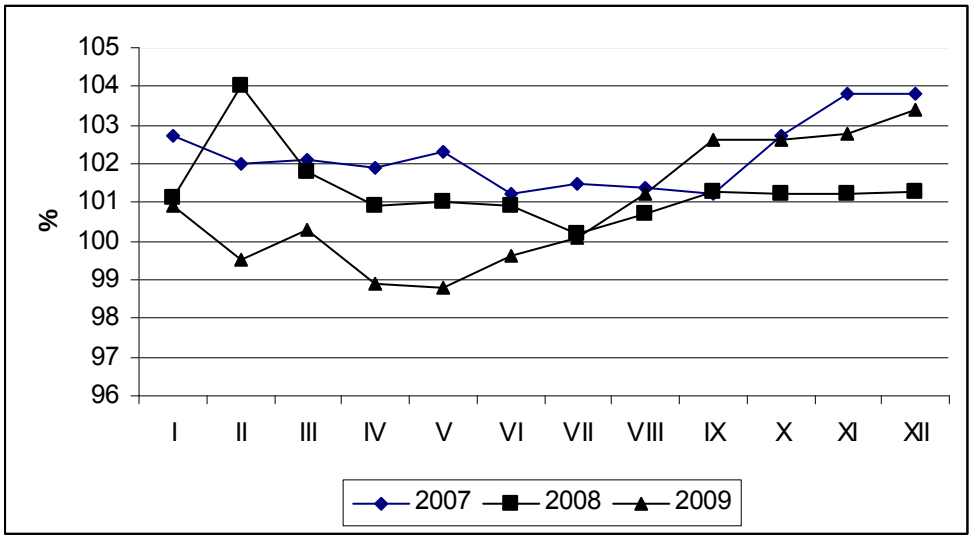


Source: Rosstat.

Fig. 3. Livestock inventories, million heads by the end of the period

Larger production volumes in corporate farms in spite of the decreasing inventories is an indicator of higher animal productivity. Previous years' data prove this trend: from 1991 to 2008 production of milk per cow in corporate farms grew by 51%, in household farms – by 36%. The 2009 indicator is not available.

The decrease of cow population from 2005 is accompanied by growth of milk output. The examination of 2007-2009 data reveals that milk production demonstrated the worst performance from January to August 2009 (*Fig. 4*).

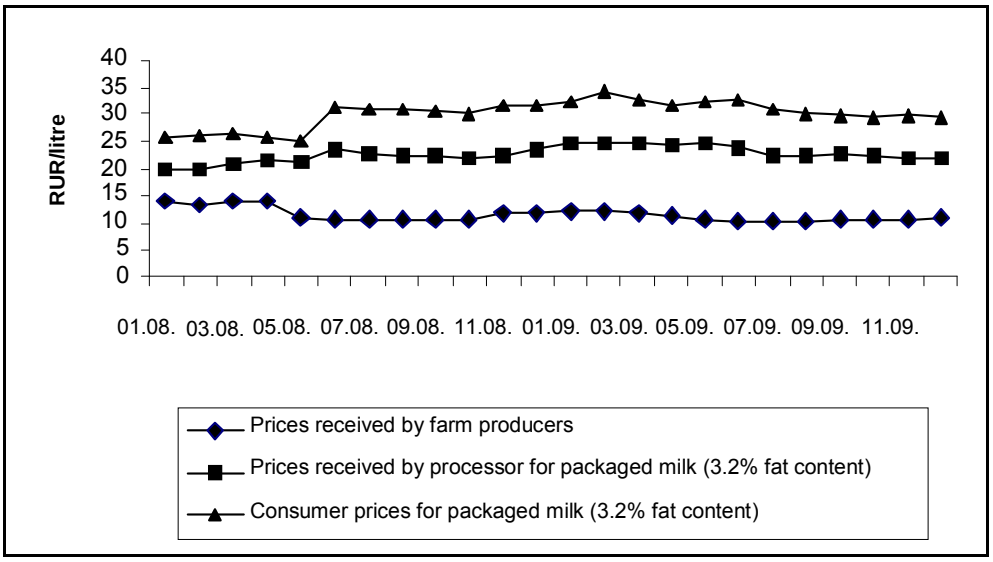


Source: Rosstat.

Fig. 4. Output of milk as percent of the corresponding month previous year

2009 was special for milk production. Beginning from December 19, 2008 the Federal Law "Technical regulation for milk and milk products" (adopted by the RF State Duma at the end of May 2008) came in force. From then on all produce named "milk" should be made out of fresh (the so called whole) milk. The Technical Regulation was meant as a measure for protecting consumers and agricultural producers. Its enforcement should have resulted in bigger demand of milk processors for milk produced by domestic producers and accordingly in the growth of prices received by them. Since before the law's enactment the price for milk made out of imported dry milk powder was unduly high, the transfer to natural milk should not have led to the surge of retail prices. The more so as in the current crisis situation they are "constrained" by the shrinking solvent consumer demand.

Within the period of the bill's examination and adoption in the RF State Duma prices for milk were fluctuating and the greatest swings occurred at the moment when it became clear that the law would be passed. Retail prices were the first to rise. Their growth was not conditioned by higher prices for raw natural milk since at the same time the prices received by farm producers became much lower. This can be well traced at *Fig. 5:* by the moment of the Regulation's adoption prices paid for milk to farm producers fell sharply. Their drop could not be attributed to the seasonal growth of milk production since usually no such swings took place in summer. After the traditional rise in autumn-winter 2008-2009 prices received by farm producers had not even reached the level of 2007.

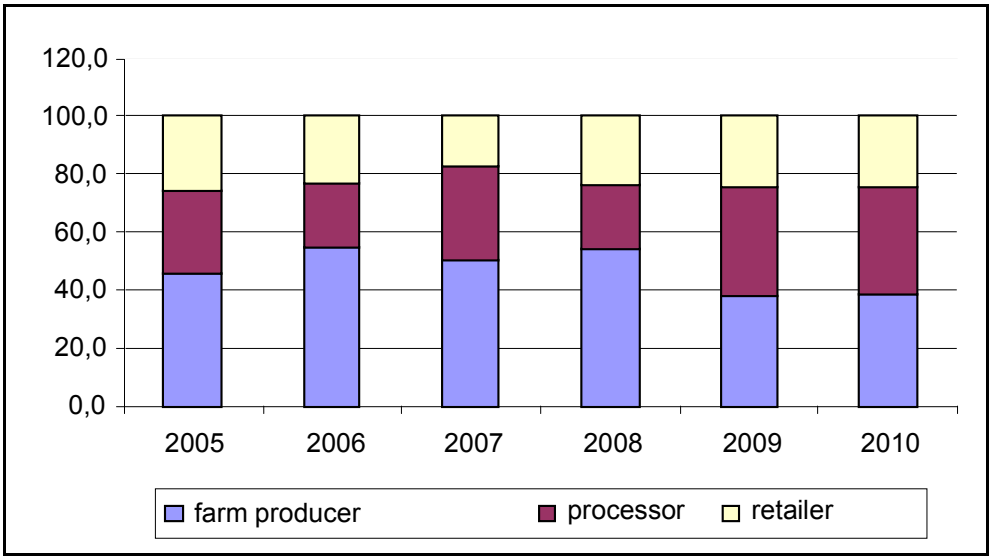


Source: www.mcx.ru

Fig. 5. Prices for milk at different stages of product chain

Retailers complain about lower demand but during the crisis average retail prices for packaged milk surged from 26 rubles per liter (January 2008) to 34 rubles per liter (February 2009). In January 2010 one liter of packaged milk with 3.2% fat content cost 31.8 rubles. Within this time the share of farm producers in the retail price for milk dropped from 54.5% in 2008 to 37.6% by January 1, 2009 and then increased to 38.6% by the start of 2010 (*Fig. 6*). However, this change in the cost structure should be examined not in the context of crisis developments but in the context of enforcement of the Technical Regulation for milk. After its adoption in the first reading there was a real threat that the demand for products out of dry

milk would fall while milk processing plants had already bought this input. As a result before the enforcement of the Technical Regulation prices paid to farm producers for whole milk were cut down to 5-6 rubles per liter while dry milk from stocks was used for manufacturing milk. Until the expiry date one could sell it without indicating that it was made out of dry milk. Within the period from the Regulation's adoption to its enforcement (from May to December 2008) and then till the expiration of shelf life of the already produced milk (up to 6 months), i.e. till the middle of 2009 the demand of milk processors for domestically produced whole milk was lower affecting prices received by farm producers.



Source: www.mcx.ru

Fig. 6. Structure of retail price for milk by stages of product chain as of January 1

The introduction of protective measure – the Technical Regulation – and the consequent reduction of milk imports resulted in the worsening of situation for domestic producers in the short run: from April 2008 to the middle of 2009 prices for milk were extremely low. Only after the sale of milk drink (made out of dry milk) under the name of "milk" became illegitimate and product inspections started, the price for whole milk began to grow very slowly. In November prices received by farm producers surged by more than 20%[1] and the government felt pressure to change the Technical Regulation (to abolish the required indication "milk drink" on the label of product reconstituted from dry milk) and to encourage larger imports of dry milk. If the government sustains the pressure, one can expect a gradual growth of domestic milk production benefiting from state support to the livestock sector.

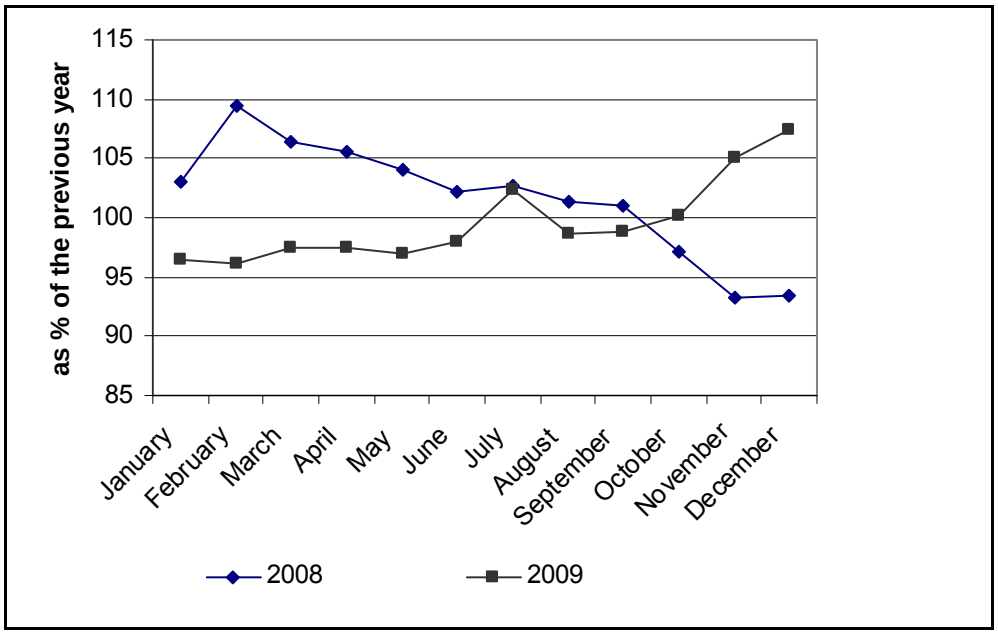
Similar situation – the lowering of prices for raw agricultural output and the rise of prices for processed products – can be observed on other commodity markets as well. (The exception is products whose producers are also their typical processors: poultry meat, pork and eggs.) For instance, purchase prices for wheat actually didn't change from the crisis' start till November 2009. Meantime prices for flour out of this wheat grew by 18% from 2008 to 2009. One could attribute it to higher prices for electricity, fuels and other inputs. But this supposition does not stand up to scrutiny since agriculture faces the same problem. The more likely

[1] http://www.profnavigator.ru/tmpl2.php?PN=doct.php&dout=text&dsubj=10&dtype=4&nid=37463

explanation is that agriculture is demonopolized while processing and marketing are relatively monopolized (as compared with the farm sector). For instance, six dairy companies account for over 60% of the domestic output of dairy products[1]. According to the Russian antimonopoly legislation such concentration is not an indicator of market monopolization. But these 6 companies producing 60% of dairy products (and accordingly buying about 60% of domestic milk output in case import of this item is restricted) are unquestionable monopolists when compared with dozens of thousands of corporate farms, hundreds of thousands of individual private farmers and entrepreneurs and millions of individuals engaged in farming. The situation with processors and traders of other agricultural commodities is similar.

3.5.2. Production of other food products

Beginning from February 2008 food industry demonstrated the slowing down of growth rates. From October 2008 the output of food products was smaller than in 2007 – by December the decrease exceeded 6% (*Fig.7*).



Source: Rosstan.

Fig. 7. Production of food products as % of the corresponding period previous year

In the last three months of 2009 production grew as compared with the corresponding periods of 2008.

Table 3 demonstrates the change of output by groups of commodities as compared with 2008. In 10 months 2009 a general growth was observed in the groups of meat, fish, fat and oil, flour-and-cereals and starch products. Production of dairy products, processed fruit and vegetables and other products reduced (*Table 4*).

[1] http://marketing.unipack.ru/352/

Table 3

Production of food products by groups in 2009 as compared with 2008, %

Products and product groups	2009/2008
Production of meat and meat products	**104.2**
Meat including 1st category subproducts	114.0
incl. beef	86.5
pork	126.0
poultry meat	114.9
Sausage products	92.2
Processed and canned fish products	**102.9**
Processed and canned potatoes, fruit and vegetables	**92.3**
Production of vegetable and animal fats and oils	**117.8**
incl. vegetable oils	**132.6**
Production of dairy products	**99.7**
incl. whole milk products	**101.5**
high-fat cheeses (including brinzen)	101.5
Production of flour-and-cereals industry products, starch and starch products	**103.1**
incl. flour	100.9
cereals	109.3
Production of other food products	**97.2**
incl. bread and bakery products	96.1
granulated sugar	86.1
incl. made out of sugar beets	95.2
made out of imported raw sugar	73.0
Pasta products	100.8
Natural coffee	143.8
Production of beverages	**96.4**
incl. vodka and alcoholic beverages	92.7
cognac	127.7

Source: Rosstat.

Production of meat products was up 4.2% as compared with 2008. However, structural changes occurred within the group: production of more expensive products, e.g. beef and sausages, reduced by 13% and nearly 8%, respectively. Meantime the output of cheaper products not requiring deep processing and made out of domestic raw inputs increased quite noticeably: that of pork – by 26%, of poultry meat – by 14.9%. The decrease of sausage production was due to lower solvent consumer demand during the crisis. The same factor conditioned smaller production of beef: as can be seen from the analysis of situation in agriculture, this decrease could not be attributed to the reduction of domestic slaughter cattle production. Beef accounted for the largest share in meat imports and during the crisis the price for imported beef rose due to the growth of dollar and euro exchange rates relative to ruble.

Production of processed and canned fish products grew by almost 3% as compared with the previous year despite higher retail prices and smaller sales. The 17.8% increase in the group of vegetable and animal fats and oils was due to a significant growth of vegetable oil production (by 32.6%) while the output of more expensive margarine products reduced by 9.1%.

The reduction of dairy output was minor but its structure also changed: production of less expensive products except cheese was growing in this group as well (output of whole milk products and high-fat cheeses was up 1.5%). Production of other dairy products fell, the decrease ranging from 3.8% for canned products to 40% for dry milk. A sharp drop of dry milk production was due to the enforcement of Technical Regulation for milk whose requirements actually lead to smaller demand for products out of dry milk since their labels should contain a special corresponding indication.

The output of processed potatoes, fruit and vegetables decreased by almost 7.7%. The biggest drop was observed in production of canned tomatoes (by 14.5%), canned fruit and vege-

tables (by 9.8%) and fruit juices (by 13.9%) while production of cheaper canned vegetables grew (by 15%) as well as that of quick-frozen vegetables and fruit.

Production in flour-and-cereals industry has not reduced. Within the group trends differed by products: production of cereals increased by 9.3% while production of bread and confectionery fell by about 4%, that of tea – by nearly 15%, of coffee drinks – by 48%, of sugar – by 14% (especially of the one made out of imported raw sugar – by 27% as different from sugar made out of domestic sugar beets whose output reduced by less than 5%). The decrease of coffee drinks' production was accompanied by the growth of production of coffee (by over 40%).

Output of beverages decreased by more than 3%. The decrease was observed in production of all items out of brewer's malt (by about 20%), vodka and alcoholic beverages (by 7.3%) and grape wine (by 0.2%). The exception was production of cognac (up 27.7%) and fruit wines (up 7.3%). Growth of output of fruit wines can hardly be regarded as a positive trend given their notorious reputation but their total output is insignificant.

The analysis revealed that with some exceptions the share of products with higher degree of processing is shrinking while that of cheaper products made out of domestic agricultural inputs is expanding in all the commodity groups.

3.5.3. Trends in the structure of food sales

In 2009 the share of foodstuffs including beverages and tobacco products in the structure of retail sales amounted to 48.6% while that of non-food commodities – to 51.4% (in 2008 – 46.8% and 53.2% accordingly)[1]. This means that in the crisis situation population spends the main part of its money funds on purchasing food products – an indirect sign of falling personal incomes or of the respective expectations. The dynamics of food sales is presented in *Table 4*.

Table 4

Sales of food products

	2000	2003	2004	2005	2006	2007	2008	2009/2008*
Red and poultry meat, thousand tons	2865	3896	4490	4804	4910	5152	5523	94.9%
Sausage products, thousand tons	1440	1862	2051	2211	2382	2515	2551	92.5%
Butter, thousand tons	388	448	471	476	492	493	508	98%
Vegetable oils, thousand tons	571	811	900	1013	1078	1175	1268	104.2%
Eggs, billion pieces	21.6	25.6	25.8	28.2	31.3	32.2	33.4	101.8%
Sugar, thousand tons	2623	2932	2736	2984	2924	2980	2950	94.1%
Cereal products, including pasta and cereals in equivalent, million tons	12.9	13.9	13.6	13.8	14.4	14.5	14.2	98.7%
Potatoes, thousand tons	5560	6037	7269	7640	7693	8486	8638	n.a.
Vegetables, thousand tons	6228	6429	7606	8062	8804	9499	10335	n.a.
Fruit and berries, thousand tons	2567	3183	3533	3982	4416	5008	5568	n.a.

* - 9 months in comparable prices.
Source: Rosstat.

Changes in the structure of foodstuffs' production corresponded to the changes in the structure of their sales. The decline of total sales of meat items was primarily due to smaller

[1] http://www.gks.ru/bgd/free/B09_00/IssWWW.exe/Stg/d12/3-1.htm

sales of processed meat products, first of all sausage products and canned meat. Production of pork and poultry meat increased noticeably as well as sales of meat. Growth was also observed in the sales of vegetable oils, dairy products, eggs, cereals, fresh vegetables (including potatoes) and fruit corresponding to trends in production. Meantime sales (as well as production) of butter, sugar, confectionery, tea, salt, flour, bread and bakery products reduced as compared with the previous year. In general, changes in the structure of food sales evidence improvements in the structure of food consumption (*Table 5*).

Table 5

Trends in sales of basic food products in January-September 2009 in comparable prices

Decrease	As % of Jan.-Sept. 2008	Increase	As % of Jan.-Sept. 2008
Meat products	92.5	Poultry meat	100.1
Fish and sea products	95.0	Vegetable oils	104.2
Animal oils	98.0	Dairy products	105.8
Sugar	94.1	including: high-fat cheeses	107.5
Confectionery	97.4	Canned dry milk products, sublimated	103.7
Tea	96.6	Eggs	101.8
Salt	94.8	Cereals	101.5
Flour	98.5	Fresh vegetables and potatoes	106.5
Pasta products	99.7	Fresh fruit	104.0
Bread and bakery products	98.7		

Source: Rosstat.

In 2009 the growth of consumer prices for food in Russia averaged 4.9%[1]. This is the highest indicator as compared with the EU countries (EU-27). Russia is followed by Poland where the growth was smaller (3.4%) and Hungary (1.3%). In several countries – Italy, Luxemburg, Romania and Sweden – prices rose by less than 1%. In all other countries prices of December 2009 were generally lower than those of December 2008. The dynamics of prices for selected food products is presented in *Table 6*.

The table shows that prices for bread, meat and meat products, fish and fish products and sugar grew at the highest rate. Their growth probably determined the decrease of sales that in its turn entailed smaller output of these products. In any case sugar and confectionery, fish and fish products, meat and meat products and bread, i.e. products prices for which were up, are among the items demonstrating decrease of sales (*Table 5*). Production of these products has also experienced the biggest drop – *Table 3*. The exception is processed and canned fish products. But it would not be quite correct to make conclusions on the basis of available information about canned fish products since not only domestically processed fish is sold but also large volumes of imported ready-for-marketing products.

[1] http://www.gks.ru/bgd/free/B04_03/IssWWW.exe/Stg/d04/ind-z.htm Calculations were made using the international classification COICOP (less alcoholic and alcohol-free beverages).

Table 6

Index of consumer prices for basic food products in December 2009 as % of December 2008

	Total	Bakery products and cereals	Meat and meat products	Fish and sea products	Dairy products, cheese and eggs	Fats and oils	Fruit	Vegetables	Sugar, jam, honey, chocolate and sweets
Russian Federation	104	103.6	106.2	110.7	99.6	94.1	100.5	99.0	122
Countries of the EU (EU-27)	99.0	99.5	100.2	99.9	97.7	96.9	98.6	95.4	101.5

Source: Rosstat.

3.5.4. Import of agricultural and food products in the crisis period

According to Rosstat data[1], in July-September 2009 the share of imports in the total resources of food commodities amounted to 34%, i.e. was the same as in the corresponding period of 2008. At the same time imports of basic food products were falling (*Table 7*).

Table 7

Imports of selected food products including those for processing in 2009

	Million US dollars	As % of 2008
Total	26580	85.4
including		
Meat, fresh and frozen	1253	84
Poultry meat, fresh and frozen	851	80.5
Fish, fresh and frozen	705	90.2
Milk and dairy products	418	96.7
including dry milk	57.5	79.9
butter	93.0	84.6
cheese and curds	261	109.7
vegetables	2364	90.2
sunflower oil	41.2	38.8
raw sugar	1218	51.8

Source: Rosstat.

In 2009 imports of all food products (except cheese and curds) decreased. The most affected were purchases of sunflower oil (down about 61%), raw sugar (about 48%), dry milk (about 20%), poultry meat (about 20%) and butter (about 15%).

The comparison of data about sales of basic groups of food commodities (*Table 5*) with the data about their imports (*Table 7*) brings to the conclusion about a gradual substitution of domestic products for the imported ones. For instance, sales of meat products reduced by 7.5% while imports of meat were down 16%, sales of poultry meat remained actually the same as in the previous year (100.1%) while its imports decreased by 20%. The sales of sugar were down 5.9% while imports of raw sugar fell by 48%. The sales of vegetable oils grew by 4.2% while their imports dropped by almost 61%. The sales of butter reduced by 2% while their imports – by almost 15%. Such a discrepancy cannot be entirely attributed to the difference between the declared customs values and the values in retail prices since the fact of import substitution is proved by a gradual shrinkage of imports' share in personal and production consumption. For instance, in 9 months 2009 this indicator for meat and meat products

[1] http://www.gks.ru/bgd/regl/b09_01/IssWWW.exe/Stg/d10/2-2-1.htm

equaled 32.3% as compared with 34.5% in 2008, for milk – 16.4% versus 18.8% in the previous year[1].

At present the weakening of ruble has less effect on import substitution since its scale is much smaller than during the previous crisis. The growth of domestic production plays a bigger role in reduction of vegetable oils' and meat products' imports. Larger domestic output of meat is due to the development of short-cycle livestock sub-sectors (poultry and pig production) in corporate farms. The reduction of dairy products' imports was largely determined by the enforcement of Technical Regulation for milk, higher import duties on milk and growing domestic production.

The substitution of domestic products for imports has some limitations not related to the volume of domestic output. The produce of households, individual private farms and most corporate farms is non-standard and not suitable for forming relatively large lots of homogeneous products. Catering and trade enterprises prefer to reduce costs and work with lots of primarily processed homogeneous products. For instance, catering enterprises need semi-cooked products the daily lots of which should be identical by quality parameters. The situation is similar with raw inputs for producing semi-cooked, sausage and canned products. The lack of standard, homogeneous and partially processed products won't make these entities buy heterogeneous products without primary processing from households, individual private and corporate farms. With regard to this one has to improve interaction between domestic producers and processors, to enforce contract mechanism ensuring production of homogeneous products in compliance with the contract terms (by means of providing seeds, technologies, consultations and equipment in exchange for guaranteed supply). It would be rational to provide state support to processing enterprises using contract agreements with agricultural entities similar to the one granted to farm producers.

3.5.5. Changes in agricultural policies in the crisis conditions

One of the key steps for agricultural policy development and improvement of support to the farm sector was the adoption of State program for agricultural development and regulation of agricultural and food markets in 2008-2012 (hereinafter referred to as the State program) approved by the RF Government Resolution No. 446 of July 14, 2007.

In 2009 because of the global financial crisis some revisions were made in the State program. Under the Program's provisions and in the framework of the Government's anti-crisis plan 183 billion rubles were allocated from the federal budget to the support of agrifood sector which is 30% above the 2008 indicator.

In the framework of the Government's anti-crisis plan Russian agrifood sector has additionally got 87 billion rubles[2]. These funds were used for the following purposes:

enlargement of authorized capital of open joint-stock company "Rosselkhozbank" – 45 billion rubles;

enlargement of authorized capital of open joint-stock company "Rosagroleasing" – 25 billion rubles;

subsidizing of interest rate on credits – 17 billion rubles.

[1] Calculated using data of Rosstat.

[2] The report of RF Minister of Agriculture E.B.Skrynnik at the session of the Federation's Council in November 2009.

So, while in 2008 54% of budget funds under the State program were allocated to efforts for improving agriculture's financial sustainability, in the crisis period priority was given to the enlargement of authorized capitals of "Rosselkhozbank" and "Rosagroleasing" – 36% (Picture 8). Meantime the share of such an important component as "Sustainable development of rural areas" including improvement of rural social infrastructure has notably decreased as compared with 2008 (from 20% to 8%).

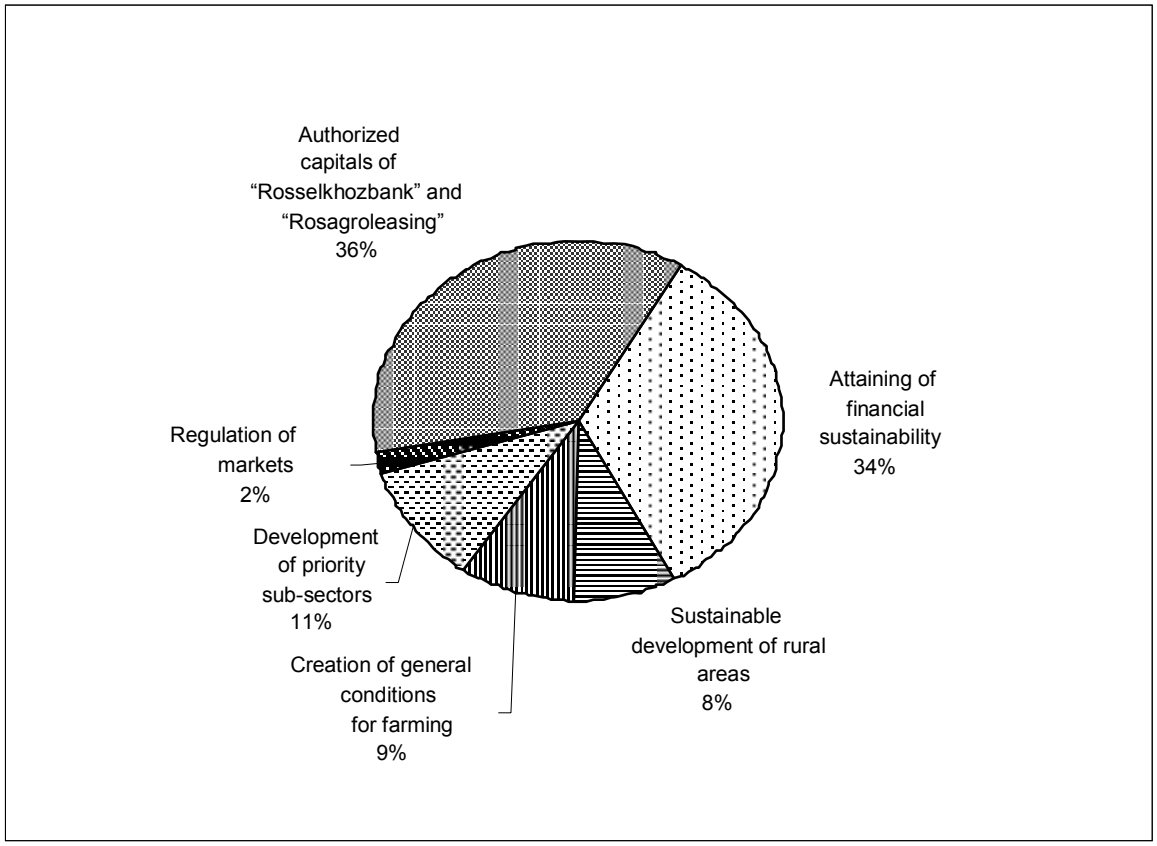


Fig. 8. Structure of budget expenditures by components of the State program in 2009

According to preliminary data of the RF Ministry of Agriculture in 2009 most financial commitments under the State program were met in full (Table 8) and some efforts got even more funds than planned (subsidizing of elite seed breeding, partial compensation of expenditures on crop insurance, subsidizing of interest rate on credits). On the contrary, financing of measures to support rape and flax production has notably reduced.

Table 8

Basic financial parameters of the State program's implementation as of January 1, 2010

Efforts	Annual plan	Financing from the federal budget, thousand rubles	
		planned	actual
1. **Efficiency indicators**			
1.1. Index of agricultural production in farms of all types as % of the previous year (in comparable prices)	8.3	X	X
1.4. Index of physical volume of investments in agriculture's fixed capital, %	82.0	X	X
1.5. Disposable monthly incomes of rural house-	8 928.0	X	X

Efforts	Annual plan	Financing from the federal budget, thousand rubles	
		planned	actual
holds, rubles per one member of household			
1.6. Share of domestic output in available resources of			
1.6.1. meat and meat products, %	63.5	X	X
1.6.2. milk and dairy products, %	79.2	X	X
2. Sustainable development of rural areas			
2.1. Construction of dwellings for rural residents – total, thousand square meters	1 050	X	X
2.1.1. including those for young families and young specialists, thousand square meters	540	X	X
2.4. Financing of measures to improve social and engineer infrastructure in rural settlements	X	8 117 800	8 099 707
3. Creation of general conditions for farming			
3.1. Prevention of agricultural lands' abandoning, thousand hectares	850	X	X
3.3. Subsidies to farm producers for the purchase of mineral fertilizers	X	9 690 000	9 690 000
4. Development of priority agricultural sub-sectors			
4.1. Development of livestock production			
4.1.1.Production of slaughter livestock and poultry (live weight), thousand tons	9 520	X	X
4.1.2. Production of milk, thousand tons	32 600	X	X
4.1.5. Subsidies to support purchase of pedigree livestock	X	5 577 200	4 835 885
4.1.6. Supply of pedigree livestock through Rosagroleasing, thousand heads	30 000	X	X
4.1.7. Supply of equipment for livestock production through Rosagroleasing, thousand stalls	65 000	X	X
4.2. Development of crop production			
4.2.2. Subsidizing of measures to support elite seed breeding	X	484 900	550 898
4.2.5. Financing of measures to support farm producers in Extreme North regions	X	400 000	375 171
4.2.8. Financing of measures to support flax production	X	587 151	152 162
4.2.11. Financing of measures to support rape production	X	613 350	132 189
4.2.14. Financing of measures to establish perennial plantations	X	884 430	789 547
5. Attaining of agriculture's financial sustainability			
5.1. Volume of subsidized short-term credits (loans)	149 400 000	X	X
5.2. Subsidizing of interest rate on short-term credits (loans)	X	14 900 000	16 647 275
5.3. Volume of subsidized investment credits with up to 8 years' term	91 700 000	X	X
5.4. Subsidizing of interest rate on investment credits with up to 10 years' term	X	40 813 252	41 318 480
5.5. Volume of subsidized credits issued to smallholder farms	35 000 000	X	X
5.6. Subsidizing of interest rate on credits (loans) issued to smallholder farms	X	6 027 200	5 984 171
5.7. Purchase of tractors by all types of farms, units	29 000	X	X
5.8. Purchase of grain harvesters, units	9 000	X	X
5.9. Purchase of fodder harvesters, units	3 500	X	X
5.10. Share of insured crop area in the total cultivated acreage, %	29	X	X
5.11. Subsidies for partial compensation of expenditures on crop insurance	X	2 000 000	2 494 862
TOTAL	**X**	**90 719 283**	**99 679 271**

Source: RF Ministry of Agriculture.

The sector's credit portfolio exceeded 300 billion rubles including newly received short-term credits to the amount of 235.4 billion rubles, investment credits – 95 billion rubles, cred-

its to smallholders – 41.3 billion rubles (Picture 9). In 2009 farm producers preferred to take short-term credits since in the crisis situation they feared to take investment ones.

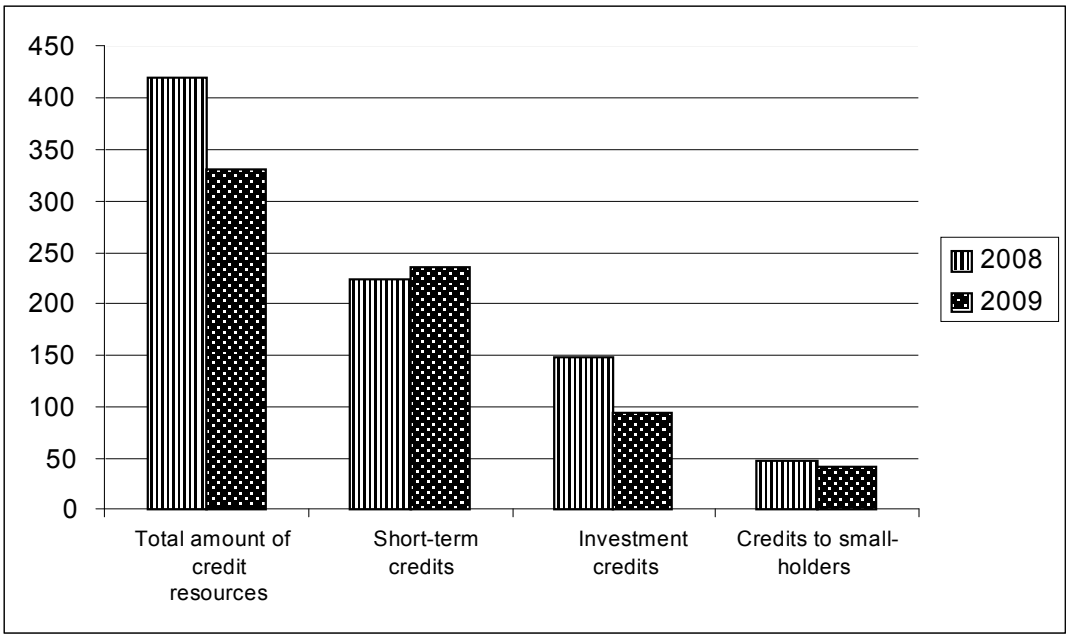


Fig. 9. Credit portfolio of the agrifood sector in 2008 and 2009, billion rubles

The principal creditor of agricultural producers was "Rosselkhozbank" from which they received 207 billion rubles of credit resources (43% of their total amount). From its establishment in 2000 the bank issued 859 billion rubles of credits to agricultural entities and rural residents and formed the second by its extensiveness net of territorial branches including 78 regional divisions and 1414 additional offices.

With the aim to strengthen support to the sector the Government adopted resolutions about prolongation of credits with subsidized interest rate:

short-terms credits – extension for 6 months;

investment credits – extension for 3 years (i.e. the maximum term of investment credits is extended from 8 to 11 years).

The crisis resulted in much smaller demand for farm machinery. In late 2008 – early 2009 its sales to agricultural producers dropped 4-5 fold.

By the end of 2009 the situation improved: "Rosagroleasing" used the funds allocated from the federal budget for purchasing and supplying to farms 15 thousand units of home-made agricultural machinery and highly productive pedigree livestock and for modernizing livestock keeping facilities. According to preliminary estimates 14 thousand tractors (48.3% of the plan), 6 thousand grain harvesters (66.7%) and 1.5 thousand fodder harvesters (42.9%) were to be bought in 2009. Only 10 out of 80 constituent members of the Russian Federation report that they will fully attain the goals of technical renovation set by the State program: Voronezh, Tambov, Pskov and Astrakhan oblasts, Krasnodar kray, Republics of Bashkortostan, Ingushetiya, Karachaevo-Cherkessiya and Saha (Yakutiya), the Jewish autonomous district. The term of machinery and equipment leasing was extended up to 15 years, the term of advance payments – by 12 months.

The main causes of weaker investment activity and smaller machinery purchases are: lower prices for basic agricultural outputs – grain and milk; poor profitability of farms; higher prices for farm machinery (tractors, harvesters, livestock equipment); scarcer financing of the program activities from the regional budgets due to the shortage of funds; worse access to credits, high credit indebtedness of farms, lack of collateral and drought in 15 regions.

The government commission on systemically important entities has designated 37 agribusiness enterprises eligible for government guarantees to the amount of 45 billion rubles, of which 17.5 billion rubles have already been granted to 7 such enterprises.

So, the policies of prioritizing support to monopolists including "Rosselkhozbank" and "Rosagroleasing" were carried on in 2009.

On the contrary, budget allocations to supporting small-scale farming in the framework of the State program shrank from 4.4% in 2008 to 3% in 2009. The share of smallholders in credit subsidies fell from 10% in 2008 to 7% in 2009 disregarding the fact that individual private and household farms continue to account for over 50% of the gross agricultural output, including over one half of meat and milk outputs, for 88% of potatoes and 78% of vegetables produced in the country.

In 2009 the amount of subsidized credits and loans to smallholders reached 94.3 billion rubles (*Table 9*). As compared with 2008 the reduction of newly received funds totaled 7 billion rubles and affected all types of smallholders except supply, marketing, purchase and processing agricultural consumer cooperatives. The principal borrowers are household farms – since the launching of priority National project "Development of agrifood sector" they have got 450 thousand credits to the amount of over 60 billion rubles (54.6% of all credits issued to smallholders).

Table 9

The amount of subsidized credits and loans received by smallholders in 2009, million rubles

	Total	Household farms	Individual private farms	Agricultural consumer cooperatives (less credit cooperatives)
Subsidized credits received in credit institutions	93387	60157	26853	6377
Subsidized loans received in agricultural credit consumer cooperatives	2242.4	1136.1	798.1	308
Total subsidized credits and loans	94316	61293	27651	6685
Credits and loans received in 2008	48 256	26 231	18 038	3 987
Credits and loans, received in 2009	41 384	22 634	14 693	4 057
Structure in 2009, %	100	54.6	35.5	9.9

Source: RF Ministry of Agriculture.

Serious hindrances to smallholders' participation in the program of subsidizing credits to agriculture are a long and complicated procedure of opening a credit (especially taking into account transaction costs, i.e. transportation expenditures and time loss) and the lack of collateral or its shortage. According to data of the annual sociological and expert study of State program's implementation in 2009 the period from a respondent's application to bank to an actual receiving of credit averaged one month. Due to the above-described complications only one out of three smallholder applicants got subsidies; for household farmers this indicator is even worse – 15%.

Agricultural cooperation developed at slow pace as well. According to data submitted by the RF regions, by January 1, 2010 5905 agricultural consumer cooperatives were registered

in Russia, including 1912 credit, 1126 processing and 2867 supply and marketing cooperatives. The support provided to cooperatives is absolutely insufficient. The key problem of the Russian system of rural credit cooperatives has always been the shortage of working capital for granting loans to their members but nothing is envisaged in the State program to solve it. An attempt to address this problem was made in the framework of Priority National Project "Development of agrifood sector" when "Rosselkhozbank" contributed its funds to the share capitals of selected cooperatives as an associated member. But this practice has not become widespread (according to the bank's data within 3 years of the National Project's and State Program's implementation contributions were made in share capitals of 85 agricultural credit consumer cooperatives in 26 regions). Another option may be the 100% subsidizing from the federal budget of the RF Central Bank's discount rate on long-term (up to 30 years) credits and loans for the replenishment of mutual financial assistance fund of credit cooperatives of the third (federal) level. It would be rational to envisage the subsidizing from the federal budget of not less than 50% of interest rate on credits and loans paid by credit cooperatives of the second (regional) level in case that the remaining 50% will be covered by co-financing from the regional budgets.

In their turn, in addition to subsidized interest rate non-credit cooperatives need investment credits for purchasing machinery and equipment. In many regions (Saratov, Astrakhan oblasts, Chuvash republic, Krasnodar kray) agricultural cooperation is supported from the regional budget under the program of small and medium business development in the framework of agreement with the RF Ministry for Economic Development.

The development of small business could have helped to mitigate the aftereffects of economic crisis and to expand employment opportunities in rural areas but the anti-crisis efforts were focused on supporting large systemically important agricultural enterprises, "Rosselkhozbank" and "Rosagroleasing".

3.5.6. Situation on selected agricultural and food markets

I. Market of grain

Basic trends

The combination of two factors – low prices for grain and credit crisis – had a negative impact on the market.

For two years in succession the crop of grain in Russia has been record high and well above the domestic market demand. In 2008 108.2 million tons of grain were produced; the 2009 net grain output is preliminarily estimated at about 97 million tons (*Table 1*). Given the extremely large carryover stocks of 19.7 million tons, the beginning stocks in 2009/2010 MY are record high (Table 2). The domestic consumption of grain in Russia does not exceed 77 million tons. So, in the last two years its supply was about 40% bigger than demand. In the new 2009/2010 MY production will exceed domestic consumption by 20 million tons and the market surplus of grain taking into account carryover stocks will be about 40 million tons.

Table 1

Gross output of grain in 2002-2009 (weight after primary processing, thousand tons)

	2002	2003	2004	2005	2006	2007	2008	Estimate 2009
Grain	86612	67199	78092	78187	78625	81796	108179.0	96300–98000
including								
Wheat	50609	34104	45413	47698	45006	49390	63765.1	60500–61500
Barley	18739	17968	17180	15791	18093	15663	23149	17600–18150
Corn	1563	2113	3516	3211	3669	3953	6682.3	3900–4100

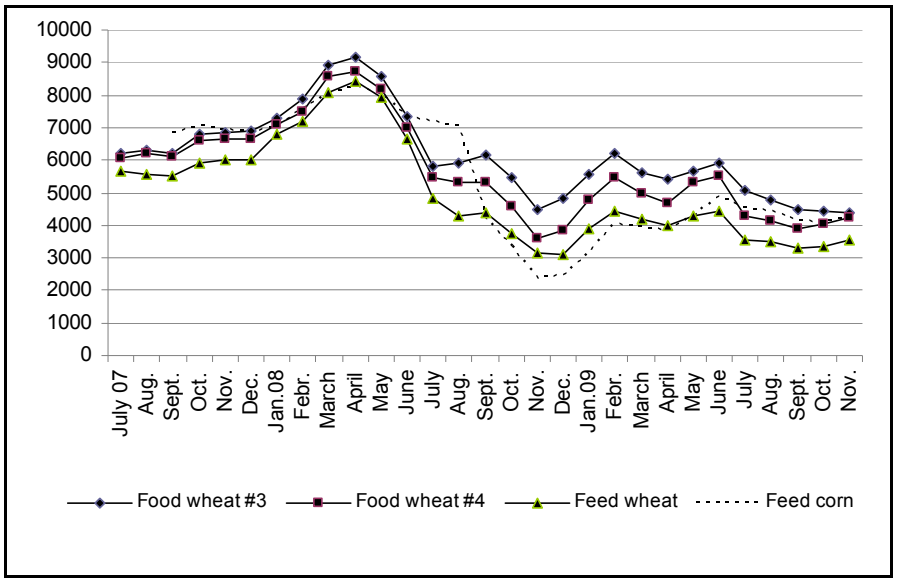
Source: Sovecon.

Table 2

Supply/demand balance for grain: estimates and forecast (million tons)

	2007/08	2008/09	2009/10 (forecast)
Supply (resources)			
Beginning stocks	8.3	7.85	19.65
incl. intervention stocks	1.45	0.2	8.25
market stocks	6.85	7.65	11.4
Production	81.8	108.2	97.0
Imports*	1.1	0.6	0.45
Total	91.2	116.65	117.1
Consumption			
Domestic consumption	70.0	73.5	77.0
Exports*	13.35	23.5	19.5-21.5
Total	83.35	97.0	96.5-98.5
Intervention purchases	-	8.05	2.0-2.5
Ending stocks	7.85	19.65	19.6-20.6
incl. intervention stocks	0.2	8.25	9.3-10.3
market stocks	7.65	11.4	9.3-11.3

*including flour in grain equivalent.
Source: Sovecon.



Source: Sovecon.

Fig. 1. Average monthly prices for wheat and corn (EXW Northern Caucasus), rubles per ton (VAT included)

The excess of grain supply over domestic demand is one of the factors exerting pressure on market prices. In 2008/2009 MY domestic prices for grain were low as compared with previous years. In October 2009 the price for food wheat #3 (EXW Northern Caucasus) was 4425 rubles per ton (VAT included), in 2008 – 5450 rubles per ton, in 2007 – 6785 rubles per ton (*Fig.* 1). In this situation prices could be supported by state purchases or export supplies.

In 2008/2009 MY 8 million tons of grain to the amount of 38.58 billion rubles were purchased for the intervention reserve (*Table 2*). In the current marketing year 9.5 billion rubles were allocated to making state purchases and according to estimates their volume won't exceed 2.5 million tons. This is very little when compared with the grain surplus of 40 million tons. So, due to their small scale state purchases of grain are unlikely to be the drivers of domestic prices in 2009/2010 MY.

As to the export of grain, in 2009 it was constrained by a number of factors: the oversupply of grain on the world market, the still unsettled logistical problems of the Russian grain market and the stricter requirements of world importers to the quality of wheat.

In 2008/2009 MY the dominating trend on the world market was the reduction of demand for grain whose consumption was affected by the global crisis that resulted in the building up of world carryover stocks and their greater pressure on the world prices (*Table 3*, *Fig. 2*). In 2008/2009 MY the situation on the world market was determined by high wheat crop (682.8 million tons) and much smaller consumption not exceeding 639.3 million tons. According to the USDA forecast, the 2009/2010 MY won't only start with high supply but will also end with large carryover stocks (*Table 3*). This means that the saturation of the world market in the new marketing year will remain high and will hinder the strengthening of the world prices. In this situation the competition between countries-suppliers of grain to the world market will stiffen.

Given low world and domestic prices the competitiveness of Russian grain in 2008/2009 MY was supported by ruble devaluation. As a result about 18 million tons of wheat where exported. In 2009/2010 MY export supplies are unlikely to be supported by weaker ruble.

Table 3

World supply and consumption of wheat (million tons)

	Production	Trade	Consumption for feeding	Consumption, total	Ending stocks
2006/07	595.7	115.6	105.9	615.6	127.5
2007/08	610.7	116.4	96.3	617.0	121.3
2008/09	682.8	142.6	112.7	639.3	164.7
2009/10 forecast	671.9	124.5	111.9	648.3	188.3

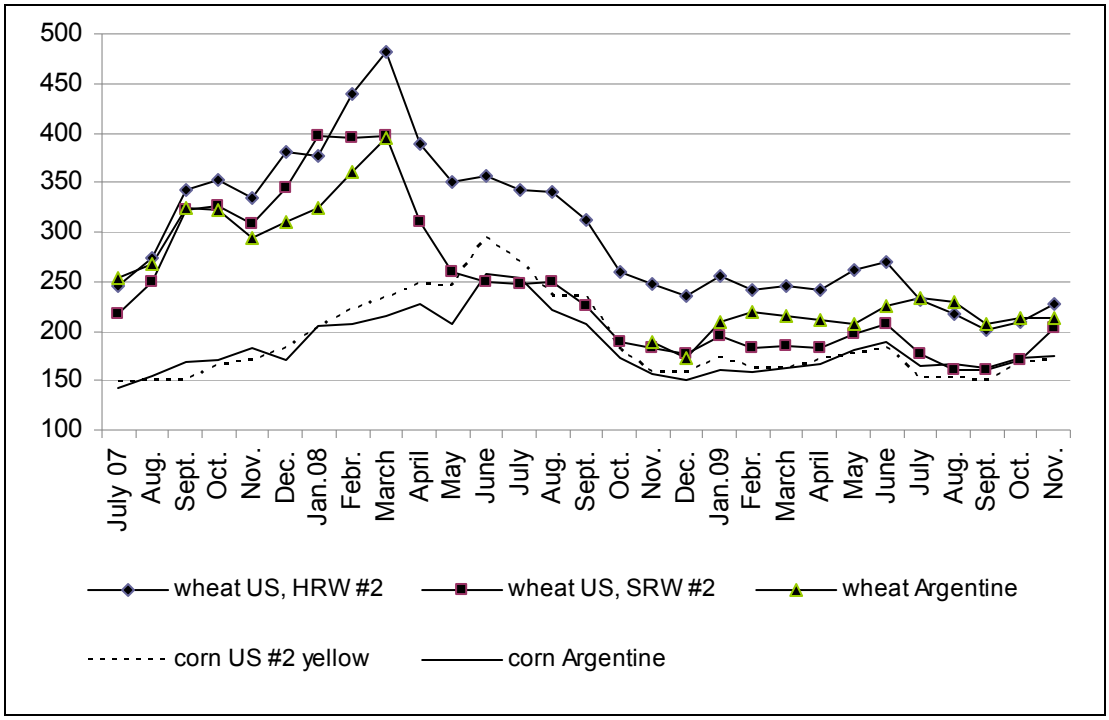
Source: USDA.

Export activities of Russian traders are also hindered by unsettled infrastructural problems of the market. The first of them is connected with grain transportation, i.e. the growth of railway tariffs and the shortage of railroad cars. Exports mainly consist of grain from southern regions of Russia that is shipped through the Novorossiysk port. Meantime the delivery of grain from Siberia or Altai where yields are rather high is economically unjustified because of the high transportation costs.

Next problem is the shortage of elevators. In the coming 2009/2010 MY the combination of good crop and high carryover stocks will aggravate the problem of grain storage. Besides, elevator enterprises prefer not to participate in the programs of state purchases since their experience shows that the state delays payments for the storage of reserves.

So, the entire infrastructure of the market (from storage to transportation) needs adjustment in accordance with the country's potential for exporting grain. Otherwise, Russian export grain will be uncompetitive due to the high logistical costs. At present a program for developing infrastructure and logistical support to the Russian food market is being worked out whose target is to expand opportunities for agricultural commodities' storage and marketing.

The oversupply of grain on the world market made the problem of its quality more acute. Narrow markets and strong competition let buyers set rigid requirements to the quality of grain including infestation by chinch bug. For instance, Egypt that in 2008/2009 MY accounted for 27% of the Russian wheat exports has set stricter requirements to crop infestation by this pest. Out of all regions of Russia's South only Krasnodar kray produces wheat that meets the new quality requirements. Small supply of adequate quality wheat in Russia's South may result in the extending of export supply zone up to Western Siberia free of the chinch bug problem. This will inevitably require the solution of logistical problem of this market mentioned above.



Source: FAO.

Fig. 2. World prices for wheat and corn, dollars per ton, FOB.

It's obvious that next year the problem of grain quality will become even more pressing. The deficit of funds due to the economic crisis has curbed opportunities for applying pesticides and adequate quantities of fertilizers, for the purchase of machinery and other inputs.

In the situation of tough competition on the world market the issue of expanding the geography of export and entering new markets needs to be addressed.

State regulation

At present the state regulation of grain market is limited to intervention purchases that are expected to be a weak support for the market in the current year. The observed negative trends on the grain market call for additional government measures for its stabilization. As noted above, efforts should be made to expand export supplies including upgrading of infrastructure, development of new promising markets and improvement of Russia's grain competitiveness by quality parameters.

An open joint-stock company "United Grain Company" (UGC) was set up in order to develop elevator capacities, transport and port infrastructure of the domestic grain market and to enhance the country's grain export potential. The company is 100% state-owned. It was formed in 2008 by transforming the federal state unitary enterprise (FSUE) "Federal agency for food market regulation" (affiliated to the Ministry of Agriculture) into a joint-stock company. From 1997 the FSUE operated as a state agent for carrying out state purchase and commodity interventions aimed at regulating agricultural and food markets. Authorized capital of UGC will incorporate assets of 31 joint-stock companies in 19 regions, with the share of state in the capitals thereof being not less than 25%. Among the most attractive assets are: the Novorossiysk factory of bakery products, six elevators and three grain terminals in Norossiysk, Eysk and Kaliningrad ports. The summary grain bunker capacity of UGC will exceed 3 million tons.

The company will act on behalf of the Russian Federation as the largest grain exporter, participant of international tenders and supplier of grain in the framework of international humanitarian programs. It will engage in construction of grain elevators and export port terminals. The forming of its own railway car fleet is planned for transporting grain by rail.

The UGC's strategy is currently being drafted. Already next year the company plans to export about 4 million tons of grain. Most likely this will be the grain from intervention stocks. The company intends to become one of the leading grain exporters and to supply up to 15 million tons of grain to the world market.

On the one hand, the market can benefit from this project. Exporting of intervention grain that stockpiled last year and became a heavy burden for the new marketing year will unload elevators whose capacities are limited as it is. A positive side may also be the establishing of trade relations with new countries-importers of Russian grain since so far traditional domestic traders cannot count on expansion to new markets. On the other hand, one cannot exclude that the state company will start operating on the already developed markets and in this case may become a serious competitor to private exporters.

II. Market of milk

Basic trends

The effect of economic crisis on the sector was coupled with the lowering of purchase prices for milk thus worsening the performance of dairy farms even more.

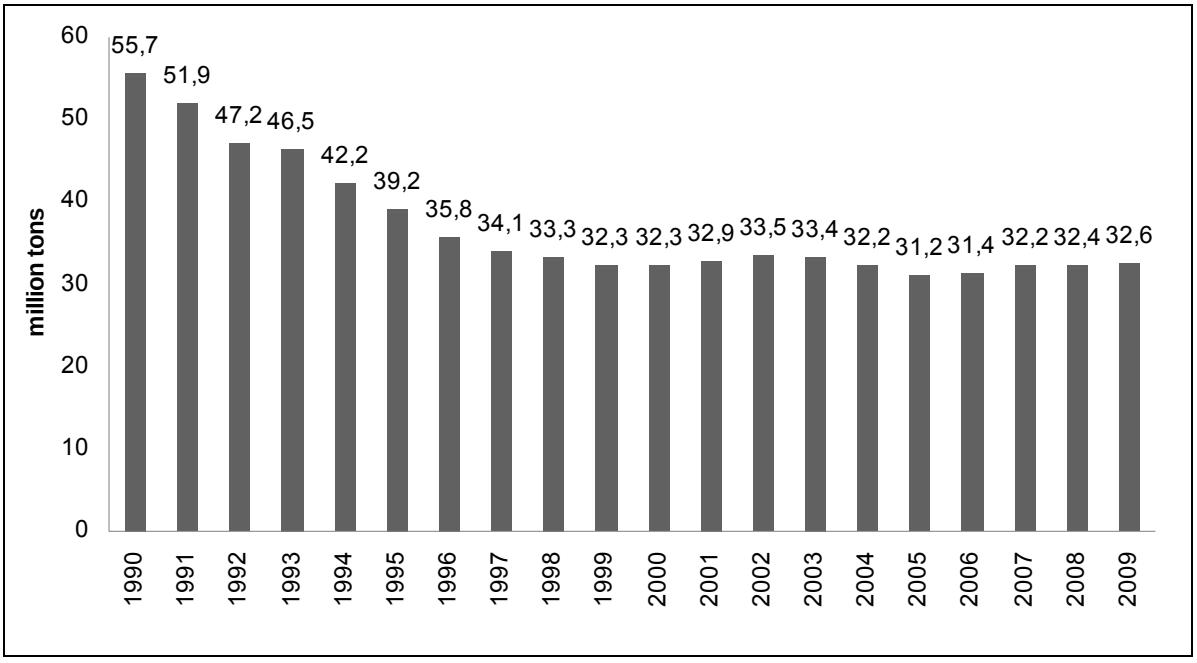
In recent years the market of milk was seriously affected by strong fluctuations of prices for raw milk received by farm producers. After growing at a high rate in 2007 – early 2008 they started to fall notwithstanding the rise of retail prices for dairy products. This trend had a negative effect on consumer demand that was also undermined by the decline of real personal incomes in the crisis period. Some government regulation measures were introduced in order

to stabilize the situation on the market including restriction of dairy items' import and stimulation of consumer demand. These efforts facilitated a certain recovery of prices for raw milk.

After the 1998 crisis when Russian agriculture benefited from active investment activities and first steps were made for intensifying dairy farming, the decline of output at dairy farms slowed down.

In 2006-2007 the drop of milk output and cow inventories was halted owing to the successful implementation of one of the components of Priority National Project "Development of agrifood sector" – "Accelerated development of livestock production". However, in 2008-2009 the lowering of purchase prices for raw milk and the worsening of farm producers' performance in the crisis situation re-triggered the decrease of dairy herd: the total number of cows in all types of farms reduced from 9.4 million heads in 2007 to 9.1 million heads in 2008. By the end of October 2009 cow inventories in corporate farms were 0.3% below the corresponding previous year indicator.

The positive dynamics of milk production still preserved owing to the improving productivity of dairy herd but the rates of growth fell. As a result the gross output of milk in 2008 was only 0.6% above the previous year indicator – 32.4 million tons (in 2007 the growth amounted to 2.5%). In 2009 milk production grew similarly and totaled 32.6 million tons (*Fig.* 3).



Source: Rosstat, 2009 – "Soyuzmoloko".

Fig. 3. Milk output in all categories of farms

In the beginning of 2000's dairy processing also started to recover. Since then the output of dairy products was growing. In 2000-2008 the biggest increase was observed in production of high-fat cheeses (by 94.7%), whole milk products (by 66.1%), dry dairy products (by 47.2%) and canned milk (by 35.9%). Production of butter, low-fat milk products and ice cream has shown actually no growth (*Table 4*).

In 2008-2009 the performance of milk processing plants was affected by lower consumer demand due to the fall of real personal incomes in the situation of global financial crisis. The output of butter, cheeses and whole milk products demonstrated a downward trend. Smaller output of dry milk products is conditioned by lower demand for them after the enforcement of Technical Regulation for milk (see the section examining market regulation).

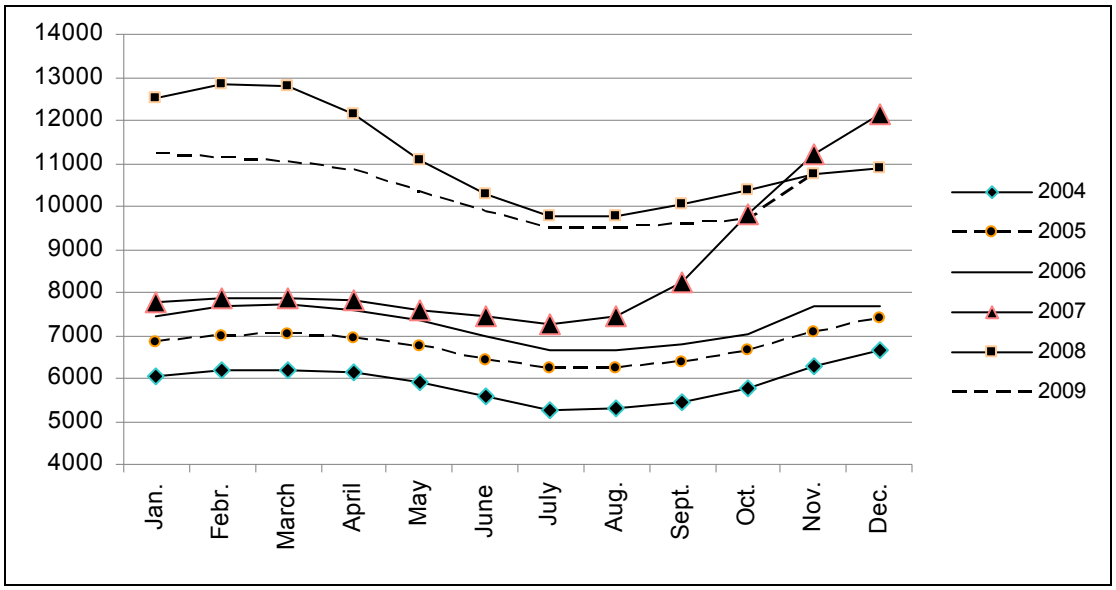
Table 4

Output of milk products, thousand tons

	2000	2005	2006	2007	2008	*2008/ 2000, %*	January-December 2009	*2009/ 2008, %*
Butter	267.2	253.9	267.8	272.4	271.8	*101.7*	231.8	*85.2*
High-fat cheeses including brinzen	220.7	378.3	421	436.6	429.8	*194.7*	436.1	*101.5*
Whole milk products in milk equivalent	6214.7	9732.6	10020.8	10514.6	10322.7	*166.1*	10473.7	*101.5*
Dry whole milk, dry cream, dry milk mixes	74.5	79.7	75.3	78.8	83.2	*111.7*		
Skimmed milk powder, milk replacer, dry whey	96.7	123.2	135.7	149	142.3	*147.2*	157.8	*70.0*
Ice cream	346.2	406.5	388.6	382.9	367.7	*106.2*	277.1*	*96.1*
Canned milk, million standard cases	623	897	833	759	865.4	*135.9*	536.9*	*98.6*
Low-fat milk products in milk equivalent	534	457.7	523.9	513.9	509.9	*95.5*	n.a.	*n.a.*

*January-August 2009.
Source: Rosstat.

In recent years the situation on dairy market was greatly influenced by strong fluctuations of purchase prices for raw milk. In 2007 – early 2008 they surged and reached the peak level in March 2008 – 12.8 rubles per kg (*Fig. 4*). But then they started to fall. By August 2009 the average price for raw milk dropped down to 9.5 rubles per kg that is below the production cost in many dairy farms.



Source: Rosstat, "Soyuzmoloko".

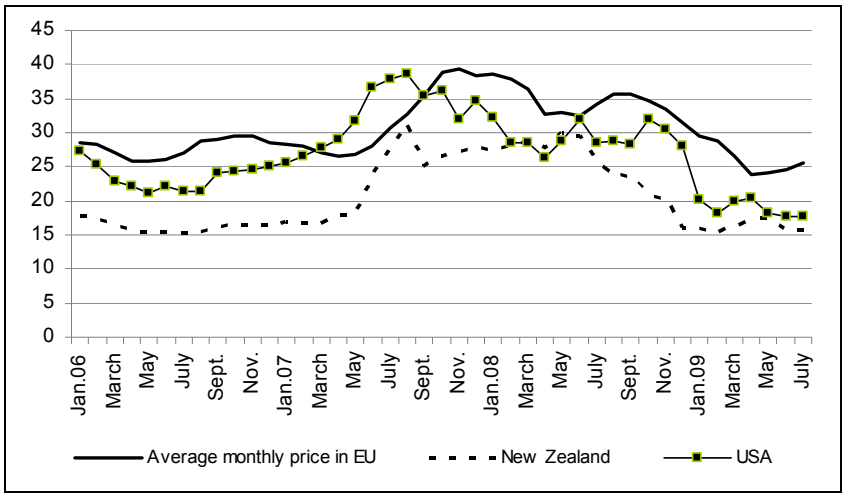
Fig. 4. Prices for raw milk received by farm producers, rubles per ton

The raising of prices for raw milk in 2008-2009 was constrained by both internal and external factors. First, sluggish demand for raw milk was due to smaller demand for domestic dry milk and supply of cheap dry milk from Belarus. Given the current ratio of prices for Russian raw milk and dry milk from Belarus, domestic processors are not interested in the development of home production of dry milk. With the price for whole milk ranging from 10 to 11 rubles per kg, the production of 1 kg of dry milk will cost minimum 100-110 rubles while the market price for skimmed milk powder from Belarus is about 70 rubles per kg.

Second, the market was influenced by the adoption of Technical Regulation for milk and milk products. The lowering of prices for milk received by farm producers was due to smaller demand for it since processors wanted to utilize earlier purchased stocks of dry milk before the enforcement of Federal Law on Technical Regulation that restricted the use of dry input for producing dairy products. In 2008 imports of dry milk were 38% bigger than in the previous year.

Third, a widespread processors' practice of replacing milk with fats and proteins of vegetable origin also had a limiting effect on the demand for raw milk (for more details see the section on market regulation).

An external market factor was the lowering of world prices for milk and milk products due to the growth of their global output (*Fig.* 5). In response to that in 2009 the EU has re-established export subsidies for cheese and butter.



*Total bacterial count < 2,5*104, somatic cells < 2,5*105, fat content 4,2 %, protein content 3,4 %.
Source: Russian Dairy Union.

Fig. 5. Purchase prices for raw milk in the EU, New Zealand and the US in 2007-2009, EUR per 1000 kg *

In recent years corporate farms produced about 44-45% of raw milk in the country. In 2005-2007 cow inventories in the TOP 100 largest and most efficient dairy farms in Russia ranged from 800 to 6000 heads[1]. 63 of them kept from 1 to 2 thousand cows. The average profitability of milk marketing by the largest producers was 41.1% while in the rest of corporate farms engaged in milk production – only 12.6%. This proves the suggestion that the efficiency of top milk producers is well above that of other farms in the sector. According to data

[1] Rating of the Russian large and medium corporate farms in 2005-2007. The All-Russian Institute of Agrarian Problems and Informatics, 2008.

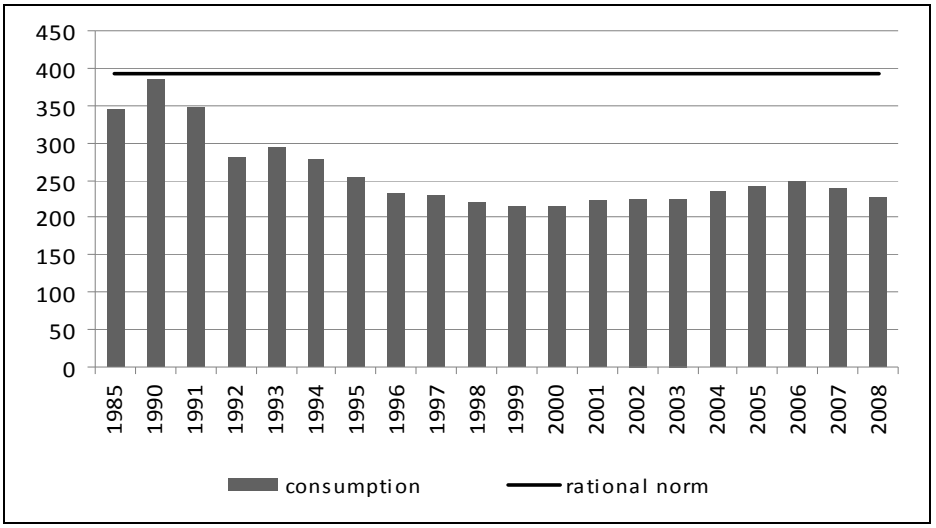
of the All-Russian Agricultural Census the most part of the latter (88% in 2006) are small farms keeping up to 500 cows. Estimates show that in farms having less than 500 cows the efficiency of milk production crosses the break-even point, i.e. they become loss-making. So, in 2008-2009 after the lowering of purchase prices for milk most Russian farms were close to this point and to the cutting of their dairy herd.

Despite the drop of purchase prices for milk the retail prices for dairy products were growing. Within two years (from September 2007 to September 2009) this growth averaged 30% and had a negative effect on consumer demand that was additionally undermined by the decline of real personal incomes in the crisis situation.

An upward trend of consumer demand was one of the contributors to domestic market development after 2000 (*Fig.* 6). A steady growth of real disposable incomes conditioned larger consumption of food products. In 2007, after a notable rise of prices for dairy products on the world and later on the domestic market their per capita consumption in Russia started to fall. In 2008-2009 the lowering of population's purchasing power led to the continuing decline of demand for dairy products (in 2008 – down to 228 kg per capita). In 2009 the drop of demand was reinforced by incorrect PR-campaign for the adoption of Technical Regulation for milk. As a result of it consumers got a strong feeling that milk offered by retailers was not natural (see the section on market regulation).

So, the limited consumer demand is currently one of the factors hindering milk market development in Russia. A campaign for social advertising of milk started in 2009 in order to promote consumption of dairy products by population. Budget funds were used to film a commercial that was demonstrated on the central TV channels. The promotional campaign is supposed to make milk (as a commodity group) more popular.

Due to the crisis developments the availability of credit resources for enterprises in real economy including agriculture reduced. The outbreak of the crisis resulted in smaller number of new investment projects in dairy farming initiated in 2008-2009. In some cases the implementation of already launched projects was halted. According to data of "Soyuzmoloko" by the middle of 2009 the construction of about 25% of founded mega-farms (with average capacity of 1-1.5 thousand heads of cattle) remained uncompleted.



Source: Russian Dairy Union, Rosstat.

Fig. 6. Average per capita consumption of milk and dairy products (in milk equivalent) in Russia, kg per annum

State regulation

In 2008-2009 the state regulation of the market of milk and dairy products was especially active. In order to stabilize the situation on the market aggravated by the crisis a complex of measures was carried out that aimed to restrict import of dairy products, to stimulate demand for them and to improve the efficiency of milk production. In particular, production of milk is supported in the framework of the State program for agricultural development and regulation of agricultural and food markets in 2008-2012. In 2008 a special branch program "Development of dairy farming and expansion of milk production in Russia in 2009-2012" was adopted to provide additional state support to the sector. Some changes to customs regulation were adopted including the raising of import duties on selected dairy items and the introduction of amendments to the balance of milk and dairy products of the Union State of Russia and Belarus that were to limit imports of cheap dairy produce from Belarus. At the end of 2008 the Federal Law "Technical regulation for milk and milk products" was enforced that sets requirements to the safety of these products, to the processes of their production, storage, transportation, marketing and utilization as well as to the terminology, packing and labeling of milk and milk products. In 2009 a social advertising program was launched in order to promote consumption of milk by population.

Despite a whole set of measures undertaken by the state on the milk market, the problems due to the limited consumer demand, seasonal fluctuations of raw milk production and non-availability of soft long-term credits for the market operators remain still unsettled. Their solution is impossible without further state support and regulation as well as private investments in the sector that otherwise won't be able to fully realize its potential competitive advantages on the domestic market.

In particular, the state needs to develop an adequate normative basis for technical regulation on the market; to widely promote milk and dairy products' consumption and to implement respective target programs; to control supply of milk products from Belarus and Ukraine; to provide long-term credits for the development of dairy farming and to settle land legislation issues.

Measures for the development of dairy farming envisaged in the State program for agricultural development and regulation of agricultural and food markets in 2008-2012 proved to be insufficient for ensuring the projected rates of milk production growth.

In order to provide additional state support to the sector aimed to cope with its lagging behind a special branch program "Development of dairy farming and expansion of milk production in Russia in 2009-2012" was developed. Its funding totals 30.5 billion rubles including 7.4 billion rubles in 2009. In the framework of the program the output of milk is planned to grow from 32.2 million tons in 2007 to 37 million tons in 2012.

The following measures are envisaged in the program:

- subsidies to pedigree breeding and pedigree reproduction farms (covering up to 30% of their per expenditures – 5000 rubles per head in the former and 4500 rubles in the latter farms);
- subsidies to pedigree reproduction farms for purchasing semen of breeding bulls (30 rubles per dose);
- subsidies for purchasing young cattle stock (30 rubles per kg of live weight);
- partial compensation of expenditures on formula feed;

– interventions on the market of dry milk[1].
– The target indicators of the program are as follows:
– the share of breeding stock in the total cattle inventories – 15%;
– purchase of not less than 100 thousand heads of pedigree young stock per annum;
– milk output – 37 million tons by 2012;
– average milk production per cow – 4.5 thousand kg per annum.

Customs and tariff regulation

In 2009 all changes in the customs and tariff regulation of dairy items' import were targeted at the protection of domestic milk producers. Import duties on dry milk, butter and some kinds of cheese were raised.

From March 2009 the specific component of the combined import duty on butter and other milk fats (15% but not less than 0.22 EUR per kg) was temporarily (for 9 months) raised to 0.35 EUR per kg and thus adjusted to the ad valorem component and current prices that grew in the previous two years. As a result in 7 months 2009 imports of butter reduced by 11.6%. At the same time deliveries from Belarus (that are not subject to restrictions since the country is a member of the Customs Union) increased by 15.4%.

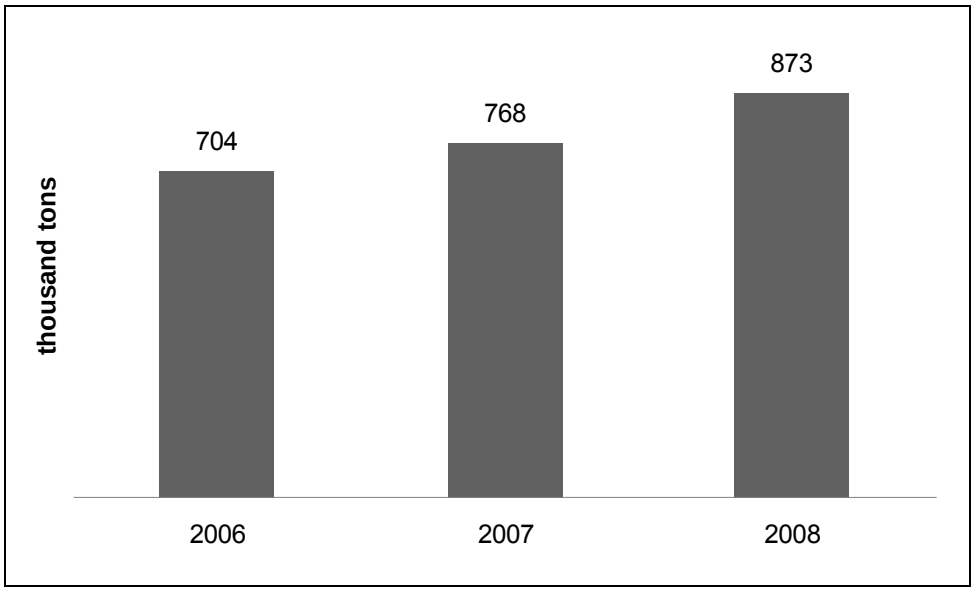
For the duration of 9 months import duties on dry milk and cream and on canned milk were raised from 15 to 20%. Since over 90% of dry milk is supplied from Belarus enjoying duty free import regime, this measure had no sizeable effect on prices. The overall decrease of dry and condensed milk imports in 7 months 2009 amounted to 23% while of those from Belarus – to 10%.

The rate of customs duty on cheeses depended on their declared value, the lowest duty applying to the most expensive brands. For instance, cheeses whose value didn't exceed 1.65 EUR per kg were subject to import duty of 0.7 EUR per kg, from 1.65 to 2 EUR per kg – of 0.65 EUR per kg, over 2 EUR per kg – of 0.3 EUR per kg. However, due to the rise of prices for dairy products in the two recent years almost all cheeses fall into the category to which minimal rates are applied. In 2009 a single tariff was established for hard cheeses not depending on their customs value – 15% but not less than 0.5 EUR per kg. The actual result of it was the raising of duty on cheeses earlier treated as expensive ones. The share of the named cheeses' imports on the domestic market is rather small – 20-25% (as estimated by the Russian Dairy Union) even though the higher duty doesn't apply to cheeses supplied from Ukraine and Belarus that account for over 50% of the total imports of these items. This causes concerns that Belarusian and Ukrainian competitors of domestic producers will use the opportunity opened by the raising of customs duty for expanding their shares on the market.

The restriction of cheeses' import was necessary since after the reduction of dry milk production in 2009 processors used the resulting surplus of non-demanded raw milk for making cheese. As a result all companies accumulated large stocks of this product that they needed to sell. But due to the above mentioned reasons the positive effect of this measure on domestic cheese producers was too limited.

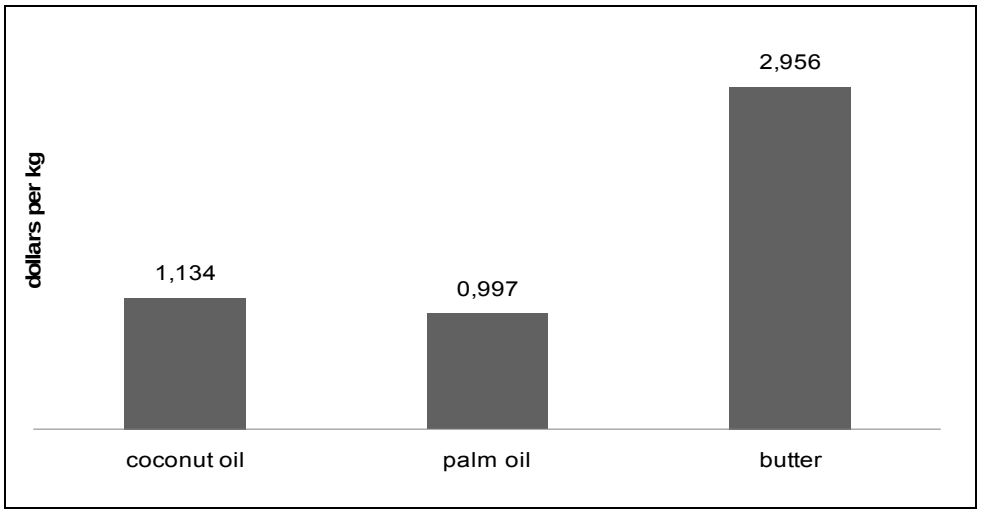
[1] Resolution No. 821 of October 17, 2009 complemented the list of agricultural products subject to state purchase and commodity interventions by including into it butter, sterilized consumer's milk and cheeses (semi-hard, hard and extra-hard).

One more important change took place in the customs and tariff regulation that had an impact on milk market – the raising of import duties on tropical oils being replacers of animal fats.



Source: Rosstat.

Fig. 7. Imports of tropical oils to the Russian Federation



Source: Rosstat.

Fig. 8. Actual prices for coconut and palm oils and butter in December 2008

Lately milk processors started to use bigger quantities of cheaper tropical oils (palm, coconut, palm kernel and other) in their production. According to data of the Dairy Union in the five recent years imports of tropical oils actually doubled and in 2008 reached almost 900 thousand tons (*Fig. 7*). In 2008 the average contract price for 1 kg of tropical oils was almost three fold below the price for butter (*Fig. 8*). The price situation on the markets of tropical oils and butter within the last 10 years resulted in the substitution of dairy fat for vegetable oils in the production of food products including the ones containing milk. According to ex-

pert estimates the volume of such substitution amounted up to 500 thousand tons – an equivalent of 6.5 million tons of milk[1].

In response to this, import duties on tropical oils were raised up to 10%. Dairy industry consumes only a part of the imported quantities. These oils are also used for producing confectionery, mayonnaise, fast food and special fats. Besides, they are major ingredients for manufacturing toilet soap. So, the raising of import duties may result in higher prices for produce of these industries.

Technical regulation

RF Federal Law No. 88-FL "Technical regulation for milk and milk products" of June 12, 2008 was enforced in December 2008. It sets special requirements to raw milk and products of its processing that are aimed "to safeguard life and health of citizens, to protect environment and to prevent actions misguiding consumers". In fact the goal of the Technical Regulation is to encourage production and purchase of domestic raw milk and to lower demand for imported dry milk.

According to the Technical Regulation a product reconstituted from dry milk is now called "milk drink". "Milk" is defined as a product made out of whole milk without adding to or extracting any substances from it. It was supposed that the introduction of this standard would lead to the division of consumer's milk market into two segments: the segment of natural milk and the segment of reconstituted milk made out of dry milk. As a result prices for qualitative raw milk should have risen. But nothing of the kind has taken place.

There is no habit of consuming milk drinks in Russia – domestic consumers are used to regard dairy products as natural ones. The introduction of new definition "milk drink" should have been accompanied by providing consumers with explicit information about this product. But since "milk drink" was discredited in mass media as a non-worthy product, it was not accepted by consumers. Due to the incorrect PR-campaign for the adoption of Technical Regulation consumers got a strong feeling that milk offered by retailers was not natural. This was an additional factor entailing lower demand for dairy products. The Russian Dairy Union offers to replace the term "milk drink" in the Technical Regulation by the term "reconstituted milk" in order to restore consumers' confidence in this product.

Having limited opportunities for the use of dry milk in production of dairy products, the Technical Regulation aggravated the problem of milk production seasonality. Earlier it was tackled by drying surplus summer milk for utilizing it later during the autumn-winter deficit period. After the enforcement of Technical Regulation milk processing plants reduced purchases of raw milk for manufacturing dry milk. In January-August 2009 the output of dry whole milk reduced by 47%, of skimmed milk powder – by 30% as compared with the corresponding period previous year[2]. As a result there was a surplus of raw milk on the market and instead of the expected rise purchase prices for it continued falling in spite of the growth of prices for processed dairy products. In June 2009 the average purchase price for raw milk dropped to its minimal level beginning from October 2007 – 8389 rubles per ton[3].

Given smaller production of dry milk some processors used the resulting surplus of raw milk for making cheese. In 8 months 2009 its output grew by 7.9%[4] as compared with the pre-

[1] According to data of the Dairy Union.
[2] According to data of the Russian Dairy Union.
[3] According to data of the Russian Dairy Union.
[4] According to data of Rosstat.

vious year. But the development of domestic cheese industry was hindered by imports of cheap cheese from Belarus and Ukraine (enjoying duty-free regime of trade with Russia) and by subsidized export of cheese from the European countries. As mentioned above, the introduction of restrictions on import of cheese did not help to fully solve this problem and thus to encourage its domestic production and support demand and purchase prices for milk.

The enforcement of Technical Regulation had not only to reduce processors' demand for dry milk but also to restrict imports of cheap dry dairy products from Belarus. In recent years dry milk produced in Russia loses price competition to the similar Belarusian item whose production is subsidized. That's why many Russian processing enterprises prefer to use raw inputs imported from Belarus.

For the period from March to December 2009 Russian government raised import duties on dry milk from 15 to 20%. But this restriction didn't apply to countries of the Customs Union including Belarus. As a result overall supplies of dry dairy products to the Russian market in the first half of 2009 fell by 12.8% down to 45 thousand tons. However, the expected reduction of dry milk imports from Belarus didn't take place. On the contrary, supplies of Belarusian commodities within this period grew by 18.5% up to 44.2 thousand tons[1].

After the introduction of Technical Regulation Belarus had to bring its permissive documentation on dairy products in accordance with the new requirements. But for almost half a year after the law's enforcement the country continued to supply dairy produce to Russia under documents not complying with the new Russian regulations. As a result in June 2009 the Russian Federal Service for Oversight of Consumer Protection and Welfare banned import of dairy products from Belarus for over a month. It regained after the harmonization of documentation.

The transfer of Russian producers to new standards is also halted. The needed changes in technical documentation, the purchase of new equipment for complying with Technical Regulation's requirements and the printing of new labels demands additional financial resources that are not easily available in the crisis situation.

The normative basis for the enforcement of Technical Regulation is not sufficient as well. Many standards and techniques are not yet defined including the ones needed for control over the law's execution. For instance, there are no certified techniques allowing to determine whether dry milk was used in production of consumer's milk.

In 2008 four new standards were worked out in the framework of the Technical Regulation's implementation, the development of 30 more was planned for 2009.

So, the practice of Technical Regulation's application showed that neither market nor normative basis was ready for the full-scale implementation of the law. The lack of necessary normative basis does not allow to exercise milk production and marketing control. There is no opportunity to prevent counterfeiting and to secure compliance with the Technical Regulation. Besides, the regulation itself requires adjustment.

The introduction of this law is certainly needed for the harmonization of domestic practice with international rules and regulations pertaining to terminology and labeling. The Regulation helps to guide dairy industry towards production of natural products. And most importantly, the enforcement of this law should provide consumers with explicit information about the dairy products they are offered.

[1] According to data of the Russian Dairy Union.

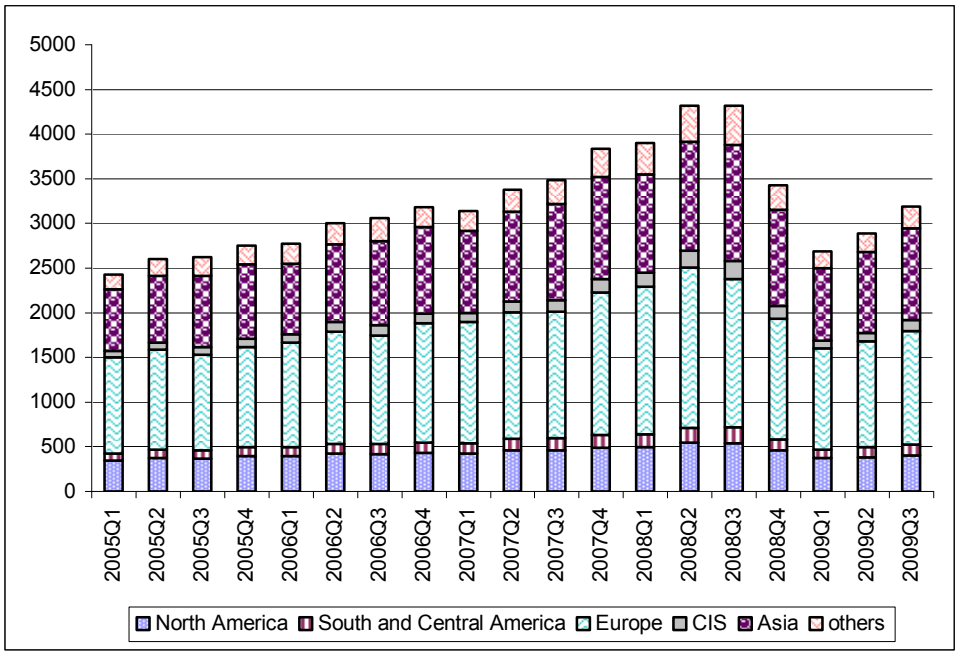
3.6. Foreign Trade

3.6.1. International Trade in the Wake of the Global Crisis

The World Bank Report[1] on the global economic outlook published in January 2010 states that the global production and trade levels have gained during the 2H 2009 after the preceding decline. Confidence strengthened significantly both in finance and in real economy, as governments' emergency measures allowed for preventing the repetition of the Great Depression. The extraordinary amounts of governments' incentives were the main driver underpinning this global recovery.

Foreign trade landslide commenced in October 2008 and lasted until the 2nd quarter of 2009; moreover, it happened in all the countries simultaneously. If we look at the EU and 10 other leading global exporters / importers (altogether accounting for the 3/4 of international trade), their export and import numbers both declined by 20–30%. Foreign trade turnover was growing in the 2nd quarter of 2008 across all the commodity lines, and in the 4th quarter the recession was obvious practically everywhere, then in the 1st quarter of 2009 the decline became really universal. After that the turnover started growing slowly, but there is still a long way to go to achieve the complete recovery.

As per the WTO data, the global export decline started way back in the 3rd quarter of 2008 (vs. the preceding quarter), however, at that stage it affected only European and North American countries. In the 4th quarter export decline became universal. The overall global export in the 4th quarter of 2008 fell by 20.7% versus the pre-crisis peaks of the 2nd quarter.



Source: http://www.wto.org/english/res_e/statis_e/quarterly_trade_e.xls

Fig. 1. Global Export Dynamics by Quarters (USD bn.)

In the 1st quarter of 2009 the global export decline constituted 37.9% versus the pre-crisis peaks. However, it then started to recover: 7.6% growth in the 2nd quarter versus the crisis minimum of the 1st quarter; 10.4% growth in the 3rd quarter versus the preceding one. Export

[1] http://siteresources.worldbank.org/INTGEP2010/Resources/GEP2010-Full-Report.pdf

recovery wasn't evenly distributed between the regions: thus, the maximum decline of export (the crisis minimum of the 1st quarter of 2009 versus the pre-crisis maximums) from North American countries made 32%, in Europe – 37%, in Asia – 35.2%, in South America – 45.8%, and in CIS countries – 51.5%.

The World Bank forecasts that after 12.3% slide in 2009 (versus the preceding year) the global trade will start its slow recovery: 5.8% growth is forecasted for 2010 and 6.3% growth – for 2011.

Table 1

Global Trade Dynamics (% vs. the preceding year)

	2005	2006	2007	2008	2009	2010[1]	2011[1]
Global trade of goods and services	107.5	109.2	107.2	102.8	87.7	105.8	106.3
Import							
Industrially advanced economies	106.1	107.5	104.5	100.5	87.8	105.5	105.5
Developing economies and emerging markets	112.1	114.7	114.5	108.9	86.5	106.5	107.7
Export							
Industrially advanced economies	105.8	108.4	105.9	101.8	87.9	105.9	105.6
Developing economies and emerging markets	111.1	111.0	109.6	104.4	88.3	105.4	107.8

[1] Forecast

Source: http://www.imf.org/external/russian/pubs/ft/weo/2010/update/01/pdf/0110r.pdf

3.6.2. Russian Foreign Trade Outlook: Market Prices Trends for Key Items of Russian Export

The global crisis has led to sharp variations of global prices for the key items of Russian export. At the same time, following the abrupt slide of late 2008 – early 2009 the global markets price dynamics for these commodities started to improve gradually. Oil prices started their rise on a global scale. The average Brent price in December 2009 was reported to gain 79% versus December 2008. The most vigorous growth pf prices fell on the spring months – from mid-February to mid-June, when the level of 70 USD/bbl was reached. During the summer and early fall the prices were fluctuating around 67 USD/bbl, and at the end of the year the new level of 75 USD/bbl was observed.

2009 oil prices growth was driven by the expectations of economic recovery after financial and economic crisis. Information about commencing recovery of some leading economies and about sustainable economic growth in China underpinned the increase in demand for oil world-wide. The USA currency dynamics had its effect on the oil prices as well: weakening of the US Dollar versus the leading global currencies resulted in the dollar-nominated commodities growing more expensive, as well as in the venture capitals partially overflowing from the currency market to the commodities markets. On top of that, OPEC countries were trying to observe the oil production quotas established back in 2008.

The average global price for Russian crude (Urals) in 2009 fell to the lowest level for the preceding four years and made 60.94 USD/bbl being 35.3% below the 2008 level (94.16 USD/bbl). The highest price for Urals in 2009 was registered on November 18 – 78.16 USD/bbl). The lowest price for 2009 was registered as of January 2– 39.39 USD/bbl. Thus, the Urals price practically doubled during the year.

Similar trends were observed at the petroleum products markets, though the growth rates were different by types of products. Thus, in the 3rd quarter of 2009 versus the 2nd quarter fuel oil demonstrated the most dramatic growth by 25%, diesel fuel price grew by 15%, and automotive gasoline – by 11%. As per the overall results of 2009, both crude and oil products

prices were 2 times lower compared to the preceding year. Diesel fuel prices showed the most obvious decline in 2009 – by 52%, automotive gasoline – by 37.8%, and fuel oil – by 40%.

The decrease of natural gas prices at the European market started in late 2008 and continued until August 2009. In August the Western European market showed first signs of growing prices, however, the growth rates were very low (and in the US market natural gas prices continued to decline until September 2009). In the 3rd quarter of 2009 natural gas prices in Europe were 15.6% lower compared to the preceding quarter (during 1st and the 2nd quarters the decline was respectively by 24.2% and 31.5%), and they were 52.8% lower versus the 3rd quarter of 2008. It was not until the 4th quarter of 2009 when natural gas prices demonstrated some growth – 13% versus the preceding quarter. As per the overall results of 2009, natural gas prices in Europe were 30.8% lower versus 2008 prices.

In September-December 2008 abrupt decline of metal products prices was observed in the global markets making 40–50% on the average. In early 2009 this downward trend continued, and only starting from June-July 2009 some positive dynamics of global prices for metal products and raw materials was witnessed. Thus, by the end of 2009 global prices remained at the same low level.

For example, the scrap steel price after reaching its peak of 700 USD/t in June 2008 fell down and made 300 USD/t in December 2009 (43% decline). The prices for hot-rolled coil fell down from 1,200 USD/t in July 2008 and by December 2009 made 560 USD/t (47% decline).

Table 2

Average Annual Global Prices

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Oil (Brent), USD/bbl	15.9	28.19	24.843	25.022	28.83	37.4	54.38	65.15	72.32	99.53	62.19
Natural gas, European market, USD/ 1 mln BTU	2.1876	4.3442	3.9764	3.23	3.86	4.4	6.6	9.03	8.93	12.61	8.72
Gasoline, $/gallon	0.529	0.887	0.7922	0.755	0.891	1.197	1.508	1.81	2.06	2.703	1.68
Copper, $/t	1539.9	1863.9	1613.6	1592.9	1785.6	2808.2	3606	6851	7119	6970	5150
Aluminum, $/t	1318.0	1550.0	1444.7	1350.7	1424.7	1693.2	1871	2619	2639	2576	1665
Nickel, $/t	5239.5	8624.0	5966.0	6175.1	9580.8	13757	14692	22038	37230	21108	14655

Source: calculated as per data by London Metal Exchange (London, UK), Intercontinental Crude Exchange (ICE, London), International Monetary Fund (IMF).

The financial crisis evolution in the fall of 2008 led to a sharp decline of major consumers' demand for basic metals. In its turn, it provoked a major fall in prices despite some artificial production-limiting programs. However, signs of global economic recovery facilitated global advance in prices at the global non-ferrous metal market. YTD prices have gone up 1.5 times for nickel and aluminum, and more than 2 times for copper.

Still global non-ferrous metals prices remained at the low lever throughout 2009 as per the LME spot quotations making as of the end of December: 2,182 USD/t or 71.1% vs. July 2008 price (historic peak) for aluminum, 6,970 USD/t or 82.6% vs. March 2008 price for copper, 17,003 USD/t or 54.3% vs. March 2008 price for Nickel.

Global macroeconomics and the overall commodity market environment also had their impact on the price dynamics for other commodities exported from Russia. In 2009 the prices for mineral fertilizers, chemical feedstock and some other commodities were 1/3 below the level of 2008.

The global markets price dynamics for food products and agricultural raw materials were multidirectional throughout 2009. Sugar prices were growing rapidly, meat and vegetable oil

prices were mainly growing, while as grain prices were declining. Reduction of global wheat production is expected in 2009/2010 farming year, however, the level of wheat stock in major wheat-producing countries (Argentine, Australia, EU, Kazakhstan, Canada, Russia, the USA and Ukraine) will remain high. The key reason is global demand decline versus its record level in 2008/2009 farming year.

Table 3

Average Annual Global Prices Dynamics for Selected Agricultural Goods

	2006	2007	2008	2009			
				I quarter	II quarter	III quarter	IV quarter
Wheat, USD/t							
Canadian, CWRS	216.8	300.4	454.6	321.9	325.5	271.3	283.2
American, HRW	192.0	255.2	326.0	231.6	250.3	208.7	205.4
American, SRW	159.0	238.6	271.5	187.4	195.6	165.2	195.6
American corn, USD/t	122.9	163.0	223.1	166.9	176.0	151.3	167.8
Barley, USD/t	117.0	172.0	200.5	116.2	129.4	122.0	145.5
Soya beans, USD/t	268.4	384.0	523.0	393.7	460.3	455.3	439.3
Soya bean oil, USD/t	598.6	881.0	1,258	754.7	862.7	857.7	920.3
Thai rice, USD/t	304.9	326.4	650.1	586.4	552.4	540.1	542.3
Crude sugar in the USA, import price, CIF New York, c/kilo	48.76	45.77	46.86	43.8	47.9	57.3	70.5

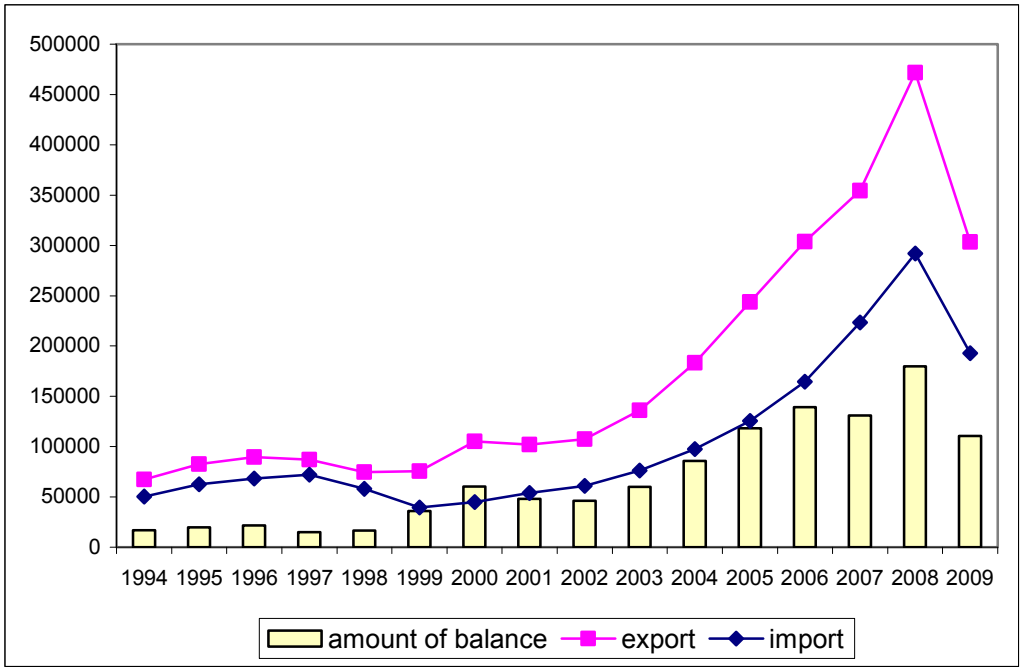
Source: World Bank.

The main reason for sugar prices surge was crop failure in Brazil and India – the major sugar producers in the world. It resulted in dramatic reduction of sugar stock across the globe, and India becoming the net-importer. Meanwhile the estimated export of sugar out of Brazil is expected to decrease versus the previous year, while as it domestic demand for ethanol will be growing. Eventually, the global sugar prices rocketed up to the highest level during the last 29 years.

3.6.3. Key Russian Foreign Trade Indicators

In 2009 Russian foreign trade indicators (*Fig. 2*) were forming in the wake of abrupt slide of prices for the key items of Russian export early in the year, volatile international trade outlook and shrinking of domestic demand predominantly affecting the import dynamics. Overall, 2009 Russian foreign trade dynamics was significantly worse compared to 2008 indicators. The accounts balance based foreign trade turnover made 495.8 bn. USD being 35.15% below the YOY value. The "far-abroad" trade turnover shrank by 35.15% down to 423.7 bn. USD, CIS trade turnover – by 34.5% down to 72.1 bn. USD. Foreign trade turnover imbalance index (export surplus to foreign trade turnover) decreased to 22.6% in 2009 vs. 23.5% in 2008.

However, after an abrupt slide early in the year Russian foreign trade demonstrated some recovery and even growth in 2009. Monthly foreign trade turnover dynamics stayed positive versus the preceding month throughout the whole year due to a certain rise in prices for Russian export items and due to recovery of both domestic and global demand. Thus, the average export prices index for 9 months of 2009 made 62.9%, and during the 4-th quarter of 2009 it amounted to 76.0%, (76.9% in December). Physical export volumes were also growing, the index in the above listed periods making 92.3, 111.9 and 112.7% respectively (*Table 4*).



Source: Central Bank of the Russian Federation.

Fig. 2. Key Russian Foreign Trade Indicators (mln USD)

Table 4

Commodities Export Index

	January-September 2009, % of January-September 2008		December 2009, % to December 2008		2009 as % to 2008	
	Physical volumes	Average prices	Physical volumes	Average prices	Physical volumes	Average prices
Total export,	92.3	62.9	112.7	76.9	97.0	66.5
including:	94.1	61.4	108.2	77.8	98.6	65.0
"far abroad" countries						
CIS countries	82.3	72.2	143.6	72.2	87.9	76.4

Source: the RF Ministry of Economic Development.

Overall the commodities export in 2009 decreased by 35.5% versus 2008 making 303.98 bn. USD. With that the decrease of export in the 4th quarter of 2008 versus the peak numbers of the preceding quarter made 28.3%; in the 1st quarter of 2009 export decreased by 41.4% versus the preceding quarter. The overall export decline (crisis minimum numbers in the 1st quarter of 2009 compared to the pre-crisis peak in the 3rd quarter of 2008) made 58%. However, the following improvement of the situation resulted in 65% increase of export monetary values in the 4th quarter of 2009 (balance of payments estimate) versus the 1st quarter.

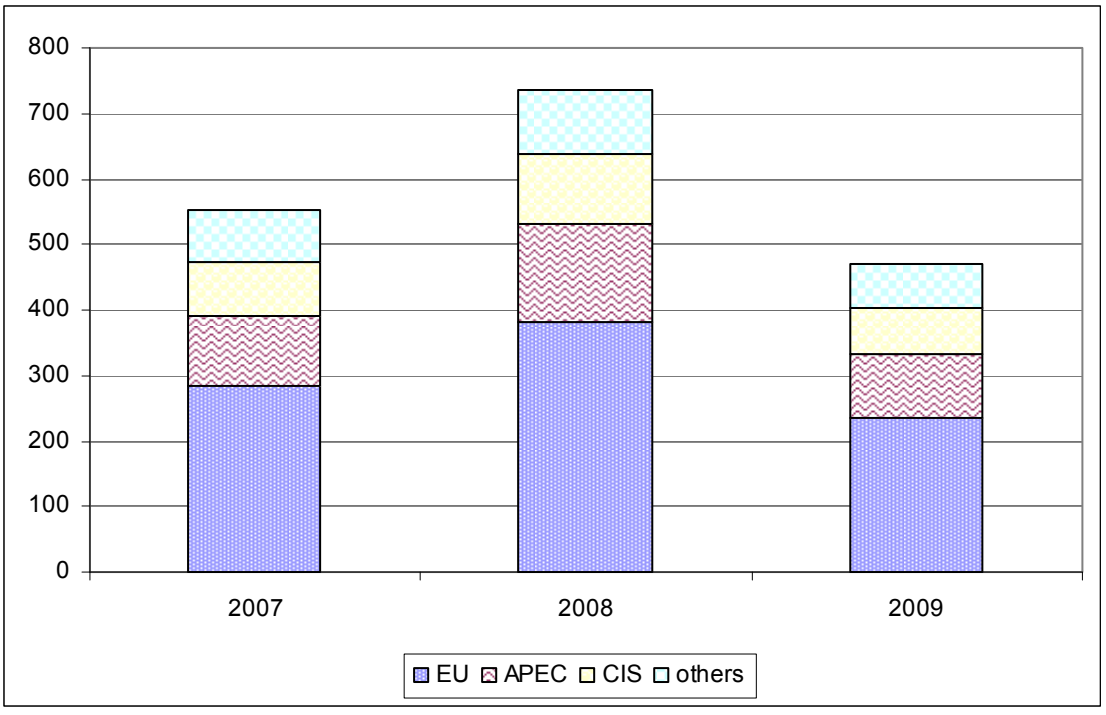
Import demonstrated similar dynamics. Its monetary values showed twofold decline during the 1st quarter of 2009 compared to the 3rd quarter of 2008 (from 82.9 bn. USD down to 38.4 bn. USD). However, during the next three quarters import was recovering rapidly. It increased by 59% in the 4th quarter versus the crisis minimum level in the 1st quarter of 2009 (preliminary payments balance based estimate). It resulted in 83% of the level of the 4th quarter of 2008 level and in 74% of the pre-crisis maximum of the 3rd quarter of 2008.

As a result, the trade balance surplus in 2009 made 112.1 bn. USD (vs. 179.7 bn. USD in 2008). Early in the year there was some concern about the trade balance fluctuating around zero level or becoming negative. However due to the rapid export prices growth, recovery of physical export volumes and quite significant decrease of import in physical terms, material trade balance surplus was successfully maintained. At the same time, it's worth noting: during the 2nd and the 3rd quarters the pace of export monetary values recovery (versus preceding quarters) was outstripping import values recovery pace, but then in the 4th quarter the situation changed: Russian export values grew 15.3% versus the preceding quarter, while as the import values grew by 24%.

Thus, the key outcome of Russian foreign trade development throughout 2009 was maintaining the trade balance surplus. And in neither month it got below the minimal level of 4.6 bn. USD, which was registered in December 2008.

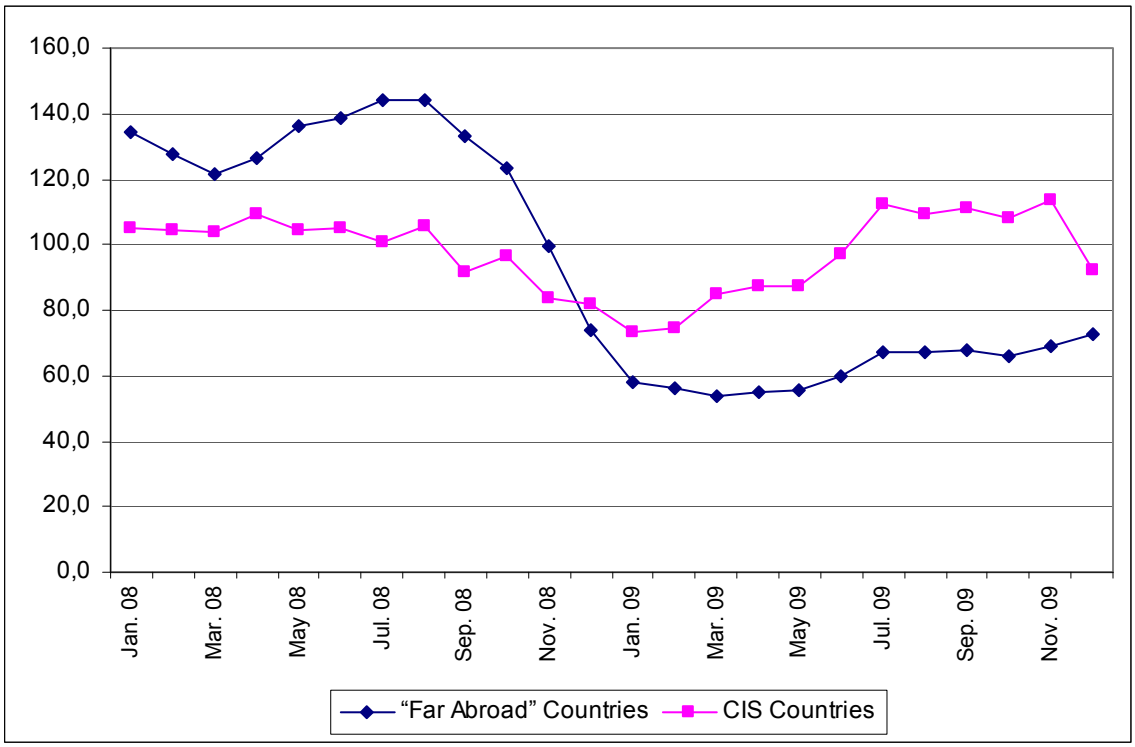
Russian foreign trade turnover decreased in 2009 in terms of most of its partner countries, except for India, Cuba, Singapore, Philippines, New Zealand and Turkmen Republic (*Fig. 3*).

In 2009 trade balance deficit was registered in terms of 20 partner countries (in 2008 it was with 23 partner countries), and their share in the overall Russian foreign trade turnover increased from 22.7 to 24.8%. The countries whose contribution in forming this deficit was the most prominent were China (–6171.7 mln USD), Brazil (–2426.7 mln USD), and Germany (–2520.8 mln USD).



Source: Federal Customs Service of the Russian Federation.

Fig. 3. Geographical Profile of Russian Foreign Trade (bn USD)



Source: RF Ministry of Economics.

Fig. 4. Terms of Foreign Trade

Foreign Trade environment (the ratio of export prices index to import prices index) started to deteriorate in 2008 and significantly worsened in 2009. This was particularly valid for trade with the "far abroad" countries. In July and August of 2009 this environment started to improve, and trade with CIS countries even demonstrated positive dynamics.

Overall, throughout the year the foreign trade environment was unfavorable for Russia due to a deeper slide of export prices versus import prices. Terms of trade index made 67.1 (the base [the respective period of the same year] being 100), while as in 2008 it made 116.0.

3.6.4. Export Profile and Dynamics

Fuel-and-energy commodities are still the basis of Russian export despite the fact that their share decreased from 72.6% in 2008 down to 69.5% in 2009 due to the global energy prices slide. The monetary value of such commodities decreased by 38.6% in 2008.

According to the RF Customs, physical volumes of exported crude increased by 1.9% – from 221.6 mln t in 2008 up to 225.9 mln t in 2009. With that the monetary value of crude export from Russia in 2009 decreased by 38.4% versus 2008 and made 93.5 bn. USD, which is related with the crude prices slide at the global market (*Table 5*).

Physical volumes of petroleum products export in 2009 exceeded the preceding year by 4.5% (120.577 mln t), their monetary value making 46.795 bn. USD versus 78.325 bn. USD in 2008.

Last year Russia exported the total of 150.07 bcm of natural gas for the amount of 39.38 bn. USD. With that Russian export of natural gas to the "far abroad" countries dropped by

23.9% making 120.5 bcm. Russian gas supplies to CIS countries increased by 90.1% reaching the level of 30.3 bcm. Export revenues in this area increased 2.4 times.

Table 5

Monetary Export Values of Russian Crude, Petroleum Products and Gas (mln USD) and Their Share in the Overall Russian Export (%)

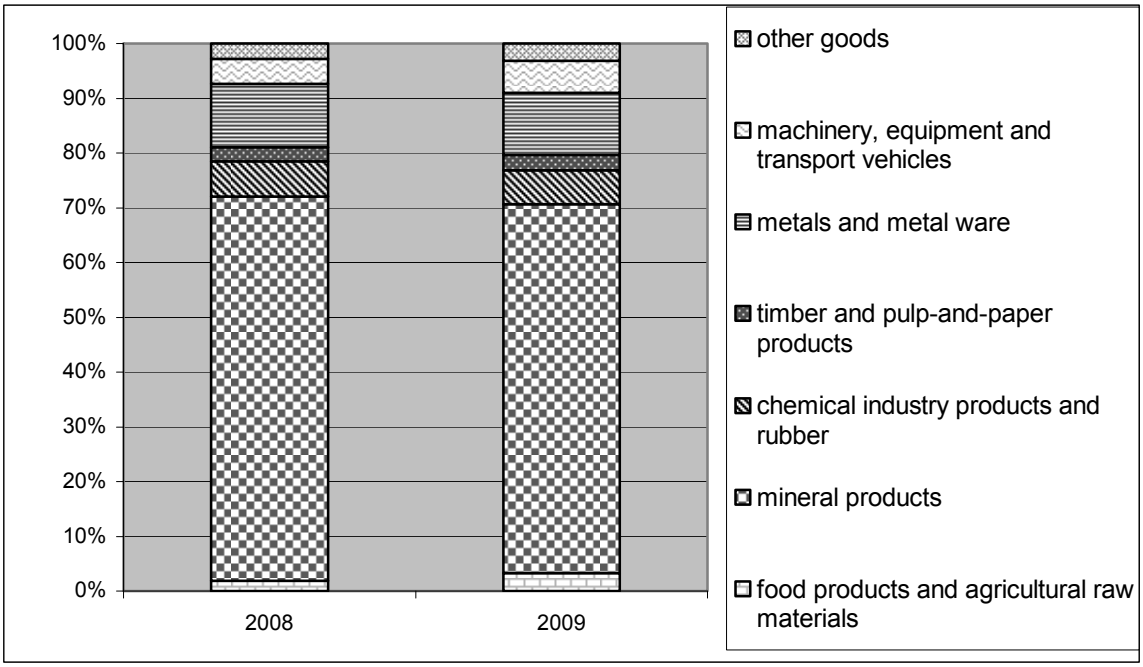
	Crude		Petroleum products		Gas	
	Mln USD	%	Mln USD	%	Mln USD	%
1992	6,662	12.4	2,202	4.1	6,389	11.9
1993	8,061	13.5	3,061	5.1	6,964	11.7
1994	8,948	13.3	3,398	5.0	7,939	11.8
1995	12,297	15.2	4,108	5.1	13,381	16.5
1996	15,578	17.6	7,442	8.4	14,683	16.6
1997	14,346	16.2	7,145	8.1	16,420	18.6
1998	10,254	13.7	4,262	5.7	…	…
1999	14,101	18.8	4,713	6.3	…	…
2000	25,284	24.1	10,938	10.6	16,644	16.1
2001	24,576	24.1	9,402	9.4	18,303	18.3
2002	28,950	27.0	11,227	10.5	15,897	14.9
2003	38,816	28.6	14,064	10.5	19,981	15.0
2004	55,024	30.0	18,998	10.5	20,918	11.5
2005	79,216	32.5	33,650	13.6	30,424.2	12.9
2006	96,675	31.7	44,217	14.5	42,815	14.1
2007	114,145,2	32.4	51,470.4	14.6	42,755.1	12.1
2008	151,668,6	32.4	78,325	16.7	66,399.7	14.2
2009	93,486,5	31.0	46,795.0	15.5	39,380.6	13.1

Resource: Federal Service for State Statistics, Federal Customs.

The relative share of the second biggest group of Russian export items – "metals and metal ware" remained at the same level in 2009 making 11.3% (versus 11.6% in 2008) (*Fig. 5*). Physical volumes of ferrous metals and metal ware export decreased by 6.6%, including: rolled iron and unalloyed steel prefabricated products – by 9.4%, cast iron – by 12.2%. Physical volumes of rolled iron and unalloyed steel export increased by 47.7%, copper – 2.5 times aluminum – by 6.2%, nickel – decreased by 3.1%.

The share of chemical industry products in the export commodity pattern in 2009 stayed at the level of the preceding year – 6.2% (6.4% in 2008). Compared to the previous year, the monetary value of export of such products dropped by 39.0%, physical volumes – by 15.0%. Decrease of monetary values and physical volumes of Russian export occurred practically for all categories of chemical industry products with the exception of nitrogenous fertilizers (15.6% increase of physical volumes), физический объем которых возрос на 15,6%, compound fertilizers (19.3% increase), plastic materials and plastic products (66.8% decrease).

The share of timber and pulp-and-paper products export made 2.9% in 2009 (2.5% in 2008). The physical volumes 2008 downward dynamics was as follows: rough timber went down by 41.0%, pulp – by 17.8%. At the same time the physical volumes of certain goods supplies to the "far abroad" countries demonstrated positive dynamics: sawn timber volumes increased by 4.7%, newspaper fibers – by 12.6%.



Source: Federal Customs.

Fig 5. Russian Export Commodity Pattern (%)

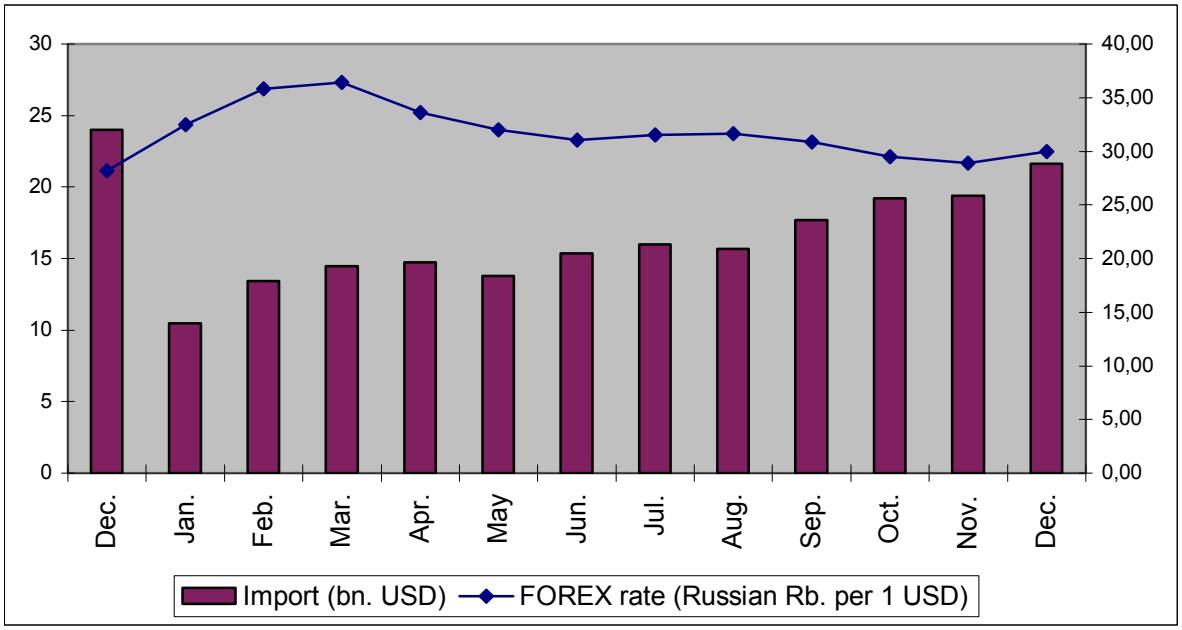
The share of machinery and equipment export increased in 2009 up to 5.8% versus 4.6% in 2008. The monetary value of export supplies of ground transportation vehicles (except for railway transport) increased by 28.5%. At the same time, electric equipment supplies went down by 7.9%, and mechanical equipment – by 5.2%. Physical volumes of cars and trucks export decreased by 18.3% and 25.4% respectively.

Expansive growth of Russian food products export stands out in the overall context of decreased export supplies across practically all commodity categories. The monetary value of their export grew by 32.4% versus 2008, and their physical export increased by 70.8% – mainly due to wheat export (47.6% growth), barley (2.4 times growth), sunflower seeds (2.9 times growth), fresh and frozen fish (5.7 times growth). The share of food products export increased in 2009 up to 3.3% versus 1.9% in 2008.

3.6.5. Import Profile and Dynamics

In 2009 import of goods demonstrated 34.3% decline versus 2008 and went down to 191.9 bn. USD. This significant decrease was caused by abrupt fall of the Russian economy (7.9% according to the estimates of Federal Service for State Statistics), effective demand shrinkage, credit activity decline leading to additional decrease of investment import, and effective weakening of the Russian rouble. According to the RF Ministry of Economic Development, the effective weakening of the Russian Rouble in real terms taking into account both domestic and foreign inflation demonstrated the following numbers in December 2009 versus December 2008: 0.4% to USD, 6.5% to Euro, 8.8% to British Pound, 8% to Swiss Franc. Russian Rouble strengthened relatively to Japanese Yen by 2.4%. The overall weakening of the effective FOREX rate for the Russian Rouble is estimated at the level of 3.8%.

While the FOREX rate was stabilizing throughout the year, the import dynamics were improving (*Fig. 6*).



Source: Federal Customs, Bank of Russia.

Fig. 6. Import dynamics (left axis) and FOREX dynamics (right axis)

The decrease of import monetary values in 2009 was related with the decease of its physical volumes, while as the average prices of the imported goods practically remained at the last year's level (*Table 6*). With that, the average import prices index made about 97.1% in January-September, but is October-December its level of 103-104% was registered.

Import physical volumes index was gradually growing – from 57.6% for the 9 months of 2009 on the yoy basis up to 81.9% in the 4th quarter of 2009. In December 2009 it made 97.6% versus 2008.

Table 6

Commodities Import Index

	January-September 2009, % of January-September 2008		December 2009, % to December 2008		2009 as % to 2008	
	Physical volumes	Average prices	Physical volumes	Physical volumes	Average prices	Physical volumes
Total import,	57.6	97.1	97.6	102.6	63.3	99.1
including:						
from "far abroad" countries	56.3	101.1	90.8	107.4	61.1	103.4
from CIS countries	65.5	76.6	154.7	78.3	76.9	77.5

Source: the RF Ministry of Economic Development.

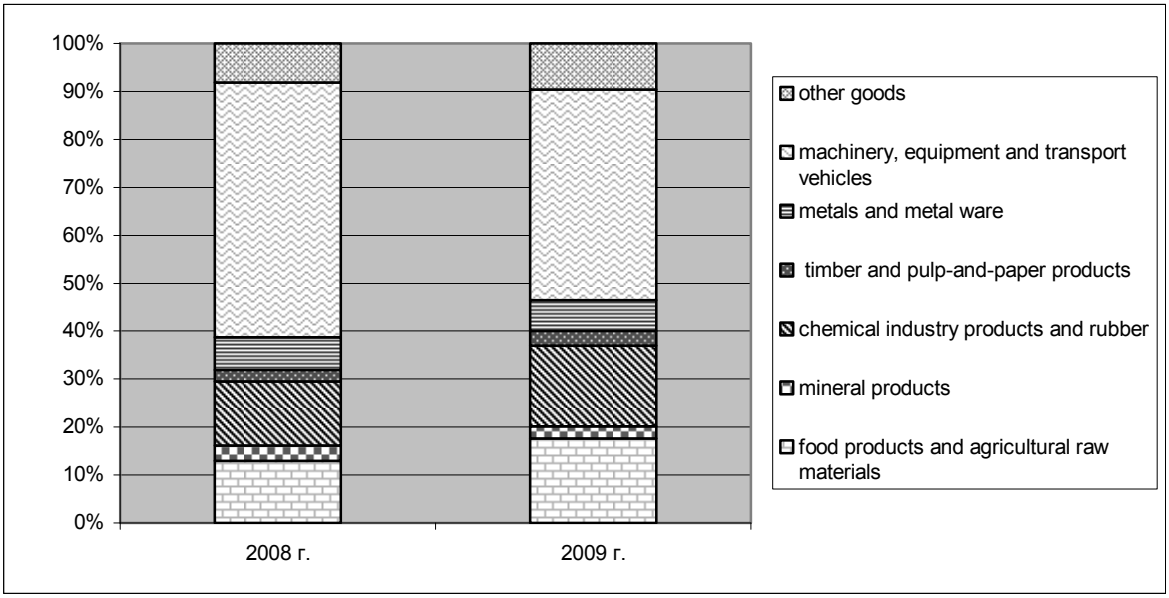
The import profile in 2009 versus 2008 demonstrated smaller share of machinery and equipment, metals and metal ware, and of mineral products (*Fig. 7*).

In 2009 the import of machinery, equipment and transportation vehicles decreased by 48.3%. This category of goods contributed the most to the overall drop of import, and its

share in the import profile decreased from 53.2% to 43.9%. Compared to the preceding year, the monetary value of engineering products import decreased by 40.6%, of ground transportation vehicles (excl. railway transportation) – by 70.5%, of electric equipment – by 34.0%, of optical instruments and devices – by 39.3%. Import of cars suffered the most: physical volumes of imported passenger cars decreased by 74.3%, of trucks – by 83.1%.

Thus abrupt decline of cars import may be explained both by erosion of the purchasing power of Russian citizens and by protectionism measures in favor of domestic cars manufacturers. As a result, in January 2009 the customs duties levied on imported used cars practically became of prohibitive character. In September 2009 the period of such elevated duties rates was extended for 9 more months. As of the end of 2009 the import of cars being in use during up to 5 years decreased by 96.6% (almost 30 times) going down to 12.37 thousand cars, and the import of cars being in use for over 5 years decreased by 81.5% (5.4 times) going down to 1340 cars. The import of new cars decreased almost 3 times (by 69%) going down to 498.8 thousand cars. Japan accounted for 28% of all the imported new cars (146 thousand cars), Republic of Korea – for 20.1% (104.93 thousand cars), Germany – for 8.2% (42.71 thousand cars).

The elevated customs duties rate for imported foreign cars will stay in effect until mid-2010. It is planned to resume discussions on the issue in spring (in particular, due to the Common Customs Tariff [CCT] coming into effect for Russia, Belarus and Kazakhstan, these partner countries were forced to significantly increase their customs duties for the imported cars).



Source: Federal Customs.

Fig. 7. Russian Import Commodity Pattern (%)

The share of food products and raw materials for their production in the Russian import pattern made 17.6%, which exceeds the 2008 level by 4.6 percentage points. The monetary value of food products import decreased by 15%. Physical volumes of imported fresh and frozen meat decreased by 19.4%, of poultry – by 20.8, of fresh and frozen fish – by 10.1, of cheese and curds – by 7.8, of butter – by 27.1, of crude sugar – by 48.2%.

The share of chemical industry products in the import commodities pattern made 16.9% versus 13.3% in 2008. The monetary value of imported chemical industry products decreased by 20.6%. The physical volumes of inorganic chemical products supplies decreased 14.2%; of pharmaceutical products – by 5.8%; of lacquer and dyes – by 29.4%; of cosmetic products – by 14.6%; of soap and cleansing agents – by 14.1%; of plastic materials and plastic products – by 30.%; of resin, rubber and respective products – by 35.2%.

The share of imported textile, textile products and footwear made 5.5% (versus 4.2% in 2008). The monetary value of imported textiles and footwear decreased by 17.8% compared to the preceding year. Physical volumes of imported cotton fabrics and genuine leather footwear decreased by 39.3% and 36.0% respectively.

The decrease of imported metals and metal ware share in 2009 was immaterial: from 6.8% to 6.4%. The monetary value of imported goods of this category decreased by 40.9% versus 2008. Physical volumes of imported ferrous metals and ferrous metals products decreased by 42.2%, including: pipes – by 53.7%, rolled iron and unalloyed steel prefabricated products – by 31.7%, ferrous metal work – by 50.3%.

The share of imported timber and pulp-and-paper products in 2009 made 3.1% (versus 2.4% in 2008). Physical volumes of imported products of those categories decreased by 33.8%, their monetary values – by 21.8%.

3.6.6. Russian Foreign Trade Regulation in the Global Crisis Environment

In accordance with Article 3 of the Law of the Russian Federation "On Customs Tariffs", the RF Government over the course of 2009 prepared and enacted 12 Resolutions fixing the rates for export customs duties for crude and petroleum products.

The export customs duty for crude and petroleum products recovered from bituminous rock and exported from Russia beyond the borders of countries participating in the Customs Union agreements was changed on a monthly basis across 2009 based on monitoring Urals crude prices between the 15th date of each calendar month and the 14th date of the following calendar month (*Table 7*).

Table 7

Export Customs Duties for Crude and Petroleum Products in 2009 (USD/t)

	Нефть	Нефтепродукты	
January 1	119.1	92.6	49.9
February 1	100.9	80.3	43.2
March 1	115.3	90.0	48.5
April 1	110.0	86.4	46.5
May 1	137.7	105.1	56.6
June 1	152.8	115.2	62.1
July 1	212.6	155.5	83.8
August 1	222.0	160.3	88.2
September 1	238.6	173.1	93.2
October 1	240.7	174.5	94.0
November 1	231.2	168.1	90.5
December 1	271.0	194.9	105.0

Resource: RF Government resolutions.

On to of that, additional tax incentives were effected in July 2009 to stimulate crude production growth. The RF Government Resolution No.574 of July 16, 2009 "On Amendments to the Customs Tariff of the Russian Federation Pertaining to Crude Oil" set a special downward rate for export duties levied on crude produced in East Siberia. This rate covered 13 oil

fields of this region and constituted 5% of the dutiable value of exported crude. The rate was set for the period of 9 months starting from the moment of the Resolution coming into effect (2 months after the date of issue).

Late in 2008 and early in 2009 the focus of customs tariff policy was shifted from traditional regulatory and fiscal functions to anti-crisis support of Russian economy and of domestic producers' competitiveness. The mechanism of tariff regulations allows for prompt government decision-making in extreme situations. On-going control of the imported goods share at Russian domestic markets was required along with improved efficiency of monitoring import volumes to create preventive protection mechanism. Weekly foreign trade and domestic market environment monitoring was organized for those purposes with regards to sensitive industrial and agricultural goods qualified as the most vulnerable ones for foreign competition in the crisis environment. Communications and interface with the Russian business community was set-up. In most cases such system allowed for prompt response to the external market signals and threats, to find solutions satisfying both manufacturers and consumers.

The RF Government enacted over 60 Resolutions correcting the import duty tariffs. The customs duties rates were not only raise, but also decreased for quite significant group of products – mainly, the rates of import duties on hi-tech equipment. Overall in 2009 the import duties were changed for 600 commodity items, and for 350 (out of these 600) items the duties were increased.

The increase of import duties pertained to certain sensitive industries and goods categories subject to high import pressure, as well as import with damping and subsidies. The crisis environment caused accumulation of huge finished stock, and many manufacturers were ready to export them at discount prices. That is why the Russian Government actions may be qualified as enforced protection. However, overall in 2009 the average weighted import duty rate decreased versus the preceding basis: 11.45% in 2008 and 10.7% in 2009.

The most important industries benefiting from such protective actions supporting their competitiveness were automotive industry, agricultural engineering, ferrous metallurgy, machine-tool building.

To support Russian agricultural producers the RF Government adopted a number of Resolutions about increasing the import customs duties for a series of agricultural and food products (rice, cheese, dairy products, vegetable oils, etc.). In addition to those measures, duty-free regime was introduced for importing growing pedigree chicken and eggs for incubators, which allowed for increase of their volumes and had a positive impact on domestic poultry husbandry.

All the Resolutions were introducing measures for the period of 9 months, during which the effect was monitored. At the end of this period decisions were made about extending the respective measures for another 9-month period, as well as about either introducing a permanent import duty or about bringing it back to the previous level.

The performed analysis has shown that for a number of commodity items the enacted measures had certain positive effect, however, it is difficult to say something in terms of improving the demand for those products.

Measures targeted at improving the domestic manufacturers' competitiveness included not only increasing of import duties, but decreasing them if necessary. In particular, the import rates for certain types of passenger aircrafts and freight carriers which are not produced in Russia were set to nil.

This measure is part of systemic solutions aimed at supporting Russian air carriers. It will allow domestic companies not to lose their positions and to remain competitive at the global market using foreign planes under the conditions equal with foreign competitors.

Also, to assure favorable conditions for Russian productive sector several decisions were made focused on expanding the resource base, increasing the capacity utilization ratio in the financial crisis environment (canceling import duties for raw materials, parts and process equipment not manufactured in Russia).

Measures to promote television engineering in Russia may be named as an example of integrated approach to developing the competitive positions of domestic manufacturers. In addition to import duties plasma panels and LCD panels, duties for the ready-made plasma and LCD TV sets were reduced to nothing. Also zero rates were introduced for integrated electronics used for TV sets manufacturing. Russian manufacturers' savings on zero rates for these parts made over 6 mln USD during January-July 2009 providing positive effect on decreasing the production costs and respectively – on improving the competitiveness.

The new economic cycle currently starting in Russia requires additional analysis of approaches to customs tariffs policy department. Immediate and prompt anti-crisis measures focused on protecting the domestic market proved to be positive overall. It is obvious that once setting the course of post-crisis development some re-thinking will be required will be required with regard to rational protection of domestic market.

Considering a real threat of import replacing some of the goods in certain sector of the economy, tariff-based protection mechanisms will still be required. At the same time artificial barriers against imported goods decrease the incentives for improving the competitiveness of Russian manufacturers, infringe the interests of the customers, lead to domestic prices growth. Due to this it is necessary to continue the practices of monitoring the competition at commodity markets which were subject to commercial protection.

Resolving the problem of Russian economy competitiveness the government needs to be based on the fact that decreasing the customs duties is an important but not the only instrument for supporting the competitive position of the domestic manufacturers and should be used in combination with other economic policy measures.

Contrary to developed industrial economies Russia uses a limited set of customs-and-tariffs policy measures, which ahs an unfavorable impact on the domestic market environment and decreases the competitiveness of Russian goods. In relation with that a conclusion may be made: fully utilize the practices of other countries in the sphere of domestic markets protection applying a comprehensive set of all legal protective measures traditional for international trade practices recognized by GATT / WTO.

Currently 13 commodity items are included into the list. Russia is building the protection of its domestic market mainly on using tariff and fiscal limitations for importing certain categories of goods. In the meantime, such instruments as quantitative limitations, licensing requirements and variable fees, technical, anti-dumping rules and countervailing measures are being neglected.

The current customs tariff in Russia is focused mainly on the following things: 1) budget revenue additions (up to 50% of federal budget revenues come from customs duties), 2) protection of weaker sectors of the economy (thus increase of import duties for many categories of foreign products), 3) adjustment to WTO requirements (Russia is negotiating ascendance with WTO and is forced to decrease the highest customs tariffs according to the agreed schedule).

Special attention should be paid to evaluation of the effectiveness of the customs tariffs policy measures in terms of their impact on the inflation processes. Thus, when it comes to supporting Russian farmers and food products manufacturers in certain cases increase of import duties for the respective kind of goods may lead to retail prices growth and not lead to production growth, it may create the prerequisites for higher level of monopolization.

In 2009 trading partners initiated 4 anti-dumping investigations, 5 revisions of previous anti-dumping measures and 10 specialized protective investigations with regards to Russian goods. As of December 31, 2009, 95 restrictive measures were registered as applied by foreign states, including 41 anti-dumping measures, 7 specialized protective measures and 47 measures of non-tariff regulation of trade including administrative regulation measures. The maximum number of restrictive measures is effective in Belarus (24), in the EU (17), in Ukraine (13) and in the USA (11). The markets with the biggest number of problems (aggressive protectionism against Russian goods) which are at the same time of special interest for Russian exporters are EU, Mexico, Australia, the USA, India, Kazakhstan, Uzbekistan, Belarus and Ukraine. More than half of all anti-dumping measures introduced against Russia are focused on Russian ferrous metals and metal ware. Mineral fertilizers and chemical agents are the second point of focus.

During 2009 trading partners of Russia, especially South-East Asian countries, applied a wide spectrum of anti-crisis measures, mainly – the selective protection measures – to protect their national producing sectors from the global financial crisis. Thus, special protective investigations were initiated in India with regards to Oxon-spirits, flat hot-rolled product; the revision of anti-dumping measure against polytetrafluoroethylene was launched. China simultaneously initiated two anti-dumping investigations with regards to Russian polyamide and transformer steel. Based on the revision results China extended the anti-dumping customs duties with regard to polyvinyl chloride and butadiene-styrene rubber. Turkey extended specialized protective measure to limit the import of flat glass. Pakistan started anti-dumping investigation with regards to Russian hot-rolled products. The Philippines government decided to introduce a specialized protective import duty on unalloyed steel L-bars.

CIS countries also activated application of their domestic markets protection measures. Thus, Kazakhstan and Kyrgyzstan started specialized protection investigations with regards to products from absorbent cotton and glass, as well as with regards to flour and sugar. Ukraine started specialized protection investigation with regards to liquid chlorine and и glass plates, as well as revision of anti-dumping duty for wood-fiber boards. Besides, Ukraine introduced a specialized protective customs duty for matches.

Armenia introduced differentiated excise rates for domestic and imported alcohol.

Simultaneously due to active dialogue with the trading partners on preventing or canceling limitations on importing Russian goods some positive results were achieved. For example, in India despite lack of cooperation on behalf of Russian producing stakeholder, the anti-dumping investigation with regards to potassium carbonate was finished without introducing any measures. Ukraine terminated specialized protective duty for imported Russian abrasive tools and roofing felt. Kazakhstan cancelled the protective measure with regards to confectionery products. The anti-dumping import duty for Russian high-carbon ferrochrome was terminated in Brazil. In Thailand, despite the decision to extend anti-dumping duties for hot-rolled steel, the metal ware being of special interest for Russian exporters received the exemption, and the revision of current duties rates was initiated. Kyrgyzstan finished specialized

protective investigation with regards to Russian sugar without suggesting any protective measures.

Brazil cancelled the import limitations introduced by their Ministry of Agriculture, Fishery and Supplies with regards to mandatory double treatment of each batch of Russian wheat grain with methyl bromide. Besides, the prohibition was removed for importing wheat grain from Russia to Brazilian states Parana, Santa-Catrina and Rio-Grande-du-Sul. Kazakhstan cancelled import limitations for the seeds of beans, sunflower, cotton plants and for oil-bearing crop.

Free access was provided for Russian wheat to the Chinese markets. The competent authorities of Russia and China achieved an agreement about guarantees for Russian wheat subject to importing into China to be grown in the dwarf bunt - free zones so there is no reason for establishing quarantine in China. It is worth noting that this issue remained outstanding back from 2005.

3.6.7. Government Priorities in the Sphere of Foreign Trade: Customs Union and WTO

The crisis year of 2009 was characterized by significant change of approaches to setting the priorities in Russian foreign trade. For many years accession to WTO had been set as the key priority for Russia, however, in 2009 it was announced that the preparation work on creation of the Customs Union between Russia, Belarus and Kazakhstan had been completed and the common customs territory was to be launched starting from January 1, 2010. This marked the start of changing Russia's attitudes towards WTO. In reality, as the beginning of common customs territory functioning has demonstrated, there still are many unresolved issues and frictions between the partners of the Customs Union, so fine-tuning of the mechanisms will at least take quite some time. Meanwhile, the mechanism for Russia approaching the WTO is still pretty vague given the new environment.

The decision to set-up the Customs Union was made by the presidents of the EurAsEC countries in October 2007. At the same time they approved of the Action Plan to create the required legal and organizational framework during the period of 2007–2010.

The Customs Union (CU) assumes cancellation of customs duties for mutual trading of goods originating within the common customs territory or goods from third countries being in free circulation within this customs territory, as well as non-application of economic limitations (except for specialized protective, anti-dumping and compensatory measures). Besides, CU assumes adoption of standard customs tariff for trading with third countries, applying uniform trading policy towards them, developing and application of uniform legislation in the sphere of customs, as well as setting up a common Customs management system.

At the Customs Union meeting in Almaty on September 25, 2009, it was declared about finalizing the work on establishing and standardization of the standard customs tariff.

Forming the common customs territory means cancellation of customs borders between the member countries and transferring all types of government control (except for border management) to the customs border of the Union. It is planned to cancel the border control between Russia and Belarus starting from July 1, 2010, and between Russia and Kazakhstan – starting from July 1, 2011.

The meeting in Almaty approved the draft Uniform Customs Code, as well as draft agreements to be submitted for review and signing by the leaders of the Customs Union member countries.

The clauses of the International Convention on Customs Procedures Simplification and Harmonization (the Kyoto Convention of 1973) were laid in the foundation of the Uniform Customs Code and are underpinning all the key innovations.

The Code consists of 8 Sections containing 50 Chapters and 372 Articles of Common and Specialized Parts.

The key innovations of the enacted Customs Code pertain to fixing the clauses about the customs procedures which were understood as customs regimes in Belarus, Kazakhstan and Russia. Such changes are caused by the need to use the terminology of the Kyoto Convention.

Several more novelties in the sphere of customs regulation should be emphasized:

- introducing the concept of "common customs territory of the Customs Union";
- creating uniform conditions for transit of goods within the Customs Union territory;
- cancellation of customs clearance and customs control of goods originating from the territories of the Customs Union member countries and foreign goods issued for unlimited consumption within the common customs territory of the Customs Union member countries;
- mutual acceptance of measures securing payment of customs payment and taxes across the whole territory of the Customs Union;
- introducing the institute of authorized economic operator, as well as the concept of "Customs representative".

The Union Customs Code contains clauses about detention of goods and their back-up documents not being subjects of administrative violations or offence for the purposes of customs control. These clauses are new for Russia.

The draft Customs Code was approved by the Commission, but received a few comments and amendments and is currently being finalized.

In the course of the meetings the scheme of customs payments distribution between national budgets of the member countries was agreed. These will be the payments collected for the goods imported into their common customs territory. Two options were discussed. The first option stipulated the RF Treasury becoming the administrator and the distributor of the payments. The second plan was proposed by Kazakhstan and supported by negotiators from Belarus, it stipulated a certain proportion of distribution the customs payments and other fees among the member countries irrespective of where and in which particular country they were paid. Eventually, the second option was adopted.

The approved scheme will be in effect for 18 months as a pilot one (starting from January 2010 and finishing in June 2011). All this time the member countries will be jointly monitoring collection of import duties by national Customs of Russia, Belarus and Kazakhstan and the procedure of mutual settlements between the countries.

During the meeting of the Supreme Body of the Customs Union which took place in Minsk on November 27, 2009, the presidents of Belarus, Russia and Kazakhstan signed a set of documents authorizing the creation of the Customs Union starting from January 1, 2010. This package of documents comprised 15 agreements, including the Customs Union Agreement, the Standard Customs Tariff Agreement, the Standard Product Mix Agreement and other documents forming the legal framework for interaction between the member countries in the sphere of trade and economics in general. A number of foreign trade regulations were discussed at the meeting, including keeping the statistics, functioning of the uniform system of prohibition and limitation, staged cancellation of economic restrictive measures in the sphere of mutual trade between the three member countries.

Starting from January 1, 2010, the Standard Customs Tariff for the Customs Union of Russia, Belarus and Kazakhstan came into force. The Standard Customs Tariff (SCT) is the first document for the Customs Union to directly pertain to all the market participants. It lists the categories for all the commodities which may be imported into or exported from the member countries. Each commodity was assigned a certain code being the basis for the Customs to calculate the duty. This document sets the rates for import duties. Export duty rates shall be established separately by other documents.

This is how the SCT import duty rates are different from those in Russia: for household appliances and electronics they were decreased, for big buses and biomedical engineering – decreased, for clothes – increased, for certain types of pearls and diamonds – decreased, for certain types of pipes and scrap metal – changed. Coding was partially changed (SCT codes are different from Foreign Economic Activity Commodity Classification of the RF).

Despite the uniform Customs Code and Standard Customs Tariff, exemptions and exceptions are inevitable for each country.

Due to introduction of the Standard Customs Tariff starting from January 1, 2010, and other instruments for foreign trade regulation within the Customs Union, consultations will be held between the major partners about changing the trading regime.

Foreign trade regulatory function was transferred to the Customs Union Commission starting from January 1, 2010. It will be in charge of changing the import duty rates for the three member countries, as well as for enacting the Standard Product Mix for Foreign Trade, setting tariff privileges and quotas, defining the system of tariff preferences, introducing non-tariff regulatory measures, carrying out specialized protective anti-dumping and compensatory investigations. The Commission resolutions shall apply to the territories of all three countries.

During 2009 the format of Russia and other countries of the Customs Union joining WTO was changed a number of times. Before June 2009 there still were 6 systemic outstanding issues at the negotiations about Russia joining WTO, the key of them being the level of government aid to agricultural enterprises, meat import regime, export duties and the activities of government-owned trading organizations (the pricing commitments were actually squared up with the EU during the St.-Petersburg Forum, at the same time basic resolution pertaining to transparency obligations were agreed with the USA).

On June 17, 2009, during the informal consultations in Geneva Russia, Belarus and Kazakhstan notified the WTO member countries about their inclination to start practical steps for setting up the Customs Union starting from January 1, 2010, and suspended their negotiations on the issue of joining WTO until developing a common position on the format and content of further process of joining WTO.

In accordance with the decisions of the Customs Union Commission of August 12 2009 the single negotiation group was formed to represent Russia, Belarus and Kazakhstan on the issue of joining WTO.

At bilateral and multilateral consultations in Geneva in October 2009 the common position of Russia, Kazakhstan and Belarus was presented, according to which the three countries will be joining WTO subject to agreeing the terms between themselves and completely harmonizing them on the issues that are falling under the Customs Union competence. The Customs Union delegation notified the WTO members that the countries are to continue their accession process in the capacity of sovereign countries, because any other approach might be associated with some major judicial and procedural problems and may significantly delay the negotiations. The representatives of WTO Work Groups for accession of Russia, Kazakhstan and

Belarus shall be making the decision on resuming the negotiations upon reviewing the data about the Customs Union. In the 4th quarter of 2009 the members of the single negotiation group were having expert consultations with WTO Secretariat and the key partners.

During the recent times WTO has been undergoing a systemic crisis worsened by global economic commotion. The WTO development agenda – DOHA negotiations started in 2001 – is stuck due to the inability to agree the interests of the developed and emerging economies. The first group would like to maintain their subsidies (mainly in agriculture), while as the second group is not ready to unreasonably open their markets. The 7th WTO ministerial conference in December 2009 did not contribute to breaking this deadlock, though the appeals to finish the DOHA round in 2010 were heard all the time.

The only practical outcome of the conference was signing the agreement between 22 emerging economies stipulating 20% customs tariffs decrease with regards to 70% of imported goods. The key objective of the agreement is to give the impetus to South-South trade relations and to demonstrate the solidarity of emerging economies conventionally referred to as "the southern countries', while as wealthy "northern" economies are not able to reach any agreement and would not meet halfway.

It's quite possible that in future WTO will be developing through such regional or group agreements. The Customs Union may then become one of such blocks inside WTO.

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TRENDS AND OUTLOOKS

(Issue 31)

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The review provides a detailed analysis of main trends in Russia's economy in 2009. The paper contains five big sections that highlight single aspects of Russia's economic development: the socio-political context; the monetary and credit and financial spheres; the real sector; social sphere; institutional challenges. The paper employs a huge mass of statistical data that forms the basis of original computation and numerous charts.

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In memoriam of Yegor Gaidar



Yegor Gaidar, founder and director of the Institute for the Economy in Transition, passed away on 16 December 2009.

His death is an irreplaceable loss for the Institute, just as it is for Russia. Yegor Gaidar is usually referred to as 'former Prime Minister', and the market reforms of the first half of the 1990s as 'the Gaidar reforms'. However, he was never even a Prime Minister – his official post was that of 'Acting Chairman of the Government of the Russian Federation', and he actually remained in office for only six months — from June through December 1992; for seven months before that, and then for another four months in 1993-94 he was Deputy Chairman of the RF Government. However, this was enough for a whole era in Russia's history to be inextricably associated with the name of Yegor Gaidar. The power of his intellect, his honesty, integrity and true courage made him a moral leader of Russian reforms of the late 20th century.

He effectively became head of the government precisely when the country was on the brink of an economic and political disaster, both the economic and the administrative systems of the government having by then become dysfunctional. Gaidar managed to lay foundations for the new market-oriented institutions and, moreover, to prevent the familiar revolution scenario when the collapse of the former regime is followed by a period of universal chaos, unrest and bloodshed.

His instinct of a brilliant economist was augmented by political astuteness based on a profound knowledge of history. Unlike an overwhelming majority of his contemporaries, his deep insight into historical perspectives was combined with sufficient moral courage enabling him to put forth his visionary initiatives despite resistance and a general lack of understanding. This is what makes Yegor Gaidar an epoch-making figure.

While heading the Institute for the Economy of Transition, Yegor Gaidar set up a school of economists capable of bringing theoretical research to the level of economic policy advice and of assessing the political consequences of economic decisions with due regard for the specificity of economic laws in conditions of systemic social transformation. Due to his intellectual honesty and moral integrity combined with fearlessness in political decision-making, Yegor Gaidar was recognized as top authority even by his opponents, and so became one of the indisputable champions of Russia's civil society.

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Section 4. The social sphere

4.1. The population's finances and the consumer market

Money incomes. In 2009, the real money incomes of the population rose by 1.9 % on 2008, while there was a significant differentiation in the dynamics of real wages and real size of pensions (see *Fig.1*).

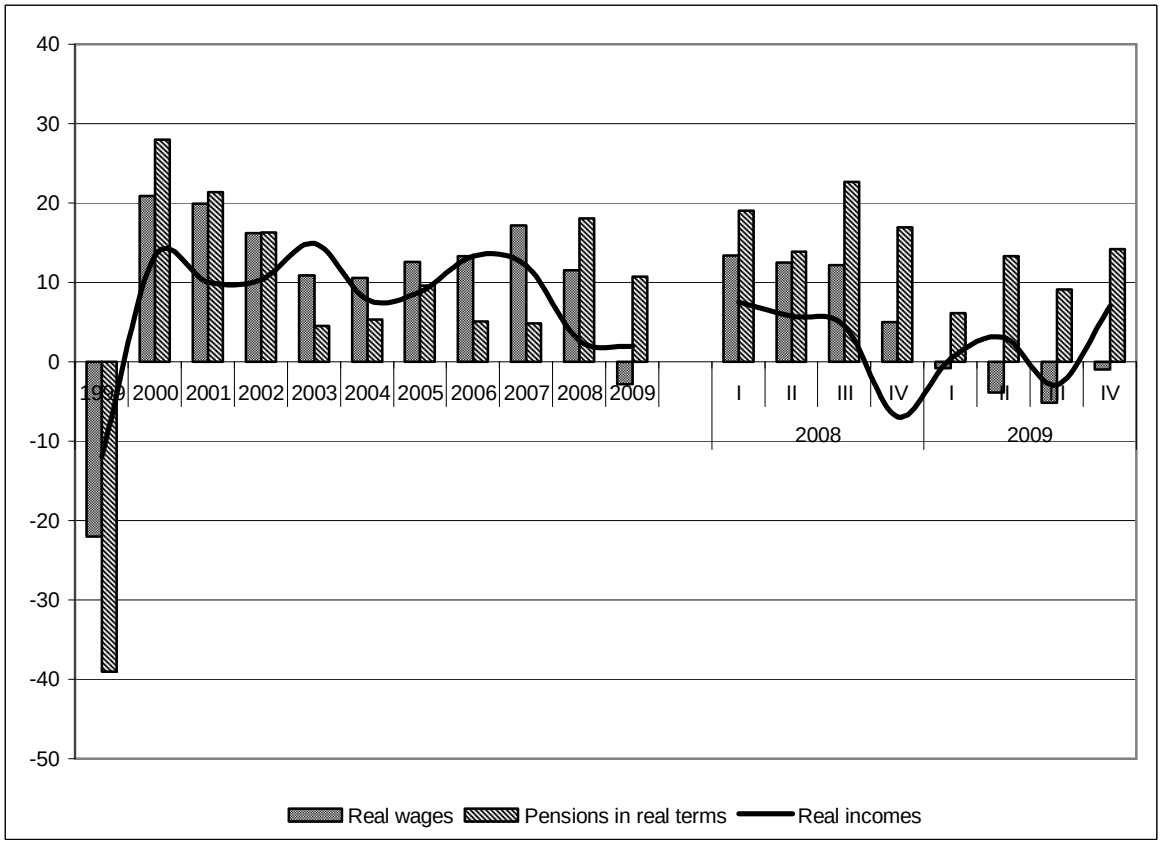
An analysis of the dynamics of the real incomes of the population and the dynamics of real wages indicates that in recent years the intra-year fluctuations of these indices had not changed until September 2008. As a rule, in December, due to increased payments, real incomes and real wages would sharply rise, thus leveling off the negative effect of the slow dynamics observed early in the year that resulted from a leap of inflation in January and a slow-down in economic activity. In 2008, with real wages having declined in October - November at an average monthly rate of 1.2 %, even the traditional December rise in wages could not compensate for the negative trends of the autumn months. As a result, in Q IV 2007, real wages increased on the corresponding period of 2007 by 5.0 %, while their annual growth amounted to approximately 11. 5 %.

In 2009, for the first time in the past 10 years, the dynamics of real wages was negative with its deepest fall registered in Q III. Despite some deceleration in the decline of real wages in Q III caused by the deceleration of inflation by the end of the year and a relative stabilization of economic activity, the overall decline in real wages in 2009 amounted to 2.8 % by comparison with the previous year.

In 2009, the average nominal monthly wage amounted to 18,785 Rb, an increase of 8.5 % by comparison with the corresponding figure for 2008. There were no significant changes in the differentiation of wages. In 2009, the highest wages continued to be paid in such sectors of economic activities as pipeline transportation, financial activities and the extraction of fossil fuel resources (2.2 times higher than the Russian average), as well as the production of coke and petroleum products (2 times higher). The lowest average monthly wages continued to be paid in the textile and sewing industries; agriculture; hunting and forestry – 48 %, 53 % and 51 % of the Russian average, respectively.

Among the positive changes in the structure of wages by type of economic activity, we can point to the continuing upward trend of wages in the social sphere – in education, health care and social services provision. In 2009, the average monthly wage of health care and social service workers amounted to 80 % of the Russian average, and that of education workers – to 71 % thereof.

The year 2009 witnessed the emergence of a downward trend in wage arrears. Growth in arrears was first recorded in September 2008; starting from the second half-year 2009, wage arrears were on a constant decline. By the end of 2009, they amounted to 3,565 bn Rb, a significant drop from their maximum level of 8,779 bn Rb registered as of early July 2009.



Source: Rosstat.

Fig. 1. The dynamics of changes in the real incomes of the population, by component, in 1999 – 2009 and by quarter, in 2008 – 2009 (as a percentage of the corresponding period of a previous year)

Wages account for almost 70 % of the incomes of the population and therefore exert a dominant influence on the social parameters of development. In 2009, the factor compensating for the dynamics of wages' negative impact on the real incomes of the population was the share of social payments in the incomes of the population having risen to 14 % against 13.3 % a year earlier (*Table 1*). In 2008 – 2009, the relative worsening of the financial position of the pensioners by comparison with the working population came to an end. In 2009, the ratio between the average pension and the average monthly wage increased to 27 % against 24.3 % in 2008 and 22.8 % in 2007. In order to improve the financial position of the pensioners, the basic part of the labor pension was increased, from 1 March 2009 onwards, by 8.7 %; and from 1 December 2009 onwards it was set at 2,562 Rb (an increase of 31.38 %). The insured part of the labor pension was indexed from 1 April 2009 and from 1 August 2009 onwards by 17.5 and 7.5 % respectively. Due to the aforesaid measures, the average monthly pension increased, in 2009, to 5,191 Rb (a 23.6 % rise on 2008), thus considerably outstripping the growth rate of consumer prices and the subsistence level of the pensioner. In real terms, pensions increased by 10.7 % in comparison with 2008. In 2009, the most visible changes in the structure of the money incomes of the population were related to the drop in property income, whose share fell by almost one third, to 4.3 %.

Table 1

The structure of the population's money incomes in 2008 – 2009, as % of total

	2008					2009				
	year	Quarter				year	Quarter			
		I	II	III	IV		I	II	III	IV
Money income – total	100	100	100	100	100	100	100	100	100	100
Income from entrepreneurial activities	10.3	10.2	9.6	10.4	10.7	9.7	10.5	9.3	10.1	9.2
Remuneration, including hidden wages	68.3	68.7	68.6	66.7	69.3	69.4	69.1	69.6	68.5	70.4
Social payments	13.2	13.4	12.8	12.8	13.8	14.6	14.7	14.5	15	14.1
Property income	6.2	5.6	7.1	8.1	4.2	4.3	3.8	4.6	4.4	4.3
Other types of income	2	2	1.9	2	2	2	1.9	2	2	2

Source: Rosstat.

In 2009, despite the adopted measures designed to increase payments for labor, pensions, benefits, and social support for individual categories of the population, the number of persons with income below the subsistence level amounted, according to preliminary data, to 19.6 mln, or 13.8 % of Russia's total population, against 13.1 % in 2008. The results of analyzing the budgets of households indicate that in 2009 the basic indices of the income differentiation of the population remained the same as in 2008. The index of income concentration (the Gini Index) remained unchanged at 0.422; the decile dispersion ratio characterizing the extent of social differentiation was 16.7 against 16.8 in 2008. In 2009, the top 10 % of the population accounted for 31.0 % of the aggregate volume of aggregate money income (in 2008 – 31.1 %), while the bottom 10 % of the population accounted for 1.9 % (1.9 %).

Population expenditures. In 2009, the total money income of the population rose to 28,388.8 bn Rb, an increase of 12.5 % on 2008). Of that, 19,635.6 bn Rb was spent by the population on the purchase of commodities and services, a 5 % rise on the previous year. The 2009 volume of savings was estimated at 5,602.3 bn Rb, a rise of 1.67 times from the previous year.

In 2009, the dynamics and structure of household expenditures were considerably influenced by inflation. Over-the-year consumer inflation amounted to 108.8 % against 113.3 % in 2008. As a result of the influence of various factors on the dynamics of prices, the structure of inflation underwent considerable changes. The moderate growth in food prices observed since November 2008 can be explained both by the decrease in the effective demand of the population and by the clear interest of trading companies and establishments in restraining the price rise in order to accelerate money turnover in conditions of credit shortage. The dynamics of prices for non-food commodities was influenced by the rising real exchange rate of the ruble and by the drop in imports. The price index of food commodities amounted to 106.1 % against 116.5 % in 2008, while that of non-food commodities - to 109.7 % against 108.0 % in 2008.

The transformation of price ratios brought about a change in consumer behavior (*Table 2*). The share of monetary means spent on purchases of commodities and services remained at a relatively low level; it amounted to 69.2 % against 74.1 % a year earlier, while the share of expenses on the purchase of commodities amounted to 53.6 % against 57.9 % in 2008.

In 2009, the incomes of the population displayed moderate growth, and the largest share of expenditures was accounted for by purchases of food commodities and articles of prime necessity. As a result, in 2009 the proportion of food commodities, including beverages and tobacco products, in the structure of retail trade turnover rose to 48.6 % (or by 1.8 pp). It exceeded the figure for the same period of 2008, while the share of non-food commodities correspondingly decreased.

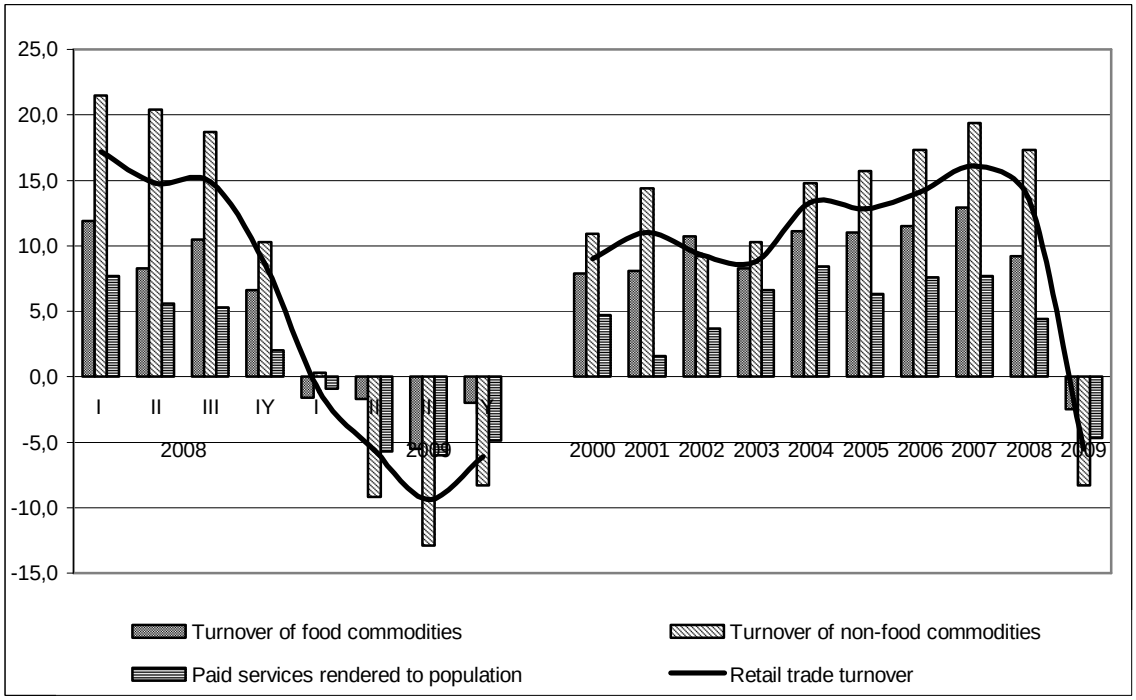
Table 2

The structure of the expenditure of the money incomes of the population, as %

	Money incomes	Of that, spent on							Growth (+), reduction (-) in currency in hands of public
		purchases of commodities and services	including on			savings	Of that, kept on deposit and invested in securities	Purchase of foreign currencies	
			purchases of commodities	purchases of services	making mandatory payments and contributions				
2008									
Q I	100	77.1	59.7	17.4	12.1	8.3	+2.7	6.9	–4.4
Q II	100	71.8	55.7	16.1	12.3	7.2	+6.4	4.7	+4.0
Q III	100	74.4	58.1	16.3	12.6	4.6	+1.7	5.7	+2.7
Q IV	100	73.6	58.4	15.2	12.0	2.2	–9.2	13.7	–1.5
Year	*100*	*74.1*	*57.9*	*16.2*	*12.3*	*5.3*	*0.0*	*7.9*	*+0.4*
2009									
Q I	100	76.3	58.8	17.5	11.3	8.7	–2.7	10.3	–6.6
Q II	100	66.6	51.3	15.3	10.4	17.1	+6.3	3.5	+2.4
Q III	100	70.2	54.2	16.0	11.4	12.9	+2.4	6.0	–0.5
Q IV	100	65.3	51.3	14.0	10.6	16.8	+8.5	3.5	+3.8
Year	*100*	*69.2*	*53.6*	*15.6*	*10.9*	*14.2*	*+4.1*	*5.5*	*+0.2*

Source: Rosstat.

Over 2009, the turnover of the food commodities market dropped by 2.5 %, while that of the non-food commodities market – by 8.3 % (*2*). There was also one positive trend that should be noted: starting in May, retail trade turnover began to grow month-to-month.



Source: Rosstat.

Fig. 2. The dynamics of the turnover of retail trade and paid services rendered to the population in 2000 – 2009 and by quarter in 2008 – 2009, as a percentage of the corresponding quarter of a previous year

It should be noted that the year 2009 was characterized by an increase in the population's propensity to save money, which can be seen as a precautionary measure in crisis conditions.

People used various instruments for safekeeping their incomes. If in Q I 2009 10.3 % of the money incomes of the population was spent on purchasing of foreign currencies, in Q 4 2009 this figure dropped to 3.5 %, while the proportion of savings kept on deposit and invested in securities rose to 8.5 % of the money incomes of the population, against the lowering of their share to -2.7 % at the beginning of the year. In Q III 2009, expenditures for purchases of foreign currency climbed to 6.0 % of the money incomes of the population, while the share of savings kept on deposit and invested in securities declined to 1.9 %.

Over 2009, the share of savings in the money incomes of the population amounted to 14.2 % against 5.3 % in the previous year, including those kept on deposit and invested in securities – to 4.1 %.

The dynamics of the savings of the population was considerably influenced by the level of inflation, the periodically emerging problems with liquidity, fluctuations of the exchange rate of the ruble and negative phenomena on the real estate market (less housing being put into operation, growth in mortgage interest rates, etc.). By the results of the first three quarters of 2009, the population's investments in share construction dropped to 37.6 bn Rb against 66.6 bn Rb in the same period of the previous year.

It should be noted that, in spite of the crisis, one of the main uses of savings continues to be purchasing of real estate and the improvement of housing conditions. These spending propensities of the population have had a certain effect on the current downward trend in arrears on housing and mortgage credits that has been observed since Q II 2009. This trend is also contributed to by the banks' toughening their credit policy. In 2008, the volume of credits granted by credit institutions to physical persons for the purpose of housing purchases amounted to 655.2 bn Rb and 103.2 bn Rb in foreign currencies, including mortgage credits in the amount of 555.4 bn Rb and 95.1 bn Rb in foreign currencies. The interest rate on housing and mortgage credits In January – November 2009, the volume of housing credits amounted to 140.5 bn Rb and 9.5 bn Rb in foreign currencies. In January – November 2009, the interest rate of housing and mortgage credits rose to 14.8 and 14.6 %, respectively, against 13.0 and 12.9 % in 2008.

The results of the opinion polls carried out by the Russian Statistics Service in Q IV 2009 indicated that consumer expectations had become more optimistic.

4.2. The Migratory Situation

Migration continues to play a prominent role in Russia's social and demographic situation. As a result of a significant drop in the natural population decrease (from 362 thousand persons in 2008 to 249.4 thousand persons in 2009) and the relative stability of the migration growth rate (at the level of 250 – 270 thousand persons), in 2009, for the first time in 15 years, Russia had its natural population decrease fully compensated for by its increase through migration. This undoubtedly remarkable fact – which occurred, in addition to everything else, during a crisis period – obviously requires some explanation.

Firstly, in accordance with the existing rules that serve as a basis for keeping the current migration records in Russia and the naturalization procedures,[1] migration-driven population

[1] First, a temporary residence permit; then residence permit; and then citizenship of the Russian Federation.

increase is now being contributed to by those migrants who have actually arrived in this country (and who have been staying in its territory) a few years ago. Since 2007, the number of persons arrived has included those migrants who obtain registration for a period of one year or more, as well as those who have for the first time obtained a temporary residence permit. In this connection, a certain part of migrants are still entered in the statistics twice; for example, these are migrants from certain countries (Kazakhstan, Kyrgyzstan and Belarus) who can register shortly after their arrival and then, within the same year, register again after having received Russian citizenship three months after their entry in this country[1].

Secondly, although the total migration-driven population growth, according to official data, not only fully set-off the natural population decrease but even exceeded it by 9.8 % (***Fig. 1***), it still has failed to compensate for Russia's loss of the able-bodied population, and can hardly compensate for it in the foreseeable future (***Fig. 2***). In the late 1990s – early 2000s, Russia was experiencing a favorable situation known as the 'demographical dividend'[2], when the overall population number was declining while the number of able-bodied persons was still high and remained on the rise until 2005. From the year 2006 onwards, there began a rapid natural contraction of the able-bodied population, its rate being comparatively low in 2006 (approx. 170 thousand persons), then doubling in 2007 and reaching the level of almost 1 mln persons in 2009.

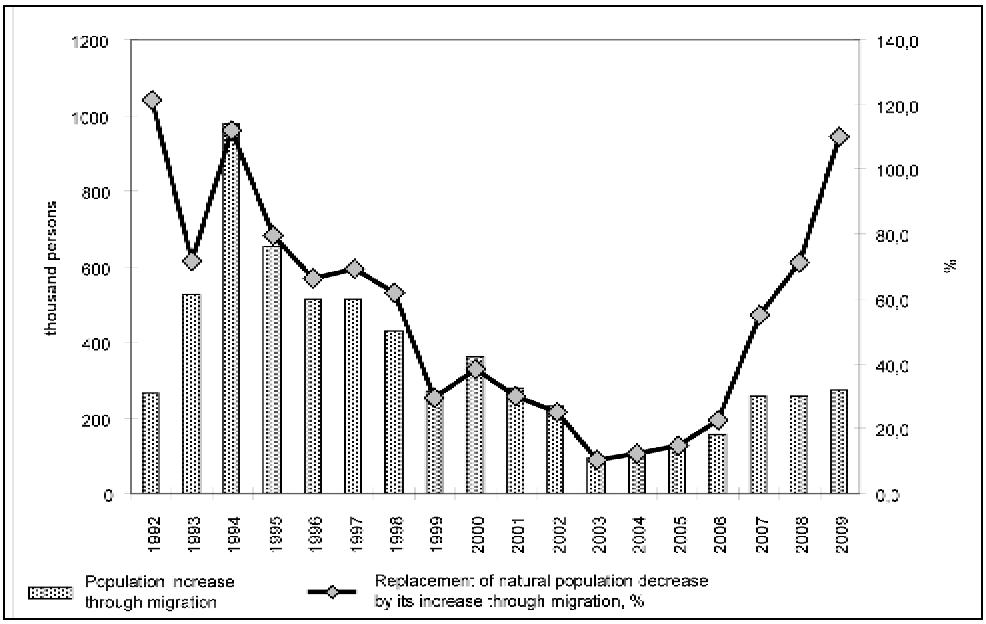
In accordance with the 'medium' variant of the forecast published by ***Rosstat***, the aggregate natural decrease rate of the able-bodied population in 2010 – 2020 will amount to 10.3 mln persons, reaching its peak in 2015 (1,152.7 thousand persons)[3]. In view of the existing number of employed in the Russian economy, the average decline per annum will be approximately 1.5 %. Neither the Russian not the Soviet economy has ever experienced a similar shrinkage of the able-bodied age groups. The experience of the first half of the 1960s – when the natural growth rate of the able-bodied population dropped dramatically (by half, as compared to the 1950s) but did not become negative – has demonstrated that, in order to liquidate the economic consequences of the impact of demographical structural factors, a package of special measures is required, including reasonable attraction of migrants[4]. The steps that have been taken in recent years in the spheres of migration and investments demonstrate that, so far, society has failed to achieve an adequate understanding of just how acute the situation with regard to providing the national economy with manpower has become. To a certain extent, the crisis-triggered unemployment in 2009 was aggravated by a drop in the size of the able-bodied population.

[1] For more details concerning this procedures, see Chudinovskikh O. S. Voprosy sovershenstvovaniia statistiki migratsii v ramkakh tekushchego uchiota i Vserossiiskoi perepisi naseleniia 2010 goda. [Issues of improving migration statistics in the framework of current record-keeping and the 2010 All-Russian Census] // http://www.valerytishkov.ru/

[2] Vasin S. Proshchanie s demograficheskim dividendom [A farewell to the 'demographical dividend'] // Demoscop Weekly. No 317 – 318. 21 January – 3 February 2008 r. http://www.demoscope.ru/ weekly/2008/0317/ tema02.php

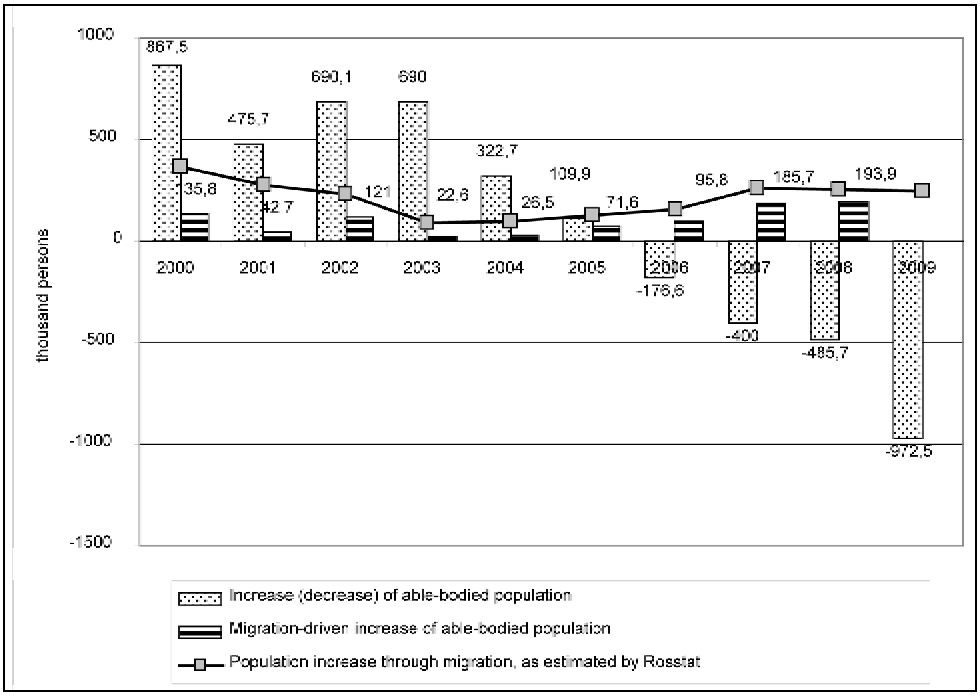
[3] Predpolozhitel'naia chislennost' naseleniia Rossiiskoi Federatsii do 2030 g. Statisticheskii bulleten'. [The presumeable population size of the Russian Federation until 2030. Statistical Bulletin. M.: Rosstat, 2009.

[4] For more details concerning this issue, see Zaionchkovskaia Zh. A. Resume doklada. Itogi kruglogo stola 'Migratsiia kak factor ekonomicheskogo razvitiia. 16 dekabria 2009 [An abstract. Summary of the round-table discussion 'Migration as a factor of economic development', 16 December 2009] // Migratsionnyi barometr v Rossiiskoi federatsii [Migration Barometer in the Russian Federation]. http://www.baromig.ru/single/events/reports/20091225153735



Source: Rosstat's data.

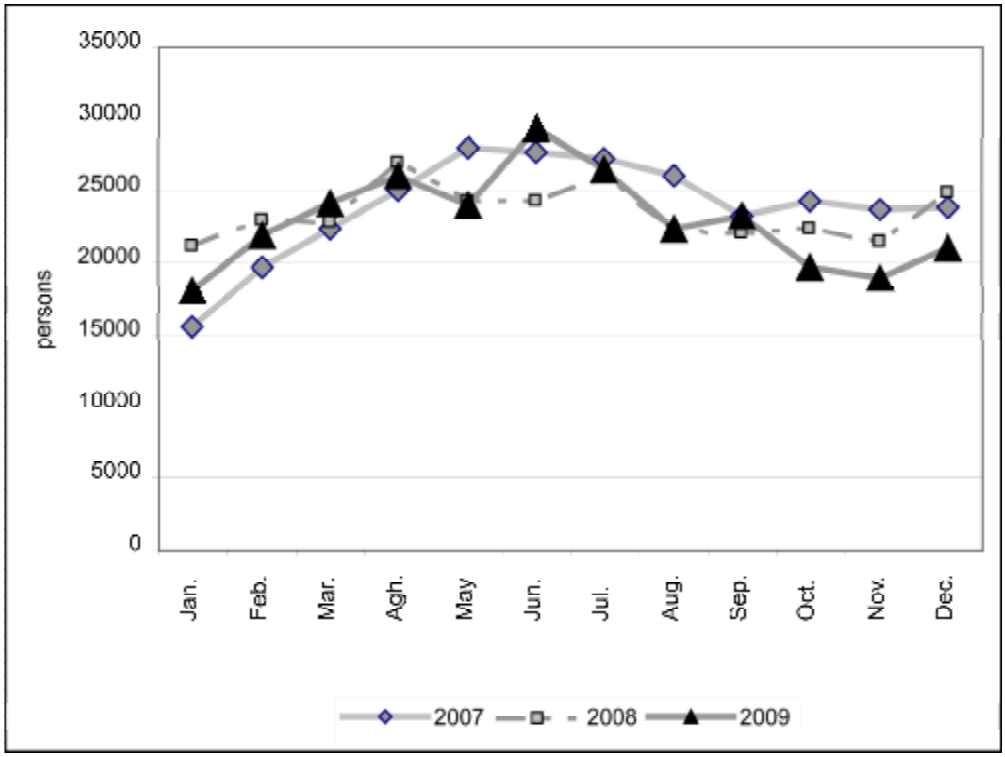
Fig. 1. Population increase through migration (thousand persons) and replacement of Russia's natural population decrease by its increase through migration (%), 1992 – 2009.



Note. For 2009, the estimates of the natural contraction of the able-bodied population are based on the data on the number of population by age group in accordance with the 'medium' variant of Rosstat's forecast as of 1 January 2010 and the published data as of January 2009.
Source: Rosstat's data.

Fig. 2. Increase (decrease) of the size of the able-bodied population and the increase of Russia's population through migration, thousand persons, 2000 – 2009.

Regretfully, due to the limitations of the migration statistics mentioned above, the relationship between the current situation on the labor market and migration flows is poorly reflected in official statistics. For example, the month-by-month arrival statistics of 2009 are almost identical to the trends observed in the previous years that demonstrate the usual winter lows and summer highs (*Fig. 3*). Nothing peculiar was recorded either in late 2008 (the 'official' onset of the crisis) or in the summer season 2009. And the total number of foreign visitor arrivals in Russia as part of international migration in 2009 was by 8 % higher than the same index recoded a year earlier[1].



Source: Rosstat's data.

Fig. 3. Monthly changes in the number of foreign visitor arrivals in Russia (international migration), 2007 – 2009, persons

Departure statistics demonstrated a continuation of gradual decline – a trend that has been Russia's typical feature for a long time and is totally unrelated to the current crisis. The drop in the number of departures by 18 % must not be regarded as an alarming phenomenon: for example, in one pre-crisis year (2006) this index dropped on the previous year (2005) by nearly a half. The number of departures to the far abroad has declined by 14 % and is rapidly approaching zero, which, however, is by no means an indication of what is actually going on; in fact, it only points to the imperfection of the procedures applied in statistical observations and to a change in the emigration channels.

[1] According to *Rosstat*'s reports for January – December 2009, the number of foreign arrivals amounted to 279.9 thousand. The figure adjusted on the basis of additional estimates (published by *Rosstat*) is 304.9 thousand. Correspondingly, the reported population increase through migration amounted to 247.4 thousand, and the estimated population growth through migration amounted to 271.6 thousand.

As a result, according to the estimates published by *Rosstat* (which have somewhat upwardly adjusted foreign arrival statistics), net migration amounted to 271.6 thousand persons.

On the whole, it can be stated that the current crisis, in contrast to the one that occurred back in 1998, has had almost no impact on migration (or, to be more precise, on migration statistics)[1]. During the first crisis the migration flows responded by a rather explicit increase in the number of departures from Russia to the far abroad and a decline in the number of arrivals in Russia. At present, we are either witnessing an extension over time of the response to the crisis (and so it has not as yet been reflected in the statistics), or statistical data represent only a rather inadequate reflection of the current crisis.

Just like it was in previous years, 93 % of all arrivals are related to the CIS countries. Throughout the 1990s, the repatriation component was unquestionably predominant in cross-border migration into Russia, the migration flows then being mainly represented by ethnic Russians and members of the so-called 'titular ethnic groups' of the Russian Federation (their shares in Russia's population increase through migration over the period 1989 – 2007 amounted to 65 and 12 %, respectively). The return of several millions of persons that shared the ethnic and cultural background of the bulk of Russia's population had a favorable influence on the Russian demographic situation, particularly in rural areas. However, thanks to the effects of many other factors (departures, adjustment to current conditions, the ageing of the remaining population, etc.), the migration potential in recent years has shrunk significantly[2]. In part, this was the reason why the government program adopted in 2006 (and implemented from 2007 onwards) that was designed to assist in the resettlement in Russia of compatriots lining abroad has never really begun to work. Instead of the initially declared target of receiving from abroad 300 thousand persons within 3 years, the numbers of persons actually received are as follows: 682 persons in 2007; 8,857 persons in 2008; 5,549 persons in 2009; so, their total number does not substantially exceed 15 thousand.

The initial hopes have proved to be futile – that is, that the small amounts of money offered as financial aid[3] would actually serve as incentives for those people who remained in the CIS republics because they had failed to act on their desire to emigrate during the years when their more active compatriots were doing so, and that they would resettle in those RF subjects that were assigned for such resettlement by responsible government agencies (as a rule, these were some 'problematic' Russian regions). On the one hand, the offered 'social adaptation' package and relocation allowance do little in terms of promoting social and economic integration, while on the other, the potential broadening of these financial support measures is fraught with the

[1] If the figures of 1.5-times growth of emigration to Israel reported by some experts (M. Tolts, Jerusalem University) are not taken in consideration.

[2] Zaionchkovskaia Zh. A., Tiuriukanova Ye. V. Immigratsiia; put' k spaseniiu ili Troianskii kon'? [Immigration: a way to salvation or a Trojan horse]? Doklad o razvitii chelovecheskogo potentsiala v Rossiiskoi federatsii 2008: Rossiia pered litsom demograficheskikh vyzovov. [Report on human potential development in the Russian Federation 2008: The economic challenges faced by Russia. M.: PROON [UN Development Program, UNDP], 2009. P. 100.

[3] For more details on this subject, see *Karachurina L. B.* Migratsionnye protsessy [Migratory ptocesses] // Rossiiskaia ekonomika v 2006 godu: tendentsii i perspektivy. [Russian Economy in 2006: Trends and Outlooks. M.: IET, 2007. Section 4.3. P. 492 – 513.

danger of stirring discontent among the local population[1] and intensifying 'paternalistic attitudes' among the resettlers[2].

No real interest in this project was demonstrated by either the migrants or the regions that were expected to receive them. The Program envisaged that the federal center should assume a few minimal obligations: to pay the transportation costs, the state duty for the preparation of the necessary documents, the relocation allowance, and the monthly unemployment benefit in an event of absence of appropriate vacancies. The rest – as, by the way, also all the practical matters associated with relocation – was to be taken care of by regional and municipal authorities. However, the necessity to deal with many other tactical issues coupled with regional budget deficits (a typical feature of some 20 – 30 Russian regions even during 'fat' years) devalued the strategic usefulness of the Program in the eyes of even those regions that were constantly complaining of chronic manpower deficit, despite all the efforts of the center to impose the Program on them[3]. There have even emerged several schemes of sabotaging the implementation of the regional 'compatriot repatriation' programs: refusal to provide financing for it from their own sources; allocation only of minimum financing; or preparedness to finance the programs only at the expense of employers or the repatriates themselves[4]. Some regions altogether refused to develop their regional programs.

As a result, at present the State Program actually serves as a kind of 'camouflage'. This was also noted by President D. A. Medvedev in his speech at the III World Congress of Russian Compatriots: 'The total number [of participants in the Program] is important, but still more important is the confidence of all those who are outside of Russia that they can indeed return to their Fatherland'[5].

The problems encountered in course of the State Program's implementation – or, to be more precise, its collapse – have revealed the unpreparedness of public institutions to work diligently and methodically when performing the task of receiving and integrating migrants; however, in view of the looming demographic 'gap' with its threat of shortage of able-bodied age groups, such work may become necessary in the nearest future.

Another key area of migration policy since the late 1990s has become regulation of the the processes of temporary labor migration. During that time – even according to official statistics – the inflow of labor migrants into Russia, especially from her post-Soviet neighbors,

[1] From the speech delivered by Governor of Khabarovsk Krai V. Ishaev: 'What moral right do we have to provide the newcomers, at the very outset, with comfortable apartments what in the city of Khabarovsk alone there are more that seven thousand families who still live in houses that look ready to collapse?' (Ishaev V.. Proekty integratsii my obsudim na forume [We shall discuss the integration projects at a forum] // Rossia v ATR [Russia in the Asia Pacific Region]. 2006. No 3. P. 19).

[2] Mukomel' V. I. Migratsionnaia politika i politika integratsii: sotsial'noe izmerenie [Mmigration policy and the policy of integration: the social dimension] // Rossia reformiruiushchaiasia.[Russia Reforming] Iezhegodnik [Yearbook] / Ed. by M. K. Gorshkov. Issue 7. M.: Institut sotsiologii RAN [Institute of Sociology of the Russian Academy of Sciences], 2008. P. 268.

[3] Beloglazova G. Kordon dlia profi [The state frontier as a barrier to keep professionals out] // Rossiiskaia Gazeta [The Russian Gazette]. 25 November 2009.

[4] Mukomel' V. I. Migratsionnaia politika i politika integratsii: sotsial'noe izmerenie [Mmigration policy and the policy of integration: the social dimension] // Rossia reformiruiushchaiasia.[Russia Reforming] Yezhegodnik [Yearbook] / Ed. by M. K. Gorshkov. Issue 7. M.: Institut sotsiologii RAN [Institute of Sociology of the Russian Academy of Sciences], 2008. P. 267.

[5] Biriukova L., Sargin A., Novikova A. Sootechestvenniki pereshli granitsu. [Compatriots have crossed the border.] // Gazeta. 2 December 2009.

has increased manifold. In 2000, the number of labor migrants obtaining work permits in Russia amounted to 213 thousand; 6 years later, in 2006, this figure became as high as 1,023 thousand. It impossible to determine reliably just how dramatically the actual indices – as opposed to official statistics – have altered over that period. Zh. A. Zaionchkovskaia and Ye. V. Tiuriukanova [1] - as well as some other researchers[2] - on the basis of their studies stressed the fact that 'the overall number of migrants present in Russia as of the end of 2006 was no more than 7 mln', including 5 – 6 mln persons arriving as part of labor migration. Selective surveys that were conducted in Russia in 2003 – 2006 revealed that up to 80 % of migrants had no written agreement with their employer, 75 % of migrants received their wages – in part or in full - 'under the counter' ('in an envelope'), and 50 % had no residence registration[3].

The increasing flows of labor migrants who were registered fully or in part (for example, prior to 2006 they had registration but worked under a contract with an employer who had no permission issued by the migration service; or, they had registration but worked without any contract) or were unregistered, as well as the growing share of illegal migrants had necessitated the introduction in legislation of some urgent alterations, which was then actually done from 15 January 2007 onwards[4] (an advising procedure for those arriving under a visa-waiver regime; the possibility to register at the legal address of their employers; a new procedure for obtaining a work permit, etc.). As it usually happens, the new legislative initiatives needed first to be somewhat adjusted on the basis of unhurried and methodical efforts to coordinate practical work with law-making and law enforcement practices. However, on the whole the new 'migration package' was perceived as a liberal innovation that was designed to achieve a maximum degree of legalization – to the extent that such legalization can actually be possible in face of Russia's existing economic realities (when 1/5 of Russia's own population are work-

[1] Zaionchkovskaia Zh. A., Tiuriukanova Ye. V. Immigratsiia; put' k spaseniiu ili Troianskii kon'? [Immigration: a way to salvation or a Trojan horse?] Doklad o razvitii chelovecheskogo potentsiala v Rossiiskoi federatsii 2008: Rossiia pered litsom demograficheskikh vyzovov. [Report on human potential development in the Russian Federation 2008: The demographic challenges faced by Russia. M.: PROON [UN Development Program, UNDP], 2009. P. 223 – 225.

[2] Mukomel' V. I.. Migratsionnaia politika Rossii: Postsovetskie konteksty [Russia's migration policy: Post-Soviet contexts. M.: Dipol'-T, 2005. P. 194 – 198.

[3] Tiuriukanova Ye. V. Prinuditel'nyi trud v sovremennoi Rossii: nereguliruemaia migratsiia i toprgovlia liud'mi. [Forced labor in modern Russia: unregulated migration and the trade in humans]. 2nd ed.. ILO, Geneva, 2006; Karachurina L. B. Osobennosti zaniatosti migrantov v Rossii (po dannym sotsiologicheskogo obsledovaniia) [The specific features of migrant employment in Russia (by the results of sociological surveys)] // Gornye strany: rasselenie, etnodemographicheskie i geopoliticheskie protsessy, geoinformatsionnyi monitoring. [Mountainous countries: population distribution, ethno-demographical and geopolitical processes, geo-informational moniroting.] Materials of an international conference. Stavropol – Dombai, 25–30 September 2005 – M.– Stavropol, 2005. – pp. 156 – 165; Problemy nezakonnoi migratsii v Rossii: realii i poisk reshenii (po itigam sotsiologicheskogo obsledovaniia). [The problems of illegal migration in Russia: the realities and the search for solutions (by the results of a sociological survey conducted by the International Organization for Migration (IOM), IOM Bureau in Russia (Ed. By G. S. Vitkovskaia). M.: Gendalf', 2006, pp. 490 — 498; Mukomel' V. I. Ekonomika nelegal'noi migratsii v Rossii. [The economics of illegal migration in Russia.] //Demoskop Weekly. No 207 – 208. http://demoscope.ru/weekly/2005/0207/tema01.php

[4] For more details, see *Karachurina L. B.* Migratsionnye protsessy [Migratory ptocesses] // Rossiiskaia ekonomika v 2007 godu: tendentsii i perspektivy. [Russian Economy in 2007: Trends and Outlooks. M.: IET, 2007. Section 4.2. P. 379 – 394.

ing not quite legally[1], and the coefficients applied in order to additionally estimate illegal activities are abnormally high).

The results of the first year of applying the altered legislation demonstrated that the number of migrants obtaining work permits had doubled. Evidently, there occurred some positive redistribution resulting in part of the unregistered migration being channeled into the registered segment – that is, legalization of part of the illegal component. However, every 'step forward' in migration policy is usually followed by (at least) a 'half-step backwards'. Thus, the events in autumn 2006 in Kondopoga (Karelia) resulted in a ban being imposed on employing foreign citizens in retail trade throughout the whole country.

The passive attitude of employers to the campaign aimed at establishing the quotas for attracting foreign workers on the basis of employer applications – the first one to be based on the newly introduced rules (according to the new law, the applications for employing foreign workers in a next year have to be submitted by 1 May of a current year[2]) – resulted in the quota for 'visa-waiver' foreign workers being reduced from 6,000 thousand in 2007 to 1,156 thousand in 2008. The world financial crisis that 'officially' hit Russia precisely at the moment when the quota for a next year was being assigned necessitated its sequestration in order to protect the labor market for the benefit of domestic workers – thus disregarding the requests of employers[3]. The initially established figure for attracting foreign workforce was 3,976.7 thousand persons (including 1,250.8 thousand persons from the 'visa-waiver' countries)[4]; later on, 50 % of this number of workers was marked as 'reserve'[5], and so the final figures are as follows: 625,4 thousand from the 'visa' countries and 1,363 thousand from the 'visa-waiver' countries[6].

Another anti-crisis measure was the alteration introduced in the procedure for issuing work permits to foreign citizens. The innovations introduced in this sphere are as follows: a foreign worker who has arrived in Russia from one of the 'visa-waiver' countries and undergone the migration registration procedure can now receive a work permit only for a period of 90 days (instead of the previously available (maximum) period of 1 year) during which he or she must

[1] The share of those employed in the 'informal' sector in September 2009 was 21.7 % // *Rosstat*: Obsledovanie naselenia po problemam zaniatosti. [A population survey with regard to employment problems]. *Rosstat*. September 2009.

[2] For more details on this subject, see *Karachurina L. B.* Migratsionnye protsessy [Migratory ptocesses] // Rossiiskaia ekonomika v 2006 godu: tendentsii i perspektivy. [Russian Economy in 2006: Trends and Outlooks. M.: IET, 2007. Section 4.3. P. 492 – 513.

[3] In late 2008, the Government of Russia decided that in 2009 the quota for permits granting the right to employ foreigners should be 3 mln 977 thousand persons, but that 50 % of this quota should be reserved, that is, not extended to regions.

[4] The RF Government's Decree 'On determining, for the year 2009, the need for attracting foreign workers to the Russian Federation' of 7 November 2008, No 834.

[5] Order of the Ministry of Health Care and Social Development of the Russian Federation 'On the distribution among subjects of the Russian Federation of the quota for the issuance of work permits to foreign citizens approved by the Government of the Russian Federation for the year 2009' of 26 December 2008, No 777n.

[6] Simultaneously with toughening the rules, the government also adopted some documents aimed at attracting foreign workers by means of 'bypassing' the consolidated rules; consider Order of the Federal Migration Service (FMS) of 23 November 2009, No 329, 'On the procedure for granting to the juridical and physical persons that have concluded civil legal contracts for the construction projects needed for holding meetings of the heads of states and governments of the countries – participants in the Asia-Pacific Economic Cooperation forum in 2012...' // See the FMS' website http://www.fms.gov.ru/upload/iblock/e60/pfms16041.pdf

find a job and to conclude with their employer a labor contract for a period of 1 year, after which the work permit can be prolongated (by once again applying to the FMS) for the period remaining until the expiry of the one-year period. From a formal point of view, the '90-days rule' has been introduced in order to reduce the number of those labor migrants who have entered this country under the conditions of visa-waiver exchange and who cannot find employment here due to the crisis. Actually, as this anti-crisis innovation is far from being impeccable from the point of view of law, the employers - who frequently avoided the legalization of their foreign workers even before the introduction of the new procedure – now are even more reluctant to conclude such contracts, thus increasing the segment of illegal migration and informal employment. Moreover, the new procedure has given rise to an absolutely vague situation with regard to foreign workforce statistics, because now it frequently happens so that one and the same migrant in entered in official statistical records of the issuance of work permits as several different individuals: first, when he is issued a three-month work permit, and then every time he applied for a prolongation of his stay.

Evidently, the law enforcement procedures relating to migration registration have also changed. It should be reminded that, from 15 January 2007, the Federal Law 'On migration registration of foreign citizens and persons without citizenship in the Russian Federation' (of 18 July 2006, No 109-FZ) came into force in this country, whereby all the foreign citizens arriving for a temporary stay are required to register at the place of their residence within three days of their arrival, while their 'place of dwelling' may be 'residential premises that are not a place of residence' or 'another premises, institution or organization in which the foreign citizen or the person without citizenship are situated'[1]. The surveys conducted by the International Organization for Migration (IOM) (2007 – 2008) have demonstrated that nearly all the labor migrants learned very soon of the simplification of the registration procedure and of the necessity to obtain a migration registration, and so tried to comply with the established rules (some – by actually undergoing the procedures, while others simply bought the necessary documents). By mid-2009, the new procedure had already been in force for nearly 2.5 years, and so in a situation of crisis and lowering quotas for the employment of foreign workers the authorities began a furtive struggle against those employers who were allowing their workers to register at non-residential premises, as it was allowed by the law[2]. The data yielded by the two 'waves' of surveys conducted by the Center for Migration Studies[3] in August – September 2008 and May 2009 demonstrated that the share of migrants who had undergone the migration registration procedure changed very little. The legalization level in Russia of temporary labor migrants re-

[1] Article 2 of the Federal Law 'On migration registration of foreign citizens and persons without citizenship in the Russian federation" (of 18 July 2006, No 109-FZ) //http://demoscope.ru/weekly/knigi/zakon/zakon056.html

[2] Yu. F. Florinskaia. Sochi – rai dlia migrantov i bezrabornykh? [Is Sochi a paradise for migrants and the umemployed?] // Rossiiskaia migratsiia [The Russian Migration]. 2009. No 5 – 6 (36 – 37). P. 27 – 28.

[3] The study was conducted by the Center for Migration Studies (Director – Ye. V. Tiuriukanova) as part of the projects 'Migration management in conditions of a demographic crisis' (The McArthur Foundation) and 'Assessment of Russia's new migration policy in the sphere of labor migration from the CIS countries' (supported by a grant of the Civic Chamber of the Russian Federation). The survey patterns were similar, and so it is possible to compare the labor flows 'before' and 'during' the financial crisis. The pre-crisis survey took place in August – September 2008 and involved 774 migrants from the CIS countries, who were questioned in Moscow, Kazan, Voronezh, Krasnodar, and Astrakhan. The 'crisis' survey was conducted in May 2009 in Moscow, in St. Petersburg, and Krasnodar, and involved 801 migrants.

mains high, 80 % of migrants register in this country. However, the share of those registered at their place of work dropped nearly by half – from 43 to 22 %.

There are some other indications pointing to further proliferation of the informal shadowy practices in the sphere of migration that have long become habitual in this country. To a various extent, their increasing significance could be contributed to by the three interested parties as follows.

1. *The State,* in the person of its control bodies, is interested in curbing unemployment and preserving jobs for the country's own population[1]. However, it should be understood that the existing interrelations between migration and labor markets are very complex, and so cannot be reduced to this simple formula: crisis – aggravation of the unemployment problem – redistribution in favor of the local population of the jobs previously held by migrants – departure / homecoming of 'redundant' migrants. In Russia, just as in many developed countries, migrants and the local population occupy different niches in terms of labor conditions, professional qualification, or even sectors of the economy[2]. Labor migrants can easily find jobs that hold no attraction for the local population because of unsatisfactory or hard working conditions, seasonability and low wages. In some localities, though, the crisis could conduce to a slight rise in the popularity of some previously undesired jobs and to a respective increase in competition on the low-skilled segment of the labor market. However, that was not the case in most Russian regions. The sectoral preferences of labor migrants (construction, wholesale and retail trade, processing industries, communal and personal services, public transport, agriculture) which have remained unchanged for a number of years do not match the sectoral structure of employment of the local population[3] (Figure *4*). Approximately the same sectoral-qualificational dichotomy between the local population and migrants (which effectively ensures the completeness and integrity of the labor pyramid) also exists in the developed countries of the world. So, when the State resorts to direct measures (such as quota reduction[4]) and attempts to

[1] Various statements with regard to this subject were plentiful throughout 2009 and early 2010. The latest of them was made by Chairman of the RF Government Vladimir Putin in the course of his meeting with the head of the Federal Migration Service, Konstantin Romodanovskii, on 17 February 2010: 'Like all European countries, Russia should try to attract foreign workers with the qualifications our economy needs, and attract them to the sectors where they are most needed. Also, this should be done in a way that does not create unnecessary competition on the labor market between foreign workers and Russian citizens, at least during the continuing economic downturn' // the website of Chairman of the RF Government Vladimir Putin http://premier.gov.ru/events/news/9427/

[2] According to a staffer of one of the employment agencies, migrants are needed '…where some form of physical labor is required… Take, for example, the plants that also frequently apply for the services of employment agencies – motor vehicle plants or plants producing dairy or confectionary goods … It is clear that native Muscovites would be unlikely to take a job as a loader … Nowadays, Muscovites reject any jobs involving physical labor, they do not take such vacancies'. // Mukomel' V. I., Kuznetsov I. M., Livshin A. Ia, Polunov A. Iu, Batovrina E. V. Sotsiologicheskii analiz problem trudoustroistva migrantov: tochka zreniia recrutingovykh agentstv [A sociological analysis of the issues of placing migrants into jobs: the point of view of recruitment agencies]. M.: Center for Student Initiatives, Department of State and Municipal Administration, Lomonosov Moscow State University; Institute of Sociology, Russian Academy of Sciences, 2008.

[3] In this connection, it is not easy to understand why it has been declared that our policy's priority should be the attraction of highly qualified specialists from abroad.

[4] Chairman of the Federal Migration Service Konstantin Romodanovskii said in this regard: 'Toughening up the procedure for work permit issuance has made it possible for us to issue 30 % fewer permits to foreign citi-

'shield' the labor market from migrants, by doing so it does not really create preferential conditions for the majority of the local population – instead, it promotes the latent presence of migrants on the labor markets. Moreover, the dynamism of the functioning of local labor markets and the ability of the State to control such extremely complex processes as migration have been greatly overestimated. Such illusions are, in fact, the consequence of a 'technocratic' attitude to people and the Soviet experience of implementing major state projects of any kind and magnitude (from construction of a chemical plant in the town of Uvarovo to the Baikal-Amur Railway to the 'Virgin Lands' campaign).

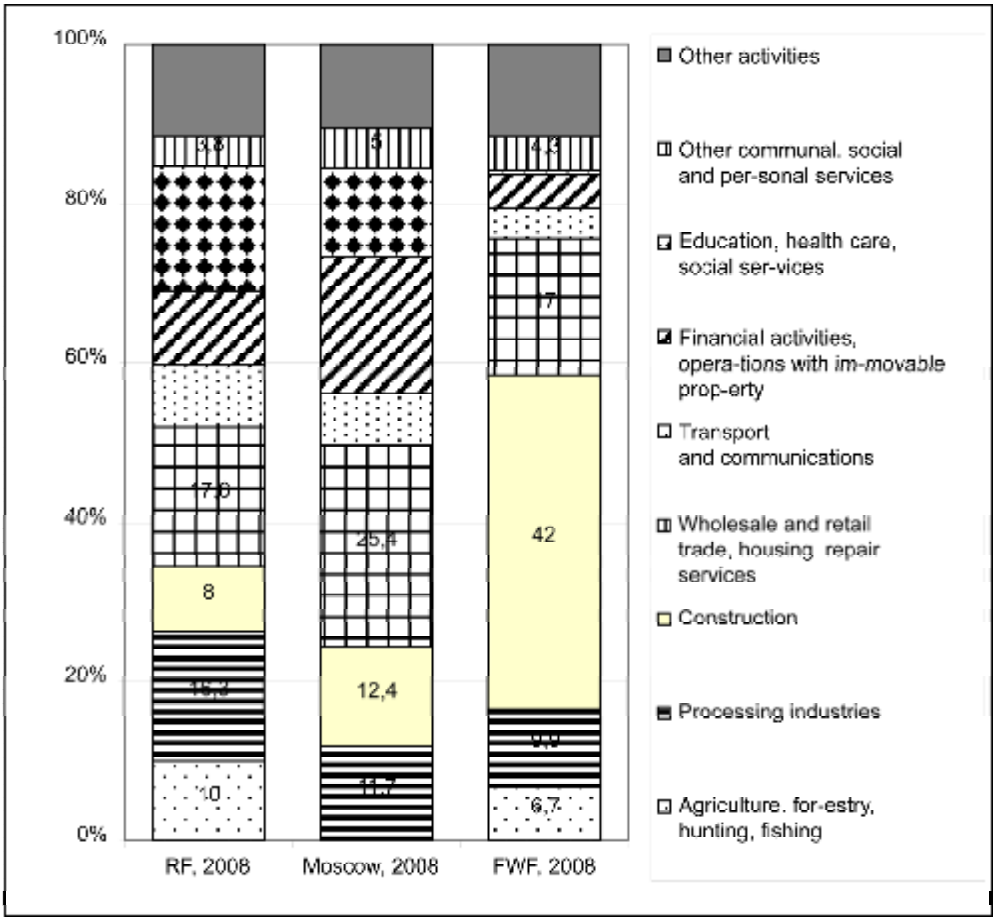


Fig. 4. Sectoral employment structure of Russia's and Moscow's population and of foreign workforce (2008, %)

2. *Employers* have their own reasons for employing semi-legal workers. The toughening of Russian labor legislation[1] and the predominance of the 'market employer' over the 'market worker' resulted, among other things, in a rise in the proportion of informally employed labor: employment surveys indicate that in September 2009 the share of such labor in Russia's total employment was as high as 21.7 %, whereas one year prior to the onset of the

zens and thus to protect the Russian worker' // The website of Chairman of the RF Government Vladimir Putin http://premier.gov.ru/events/news/9427/

[1] For more details, see Kapeliushnikov R. I. Konets rossiiskoi modeli rynka truda? [An end of the Russian model of the labor market?] M., 2009.

crisis, in November 2007, it was 17.1 % [1]. Migrants – who by definition enjoy fewer rights than 'the natives' - began to fall into the 'trap' of illegal employment because employers became even more reluctant to legalize their employment status. The crisis has in no way shattered the existing system of incentives for employers to attract migrants from other countries (lack of Russian workers with the necessary specialties, the predictable quality of migrants' work, and their submissiveness to their employer). Moreover, some of these motives (for example, the desire to save on wages – because migrants usually agree to work overtime and to skip their weekends and holidays for the same pay) have even become more prominent as a result of the crisis.

The survey conducted by the Center for Migration Studies demonstrated that even in the pre-crisis period the average workday of a migrant was 9 hours. By May 2009 (the second 'wave' of the survey) it had increased to 10 hours. The duration of a working week remained practically unchanged, but even during the first phase of the survey it was 5.9 days[2]. At the same time, both in 2008 and in 2009 the average workday of a migrant without a work permit was longer than that of those with work permits (*Table 1*). Thus, the average working week in May 2009 was 59 hours, which is indicative of an increased workload both by comparison with the pre-crisis period and with the results of other pre-crisis surveys conducted by G. S. Vitkovskaia (in 2006 – 53 hours)[3].

The stronger trend towards illegal employment of migrants can be demonstrated by the changes in the index describing the form of payment of wages. Among those who had work permits, in 2008 the wages were paid in accordance with payment records (fully or in part, when part of the wages was recorded in the accounting documentation, and part was paid off-record ('in an envelope')) to 78 % of migrants, and in 2009 – to 71 % of migrants (which means that the illegal segment increased among those who had opportunities for legal employment). Besides, the size of wages – for those with and without work permits alike – could no more be applied even as a 'weak' index of the 'normality' of work, when the wages of illegal workers were lower than those of the legal ones. In this connection, the amount of wages did not decline – instead, it even increased[4]. On the whole, it is close to the average nominal level of wages across Russia (in April 2009 – 18,287 rubles). Similar proportions of the wages paid to Russians and to migrants were observed in the pre-crisis surveys: thus, for example, in the

[1] Rosstat: Obsledovanie naseleniia po problemem яaniatosti [Employment Survey]. Rosstat. November 2007; September 2009.

[2] We should like to cite here an employer's opinion recorded as part of Yu. F. Florinskaia's survey during a focus group meeting with employers: 'With us, they work not 8 but 14 hours, and without any Saturday or Sundays off. And we pay them for speed and quality. There exist certain time limits for them to complete the project. And that is why they work without Saturday or Sundays off, and without leaves.' // Materials of Yu. F. Florinskaia's presentation 'The practices of migrant employment during the period of crisis' at the regional experts' meeting 'Partnership of the CIS countries in the sphere of migration: a search for coordinated decisions' (Moscow: The Institute for Economic Forecasts of the RAS – the Center for Migration Studies, 24 – 25 September 2009).

[3] Problemy nezakonnoi migratsii v Rossii: realii i poisk reshenii (po itigam sotsiologicheskogo obsledovaniia). [The problems of illegal migration in Russia: the realities and the search for solutions (by the results of a sociological survey conducted by the International Organization for Migration (IOM), the IOM Bureau in Russia (Ed. By G. S. Vitkovskaia). M.: Gendalf', 2006, p. 122.

[4] The average size of earnings depends on the sector of employment, the quality of the labor force., the territory of preferential employment and other factors the comparison with which without no correct description of migrant earnings can be possible.

study conducted by Ye. V. Tiuriukanova (June 2003) the average wage of illegal migrants was 5,338 rubles (approx. 176 USD), while the country's average wage was 5,591 rubles (or 184 USD)[1]. In G. S. Vitkovskaia's survey conducted in 2006, 50 % of migrants believed that their pay was the same as that of the locals.[2]

Table 1

Influence of Work Permit on Some Features of Migrant Employment

Index	Phase of survey	Work permit	
		Yes	No
Workday duration (hours per day)	2008	9.2	9.5
	2009	9.7	10.2
Entry of wages in payment records (in full or in part), %	2008	78.0	30.7
	2009	71.0	31.1
Amount of wages, thousand rubles	2008	15.8	14.9
	2009	18.2	20.0

Source: Obsledovanie TsMI [The Center for Migration Studies' Survey], 2008, 2009.

3. *Migrants*: their desire to find work at any cost and to be able to help their families in the poor countries of the CIS could also increase the level of informal migrant employment. The differences in payment for labor and in the levels of unemployment, boosted by the increased labor supply on the part of the major donor countries whose population is rapidly increasing and becoming more mobile, has made Russia extremely attractive in the eyes of labor migrants in the past few years (*Table 2*).

Table 2

Selected Socioeconomic Indicators for CIS Countries, 2008 and 2009

Country	Average number of unemployed persons according to ILO standards, 2009	GDP at purchasing power parity, USD, 2008	Average nominal wage, USD, Aug 2009	Average wage of migrant worker in Russia according to Center for Migration Studies' surveys, Rb, Aug – Sept 2008 г. / May 2009 г.
Azerbaijan	6.0	7,770	317	17,090 / 26,031
Armenia	16.4	6,310	293	18,491 / 17,221
Belarus	0.9*	12,150	396	
Kazakhstan	6.3	9,690	485	15,716 / 17,000
Kyrgyzstan	8.2	2,130	137	14,092 / 16,667
Moldova	5.7	3,210	230	14,745 / 17,303
RF	8.2	15,630	718	
Tajikistan	7,4	1,860	63	15,808 / 15,744
Uzbekistan		2,660		14,769 / 15,555
Ukraine	9,1	7,210	356	18,206 / 18,947
Turkmenistan		6,210	626	

* According to registration records as of the end of the year.

Note. Migrants from Belarus and Turkmenistan were not questioned in the survey.

Source: data of the CIS Statistics Committee http://www.cisstat.com/rus/, Demoscope Weekly http://demoscope.ru/weekly/ app/world2009_3.php, Obsledovanie TsMI [The Center for Migration Studies' Survey], 2008, 2009.

[1] Tiuriukanova Ye. V. Pronuditel'nyi trud v sovremennoi Rossii: nereguliruemaia migratsiia i toprgovlia liud'mi. [Forced labor in modern Russia: unregulated migration and the trade in humans]. 2nd ed.. ILO, Geneva, 2006, p. 59.

[2] Problemy nezakonnoi migratsii v Rossii: realii i poisk reshenii (po itigam sotsiologicheskogo obsledovaniia). [The problems of illegal migration in Russia: the realities and the search for solutions (by the results of a sociological survey conducted by the International Organization for Migration (IOM), the IOM Bureau in Russia in Russia (Ed. by G. S. Vitkovskaia). M.: Gendalf', 2006, p. 122

The CIS countries have been hit by the crisis at least as severely as Russia. As a result, the economies of the Central Asian countries – which had been weak and dependent even before the crisis – were then faced with 'export' of unemployment, a problem that they cannot not adequately cope with. The surveys carried out in Tajikistan and Moldova have revealed that the number of arrivals of labor migrants in 2009 was 15 – 25 % lower than that recorded in the summer season of 2008.

The survey conducted by the Public Opinion Department of the Shark Research Center (Tajikistan)[1] indicated that the seasonal winter outflow (2008/2009) of migrants from Russia into Tajikistan was one-third less than normal because part of the migrants stayed on in Russia in order to 'see how the situation would develop'. Therefore the arrival curve in Tajikistan was 'less steep' than usual, while the spring departure in search of foreign earnings, on the contrary, was more 'protracted'. Some of the migrants elected to wait in Tajikistan for the crisis to subside, while at the same time making no strategic plans for reintegrating in Tajikistan and still relying, in a longer term, on their future seasonal earnings in Russia[2]. As a result, the overall number of migrants dropped by 20 %. The data collected during the survey demonstrated that 'migration is influenced not so much by the crisis (its comprehensive impact having been noted by 13.7 % of the respondents) as by the tougher attitude of the Russian law enforcement agencies to migrants, the desire of employers to compensate for their losses resulting from the crisis at the expense of migrants, and the increasing amount of formal and informal payments' [3].

The survey in Moldova[4] also demonstrated that the number of labor migrants declined by almost 20 %; however, there was no large-scale return to their native country[5]. The surveys conducted by CASE-Moldova (Q III 2008 – Q I 2009) and MOM-SBS-AXA (July – August 2008 – March 2009) revealed that, in face of the aggravating problems on Moldova's labor market, migrants cannot come back home, but at the same time they are prepared to ultimately reduce their spending on their own needs, while as far as possible to maintain the amount of their money transfers to their families in Moldova at their former level.

The size of cross-border money transfers by physical persons in 2009 amounted to 25,362 mln USD, of which 9,555 mln USD (37,7%) was accounted to by transfers to the CIS countries. The drop in the volume of transfers to the CIS on last year was 31.5 %, while the average amount of one operation was slightly above 500 USD. In 2008 and then again in 2009 the

[1] S. Olimova. Kogda rabota stanovitsia neeffektivnoi, oni vozvrashchiautsia domoi. [When work becomes ineffective, they return home.] // Rossiiskaia migratsiia. No 5 - 6 (36 - 37) August – September 2009. P. 35-38.

[2] Russia is the principal 'recipient' country for Tajikistan, being a target for 97 % of all Tajik migrants. The total number of emigrants from Tajikistan in 2008 was estimated to be at the level of between 800 thousand and 1 million persons. For Russia, labor migrants from Tajikistan constituted 14 – 16 % of all registered foreign workforce in 2007 – 2008.

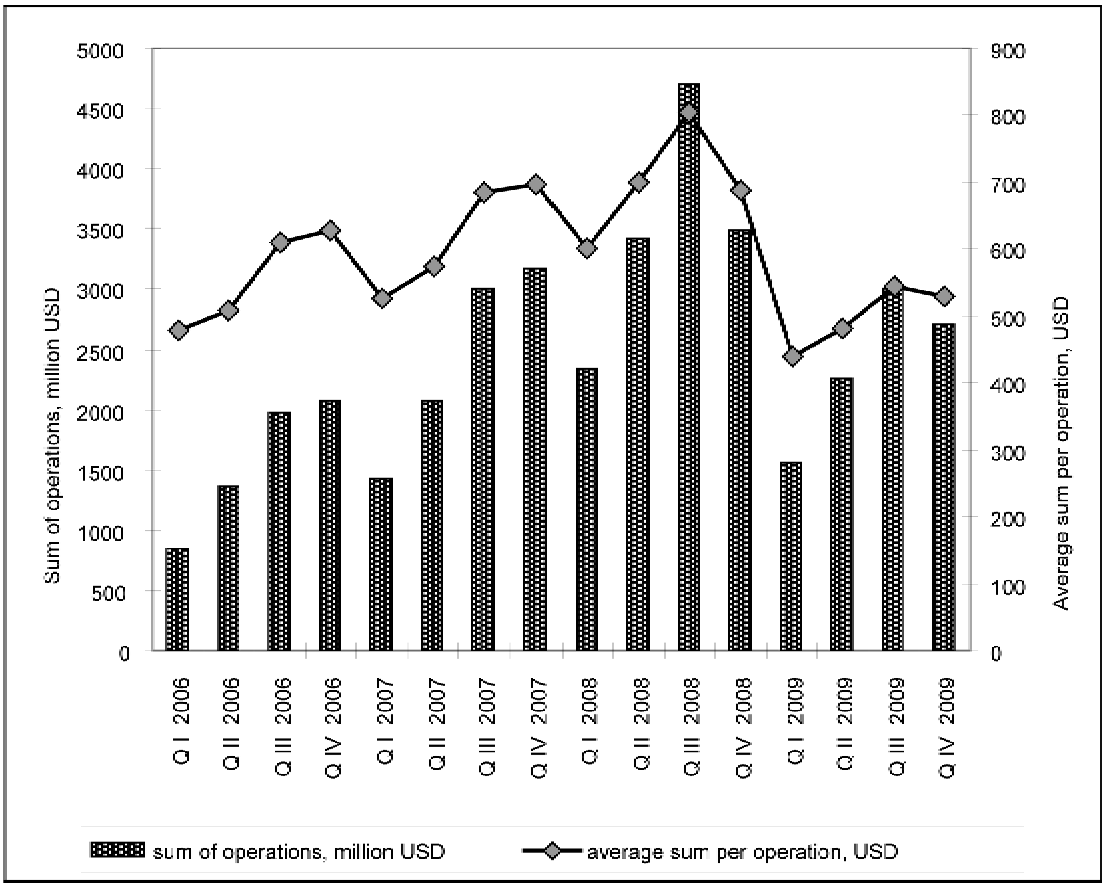
[3] S. Olimova. Kogda rabota stanovitsia neeffektivnoi, oni vozvrashchiautsia domoi. [When work becomes ineffective, they return home.] // Rossiiskaia migratsiia. No 5 - 6 (36 - 37) August – September 2009. P. 38.

[4] The report by V. Moshniaga delivered at the regional experts' meeting 'Partnership of the CIS countries in the sphere of migration: a search for coordinated decisions' (Moscow: The Institute for Economic Forecasts of the RAS – the Center for Migration Studies, 24 – 25 September 2009)

[5] The number of labor migrants from Moldova, according to the 2004 census and the results of sociological surveys conducted in 2004 – 2008 is estimated to be at the level of 600 thousand, Russia's share being 58 – 63 %. For Russia, labor migrants from Moldova account for 4.5 – 5.5 % of the foreign workforce registered in Russia per annum.

atypical trends observed in Q IV (which is usually the most 'prosperous' quarter) serve as markers of the crisis and its 'retranslation' onto the CIS countries, where both human and money flows are closely linked to Russia (*Fig. 5*)[1].

The 31 % drop in the volume of transfers in 2009 by comparison with the previous year can be viewed as an indirect source of information concerning the number of labor migrants in Russia: considering the general decline in the size of real wages across Russia by 7.4 %[2], one can speak of a drop in the number of labor migrants in Russia by 20 %, but no means by 30 % as it follows from the official statistics published by the FMS: the number of work permits was 1,473.4 thousand, including those issued to foreign citizens arriving under the visa-waiver regime – 1,181.3 thousand (80 % of the total number of work permits).



Source: data published by the RF Central Bank.

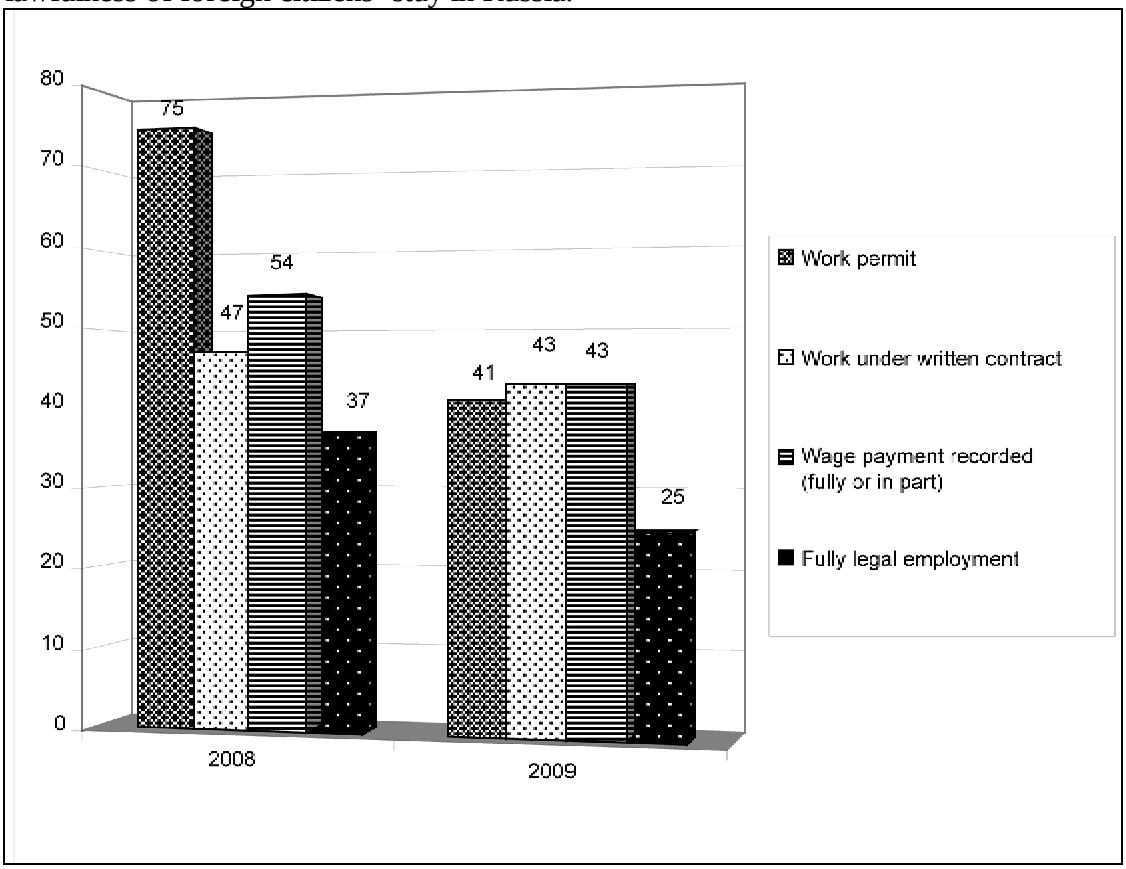
Fig. 5. Money transfers from Russia to the CIS countries, based on the statistical data on cross-border operations carried on by physical persons, Q I 2006 – Q II 2009

The strengthening of the informal labor market is aptly illustrated by data on Moscow - the only subject of the Federation that was examined in the course of both 'waves' of surveys car-

[1] However, the drop in the volume of money transfers could be partly caused by the fact that more people are now preferring to bring home cash instead of sending it via bank transfers.

[2] March 2009 to October 2008, with a seasonal adjustment. Kapeliushnikov R. I. Konets rossiiskoi modeli rynka truda? [An end of the Russian model of the labor market?] M., 2009. P. 44.

ried out by the Center for Migration Studies. In less than one year, the share of legally employed migrants (properly registered with the migration authorities and working under written labor contracts) has dropped in Moscow from 37 to 25 % (*Fig. 6*), while the percentage of migrants with work permits has decreased by more than 1.8 times. As a result, only one quarter of Moscow migrants have full legal status, which roughly corresponds to the state of affairs that had existed before the 2006 reform of migration legislation which was intended to increase the lawfulness of foreign citizens' stay in Russia.



Source: Obsledovanie TsMI [The Study for Migration Studies' Survey], 2008, 2009.

Fig. 6. Levels of legal employment in Moscow, 2008 (N = 150), 2009 (N = 300), as %

It must be acknowledged that the presence of migrants in the labor market, including in time of crisis, is profitable not only for the migrants alone. Therefore the restrictive measures being introduced with regard to the labor migration of CIS citizens are creating an illusion of a significant drop in the number of labor migrants. In reality, however – given the general vagueness of socio-economic targets – the disconnection and the poorly definable configuration of labor markets, as well as the widespread informal practices, the toughening of migratory regulation which stifles the desire to improve existing legislation has already resulted in the spread of illegal migration and shadowy practices and will undoubtedly conduce to their further proliferation.

According to *Rosstat* data that are based on migrant registration at the place of residence, the level of internal labor mobility in Russia remains low. As no aggregate information on tem-

porary migration and *de-facto* long-term migration without registration at the place of residence or with a stay for a period in excess of one year is published in Russia, the dynamics of such migration cannot be assessed properly. In the crisis year 2009, several differently vectored trends could be at work in Russia, simultaneously reducing and increasing spatial mobility therein.

A drop in mobility could result in a reduction of labor supply in big cities, especially in such sectors as construction and retail trade where traditionally a lot of migrant workers are employed. With the advent of crisis, this situation contributed to 'export' of unemployment when people who had lost their jobs usually returned to their native places thus aggravating the situation in the local labor markets. At the same time, the tense situation in the labor markets of small towns, including mono-industry towns, represents a serious factor that induces people to seek employment in other towns and regions of the country.

In order to cope with this situation, the RF Government has taken a number of measures aimed at bringing down tensions in the labor market of subjects of the Russian Federation. These measures involve the provision of targeted assistance to citizens – for example, by organizing their resettlement in another locality for the purpose of filling the existing job vacancies, including those created within the framework of federal target programs and investment projects. Initially the government planned to assist the resettlement of 100 thousand persons[1]; however, at the final stages of signing resettlement agreements with the regions, this figure was reduced to 15.9 thousand persons. Resettlement assistance was actually rendered to 11 thousand persons; the corresponding allocations accounted for 70 % of the funds earmarked for resettlement purposes[2]. The failure of that government initiative was predicted by experts from the very beginning: an analysis of the vacancies (approximately 900 thousand vacancies in all Russian regions) that is posted to the much-advertised Work in Russia portal has indicated that these vacancies (as well as all the other options offered by the Federal Employment Service) have a rather low attractiveness in the eyes of employment seekers even in time of crisis. As of mid-February 2009, 6.5 % of the posted vacancies offered the minimum wage of 4,330 Rb, and another 9 % of them – wages ranging from the minimum wage to 5 thousand Rb[3]. Only 12 % of the vacancies offered wages in excess of 20 thousand Rb (most of these vacancies were situated in Moscow Capital Region and the northern regions of Russia which differ significantly from the rest of the country in terms of purchasing power parity), and only 5.3 % of the vacancies offered the provision of a dwelling (usually it was employer-provided lodging or a room at a hostel))[4]. This situation has not changed since then: as of the beginning of 2010, only 5 % of the vacancies posted to the Federal Employment Service Portal implied the provision of a specified dwelling, and 8.1 % of the vacancies offered subsistence wages.

[1] Doekhat' do raboty. [To travel to work] // SmartMoney. 18 May 2009.

[2] Monitoring realizatsii regional'nykh programm, predusmatrivaiushchikh dopolnitel'nye meropriiatiia, napravlennye na snizhenie napriazhennosti na rynke truda (ianvar' – dekabr' 2009) [Monitoring of the implementation of the regional programs envisaging additional measures designed to reduce tensions on the labor market (January - December 2009)]. M.: Rostrud [RF Federal Labor and Employment Service], 2010. P. 11. Under the sub-program, the State undertook to cover the transportation costs connected with resettlement and the cost of renting a dwelling (550 Rb per day, for three months on average) and to pay per diems for the time of travel.

[3] At the same time, the increased maximum unemployment benefit amounts to 4.9 thousand Rb.

[4] Mkrtchian N. V. Gotovy li bezrabotnye ekhat' za rabotoi [Are jobless people ready to seek work elsewhere? // Rossiiskaia migratsiia [Russian migration]. 2009. No 1.

The resettlement of 'mono-towns' (one-industry towns) is an even more questionable measure. The resettlement model plan is based on a very untypical town – Togliatti. The program of resettling the inhabitants of mono-towns in other regions of the country has been developed by the Agency for Mortgage Loan Restructuring (ARIZhK). In particular, the program envisages that part of the newly laid-off workers from Togliatti should be resettled in Tikhvin, Leningrad Oblast, where a railcar building plant has recently been launched[1]. The results of this program's implementation are yet to be seen, but it is unlikely that it will become popular – for at least one reason: these people are asked to move from a big city to a small town.

Thus, even if the migratory processes did respond to the crisis phenomena in the economy, the existing statistical instruments have made it impossible to adequately assess the changes. The measures taken by the authorities with regard to the migration sphere were predictably populist. Perhaps, the only result of those measures was a change in the ratio between the legal and latent components of temporary labor migration into Russia.

4.3. Socio-cultural Sphere

4.3.1. Development of the Educational System in 2009

Characteristics of the State of Affairs in the Field of Education

The global economic crisis which broke out in autumn 2008 has brought the educational system before the new challenges: on the one hand, the need to ensure advance of reforms in this field, and on the other, direct it to the training of new specialists needed for the post-crisis development. At the same time, different levels of educational system face new tasks in the new circumstances. Simultaneously, we should bear in mind the demographic factor, which affects all educational subsystems to the highest extent.

Preschool Upbringing and Education

Statistics on the situation in preschool education system provide information on its development solely prior to 2007 inclusive.

Prolonged decline in the number of children attending preschool educational facilities has stopped. At present, we observe an upward trend which marks a growing number of children attending preschool education facilities. (*Table 1*).

According to the Rosstat data, at the onset of 2008[2] 2,232 thousand children required places in preschool education facilities.

As registered from 2005 a growing number of pupils in preschool education system were caused by two reasons.

[1] Sokrashchennykh rabotnikov 'AvtoVAZa pereseliat iz Tol'iatti v Leningradskuiu oblast' [The dismissed workers of AvtoVAZ will be resettled from Togliatti to Leningrad Oblast] / / NEWSru.com, 28 January 2010.
[2] Latest available data.

Table 1

Preschool Education Facilities (by year end)

	1993	1995	2000	2003	2004	2005	2006	2007
Number of preschool education facilities, thousands	78.3	68.6	51.3	47.8	47.2	46.5	46.2	45.7
Number of children at preschool education facilities, thousands	6763	5584	4263	4321	4423	4530	4713	4906
Number of preschool education facilities, which have amenities for short-run stay of children	–	–	–	3241	3912	4172	4423	6355
Of which:								
Number of groups of short-run stay of children	–	–	–	4879	6150	7008	7852	8784
Number of children in groups of short-run stay, thousands	–	–	–	48.3	60.9	70.7	80.9	92.4
Number of children per 100 places in preschool education facilities, persons.	90	83	81	88	92	95	99	105
Coverage of children by preschool education facilities, % of the number of children aged one to six	57.4	54.3	55.0	57.6	57.7	57.3	58.3	59.2

Source: the Rosstat, Russia in numbers.

First, the number of birth has marked an upward trend since the beginning of 2000s (*Table 2*).

Table 2

Number of Births (minus still-born), Russian Federation, thousand.

2001	2002	2003	2004	2005	2006	2007	2008
1311.6	1397.0	1477.3	1502.5	1457.4	1479.7	1610.1	1714.0

Second, the number of preschool age children attending preschool facilities has been growing: from 55% in 2000 to 59.2% in 2007. This upward trend to a great extent was due to an economic boom, when labor demand went up and mothers were anxious to send their children to kindergartens in order to turn up to work. However, economic crisis may change the trend, because for low-income households access to preschool education facilities, first of all, depends on the charge rate and availability of benefits.

On the whole, to date attendance of 5-6 year children of the preschool education facilities remains low. This resulted in raising a question in 2004 regarding introduction of preschool education mostly for the children from low income households in order to prepare them for a comprehensive school. This measure would have allowed leveling starting conditions for pupils from different income groups, increasing the quality of instruction in basic schools. In the wake of the global economic crisis this issue has become even more acute.

Comprehensive Education

The number of pupils in comprehensive schools continued falling in 2007-2008 (*Table* 3).

Table 3

Number of Pupils and Teachers in State and Municipal Comprehensive Schools (as of the beginning of the school year, thousands)

	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Number of pupils in comprehensive schools	20493	19843	18850	17729	16561	15559	14727	14103
Of which:								
In cities and urban-type settlements	14389	13848	13159	12385	11591	10845	10271	9871
In rural areas	6104	5995	5691	5344	4970	4714	4456	4232
Of which number of pupils:								
Day time comprehensive schools	20013	19363	18372	17254	16098	15113	14291	13695
Of which:								
In cities and urban-type settlements	13998	13471	12784	12017	11232	10497	9929	9557

	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
In rural areas	6015	5892	5588	5237	4866	4616	4362	4138
Evening (shift-type) comprehensive schools, including trained by correspondence	480	480	478	475	463	446	425	408
Of which:								
In cities and urban-type settlements	391	377	375	368	359	348	331	314
In rural areas	89	103	103	107	104	98	94	94
Number of teachers	1751	1718	1701	1666	1614	1575	1517	1467

Source: the Rosstat, Russia in numbers.

Reduction in the Number of Pupils Has Led to a Fall in the Number of Schools (*Table 4*).

Table 4

Number of State and Municipal Comprehensive Schools (as of the beginning of the school year, thousands)

	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Number of comprehensive schools	68.1	68.0	66.8	65.5	64.2	62.5	60.3	57.3
Of which:								
In cities and urban-type settlements	22.7	22.8	22.6	22.4	22.2	21.8	21.4	21.0
In rural areas	45.4	45.2	44.2	43.1	42.0	40.7	38.9	36.3
Out of the total number of schools:								
Daytime comprehensive schools	66.4	66.2	65.0	63.8	62.5	60.8	58.7	55.7
Of which:								
In cities and urban-type settlements	21.3	21.3	21.2	21.1	20.9	20.4	20.1	19.7
In rural areas	45.1	44.9	43.8	42.7	41.6	40.4	38.6	36.0
Evening (shift-type) comprehensive schools	1.7	1.8	1.8	1.7	1.7	1.7	1.6	1.6
Of which:								
In cities and urban-type settlements	1.4	1.5	1.4	1.3	1.3	1.4	1.3	1.3
In rural areas	0.3	0.3	0.4	0.4	0.4	0.3	0.3	0.3

Source: the Rosstat, Russia in numbers

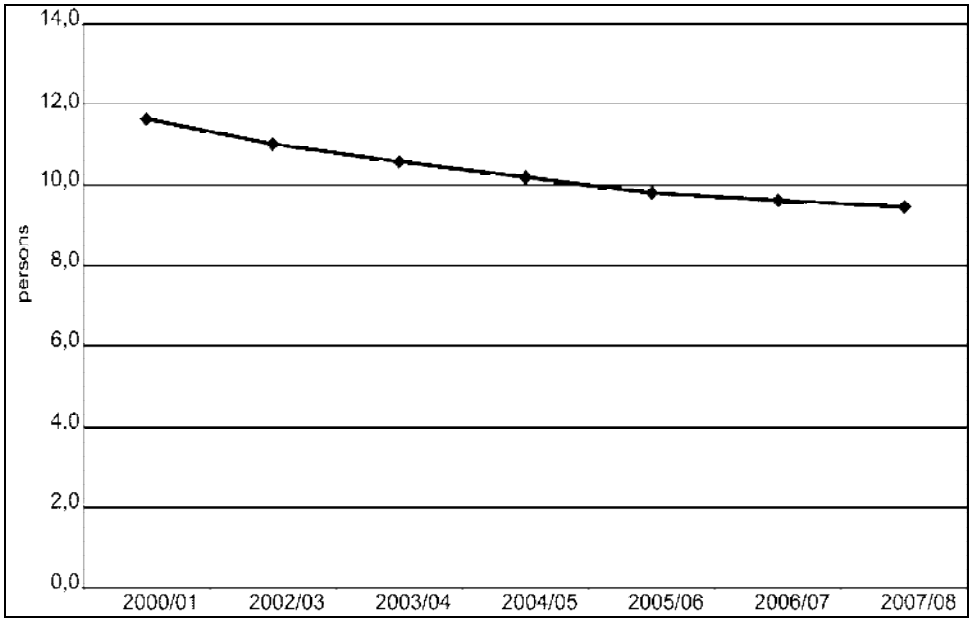
In spite of different measures aimed at restructuring school network and stopping the number of schools from falling (from 2000/01 through 2007/08 academic year this amount slumped by about 10.8 thousand), number of pupils per a teacher continues falling: by 2007/08 academic year it has already fallen to 9.5:1 (*Fig. 1)*.

Thus, the system of school education remains practically uneconomical by world standards.[1] At the same time, it should be noted that this situation to a great extent is attributed to demographic situation which was going from bat to worse all these years, and to the existing settling system, large distances and low density of roads which are essential for taking pupils to comprehensive schools.

For the period 2000-2008 the number of pupils in state and municipal comprehensive schools went down by about one third. As a result, the number of state and municipal schools significantly decreased together with the number of teachers. At the same time, it should be noted that although the number of pupils for this period went down by 31.7%, the number of state and municipal schools decreased only by 11.8%, and the number of teachers – by 16.1%. In addition to space factor which impedes a faster reduction of school network, we should bear in mind the social factor: in many Russian regions education belongs to a sector with low salaries and high employment level, thereby preventing unemployment growth. With the onset of

[1] See, for example, Education in the Countries with Transition Economies: Development Tasks. World Bank Report. Moscow, 2002.

the global economic crisis this fact has become more evident. For example, social sectors including the field of education actively exercise this function especially in single-industry cities.



Source: Calculated on the Rosstat data.

Fig. 1. Ratio Pupil: Teacher in Comprehensive Schools (number of pupils per a teacher)

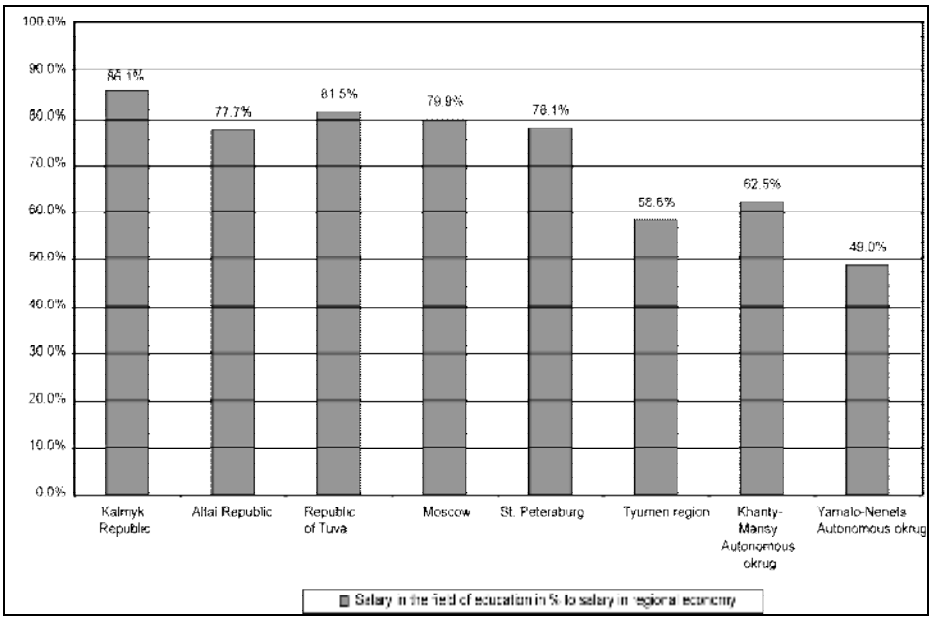
Age pattern of teaching staff remains unfavorable. It cannot but give rise to concern because, for example, 36.6% of teachers of 5-11 grades have worked in school for over 20 years. In basic schools this age group constitutes about 38.4%. Where in 1995, only 54.2% of teachers in basic schools had work record exceeding 10 years, then in 2006 – already 84.3%.[1] Thus, inflow of young teacher to schools does not develop, teaching personnel is getting older which to a large extent hampers the new pedagogical technologies expansion, as well as promotion of institutional changes in the field of general education. In principle, this alone becomes a certain deterrent in Russia's school modernization.[2] It should be noted that in highly subsidized regions the level of teachers' salaries in comparison with the average salaries and wages across the economy is often greater than in donor regions[3] (*Fig. 2*).

On the whole, teachers' salary differentiation across Russian subjects of Federation in 2007 constituted 5.3 fold. At that, it went up somewhat in comparison with 2006 when similar indicator constituted 5.0. At the same time, it should be born in mind that cited salary volume is nominal and not adjusted to a coefficient of price rise in the budgetary services across Russian regions.

[1] 2006 – last year, which has information.

[2] At the same time, there is a point of view that old teachers can teach something and the young teachers do not master teacher's profession. One thing is paramount: in any case school continues wasting its staff potential. Its staff renewal does not take place.

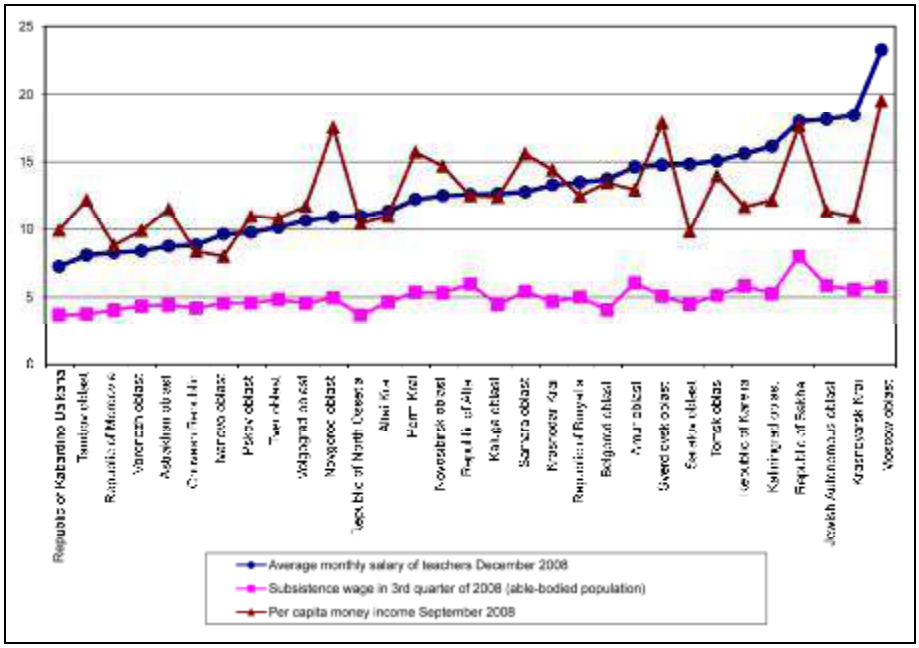
[3] PNPO has changed this situation for the better. However, the global economic crisis most likely will lead to resumption of the trend.



Source: Education in the Russian Federation. M., SU-HSE, 2007.

Fig. 2. Salary in the Field of Education in Comparison with Salary in the Economy of Some Regions in 2006, in %

A complex project of education modernization has been implemented in the regions starting with 2007. There the new system of labor remuneration has been introduced and the salaries of teachers went up significantly (*Fig. 3*).



Source: Data of IRO SU-HSE.

Fig. 3. Correlation Between the Average Monthly Salary of Teachers and the Subsistence Wage of Able-Bodied Persons and Per Capita Money Income, Thousand Rbles

At the same time, the global economic crisis has put a question mark over the achievements in this field due to the fact that the regional budgets revenues have significantly dropped which led to a reduction in budget allocations including on education in a number of subjects of the Russian Federation which has been implementing a complex project of education modernization.

According to the Rosstat data, in January-September 2009 the level of average payable monthly salary in the field of education constituted 79% of its level in processing industry (January-September 2008 – 68%).

Basic Vocational Education

Table 5

Institutions of Basic Vocational Education

	Number of institutions (as of the end of the school year)	Number of students*, thousands	Students entered*, thousands	Graduates, skilled labor*, thousands
All institutions of basic vocational education (BVE)				
2000	3893	1679	845	763
2001	3872	1649	837	759
2002	3843	1651	842	745
2003	3798	1649	823	722
2004	3686	1604	783	708
2005	3392	1509	688	703
2006	3207	1413	630	680
2007	3169	1253	586	656
Of which:				
Daytime education	2743	1169	480	548
Of which:				
Departments on the basis of main general education	2515	906	294	353
Departments on the basis of secondary (senior) general education	1909	157	124	124
Groups where young people do not get secondary (senior) general education diploma	1483	106	62	71
Evening (shift-type) and other institutions	426	84	106	108

***** In educational institutions of basic, secondary and higher vocational education which implement a program of basic vocational education

Source: the Rosstat.

In 2000–2007 the number of students in educational institutions of basic vocational education (BVE) went down (*Table* 6).

Table 6

Number of Students in Educational Institutions of Basic Vocational Education

	2000	2002	2003	2004	2005	2006	2007
Number of student in basic vocational education system*, thousands	1679	1651	1649	1604	1509	1413	1256
Number of student in basic vocational education system * per 10,000 persons	115	114	114	112	106	99	89

* Since 2005 including students of educational institutions of secondary and higher vocational education which implement programs of basic vocational education.

Source: the Rosstat.

The basic vocational education has been recently viewed as one of the most problem-ridden fields of the national education system. Meanwhile, prior to the onset of the global economic crisis, demand for skilled labor grew consistently despite the fact that in the employment structure the share of skilled labor went up. Correspondingly the share of jobless BVE graduates of the daytime form of education in the overall number of graduates decreased. At the same time, against the background of the falling share of unemployed BVE graduates, on the whole, in the Russian Federation even prior to the onset of the crisis, this indicator marker an upward trend in a number of RF Subjects. First of all, it was linked with the difficult economic situation in such region as: the Republic of Dagestan, Kabardino-Balkaria, the Kalmyk Republic, North Ossetia, the Tuva Republic, and the Altai Republic.

Prior to the onset of the global economic crisis, large businesses gradually began to incorporate BVE educational institutions into their structures, invest large sums of money into skilled labor training. However, this type of policy could not be implemented by medium- and small-size business, which did not dispose of sufficient resources allocated for that purpose. At the same time, in the pre-crisis period the share of education in the consolidated budget allocated on the BVE system development was falling.

Secondary Vocational Education

In 2008 according to the Rosstat data, the number of independent, state and municipal institutions of secondary vocational education was going down (Table 7). At the same time, the number of branches of the institutions of secondary vocational education went up by 25 points (by 5.9%) and constituted 449.

Table 7

Institutions of Secondary Vocational Education
(as of the beginning of the school year)

Years	Number of educational institutions	Number of students – total, thousands	Of which attended departments				Number of students per 10,000
			Daytime	Daytime--by correspondence (evening)	By correspondence	External studies	
All Institutions of Secondary Vocational Education							
2000/01	2703	2360.8	1721.5	93.4	540.1	5.8	162
2001/02	2684	2470.2	1788.6	93.4	581.7	6.5	169
2002/03	2816	2585.5	1855.1	95.7	625.9	8.8	179
2003/04	2809	2612.1	1903.0	86.9	614.0	8.2	182
2004/05	2805	2599.6	1933.3	81.1	575.8	9.4	181
2005/06	2905	2590.7	1960.3	70.7	549.4	10.3	181
2006/07	2847	2514.0	1911.0	64.4	527.3	11.4	177
2007/08	2799	2408.2	1822.7	59.4	511.4	14.7	170
State and Municipal Institutions of Secondary Vocational Education							
2000/01	2589	2308.6	1697.6	86.9	519.2	4.9	158
2001/02	2595	2409.8	1757.1	88.2	559.1	5.4	165
2002/03	2626	2488.5	1807.5	84.6	589.4	7.0	172
2003/04	2627	2501.6	1842.5	81.4	570.7	7.0	174
2004/05	2637	2503.6	1878.4	75.8	541.4	8.0	174
2005/06	2688	2473.0	1887.5	66.8	510.3	8.4	173
2006/07	2631	2388.9	1836.0	60.4	482.8	9.7	168
2007/08	2566	2288.5	1749.2	55.1	472.4	11.8	161
Non-State Institutions of Secondary Vocational Education							
2000/01	114	52.2	23.9	6.5	20.9	0.9	4
2001/02	89	60.4	31.5	5.2	22.6	1.1	4
2002/03	190	97.0	47.6	11.1	36.5	1.8	7

Years	Number of educational institutions	Number of students – total, thousands	Of which attended departments				Number of students per 10,000
			Daytime	Daytime--by correspondence (evening)	By correspondence	External studies	
2003/04	182	110.5	60.5	5.5	43.3	1.2	8
2004/05	168	96.0	54.9	5.3	34.4	1.4	7
2005/06	217	117.7	72.8	3.9	39.1	1.9	8
2006/07	216	125.2	75.0	4.0	44.5	1.7	9
2007/08	233	119.7	73.5	4.3	39.0	2.9	8

Source: the Rosstat.

In 2008 admission in the state and municipal institutions of secondary vocational education (SVE) decreased by 60.3 thousands or by 8.3% in comparison with 2007. As many as 190.4 thousand first year students admitted in vocational technical schools under the condition of complete compensation for tuition costs or 28.4% of the total number of admitted (in 2007 there were 238.1 thousand or 32.6%, in 2006ther were 260.8 thousand or 34.5%)

It should be noted that at present the secondary school (11 years) leavers have found it rather difficult to make their choice in favor of BE or SVE institutions regardless of the region they reside in (*Table 8*).

Table 8

Educational Preferences of Senior Students and their Parents Depending on the Region of Residence

Region of residence	Educational priorities (number of respondents in %)						
	Luck	General education	BVE	SPE	PSVE	Scientific degree	Total
Moscow	6,8	0,0	0,4	10,0	80,0	2,8	100
Nizhniy Novgorod	16,0	0,8	1,2	10,4	70,8	0,8	100
Vologda	12,8	0,5	0,5	11,2	72,9	2,1	100
Ivanovo	3,2	0,8	0,4	8,0	86,7	0,8	100
Overall on sampling	9,5	0,5	0,6	9,8	78,0	1,6	100

Source: ИISEPN research (author – E.M. Avramova).

As can be seen from the Table, for those who finish 11 years of school education and for their relatives the choice in favor of BVE is around 1%, for educational institutions of SVE – around 10%. The fact that in the city of Ivanovo which is the center of highly subsidized region more school leavers choose higher education as a priority then even the Moscow school leavers draws much attention. One may assume that it is connected with the families' aspiration to provide their children with a possibility to get out of a negative economic situation by means of obtaining higher education.

Right up to 2009 the number of unemployed graduates of the daytime form of SVE was decreasing in Russia. At the same time, we can name okrugs where thee was an upward trend:

Sothern, Urals and Far Eastern okrugs. Simultaneously, sociological surveys demonstrated that in 2005-2008 secondary vocational education was increasingly growing into a "transit" level of vocational training: the vast majority of its graduates aspired to enter the higher educational institutions. For example, out of 76% of graduates from SVE institutions who would like to continue education, with 91% of them, or nearly 70% of the overall number of school leavers were opting for university degree.

Higher Vocational Education

In 2000/01–2007/08 academic years the system of higher vocational education was growing rapidly both in number of institutions (state and non-state) and in the number of students (*Table* 9)

Table 9

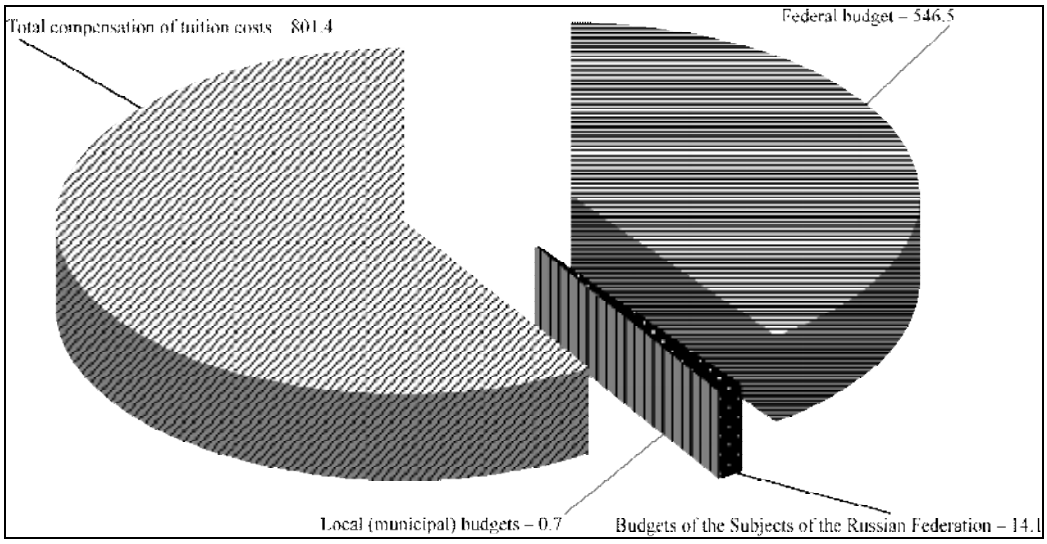
Higher Educational Institutions
(as of the beginning of the school year)

Years	Number of institutions	Number of students – total, thousands	Of which studied at departments				Number of students per 10,000 persons
			daytime	Daytime-by correspondence (evening)	By correspondence	External studies	
	All Higher Educational Institutions						
2000/01	965	4741.4	2625.2	302.2	1761.8	52.2	324
2002/03	1039	5947.5	3104.0	346.0	2399.9	97.6	410
2003/04	1044	6455.7	3276.6	351.3	2703.7	124.1	448
2004/05	1071	6884.2	3433.5	361.8	2942.5	146.4	480
2005/06	1068	7064.6	3508.0	371.2	3032.0	153.4	495
2006/07	1090	7309.8	3582.1	372.3	3195.9	159.6	514
2007/08	1108	7461.3	3571.	352.9	3367.9	169.2	525
	State and Municipal Higher Educational Institutions						
2000/01	607	4270.8	2441.9	258.6	1518.8	51.5	292
2002/03	655	5228.7	2861.6	298.8	1973.4	94.9	361
2003/04	652	5596.2	3009.9	301.8	2164.9	119.6	388
2004/05	662	5860.1	3143.6	300.3	2279.4	136.8	408
2005/06	655	5985.3	3195.2	299.9	2348.3	141.9	419
2006/07	660	6133.1	3251.2	291.3	2443.2	147.4	431
2007/08	658	6208.4	3240.7	280.4	2532.4	154.8	437
	Non-state Higher Educational Institutions						
2000/01	358	470.6	183.3	43.6	243.0	0.7	32
2002/03	384	718.8	242.4	47.2	426.5	2.7	50
2003/04	392	859.5	266.7	49.5	538.8	4.5	60
2004/05	409	1024.1	289.9	61.5	663.1	9.6	71
2005/06	413	1079.3	312.8	71.3	683.7	11.5	76
2006/07	430	1176.8	330.9	81.0	752.7	12.2	83
2007/08	450	1252.9	330.6	72.4	835.5	14.4	88

Source: the Rosstat.

In 2008 enrollment in the state and municipal higher educational institutions decreased by 21.3 thousand persons (by 1.5%) mainly at the expense of students who entered the daytime form of education. The number of entrants at the correspondence departments went up by 29.8 thousand persons or by 5.1%.

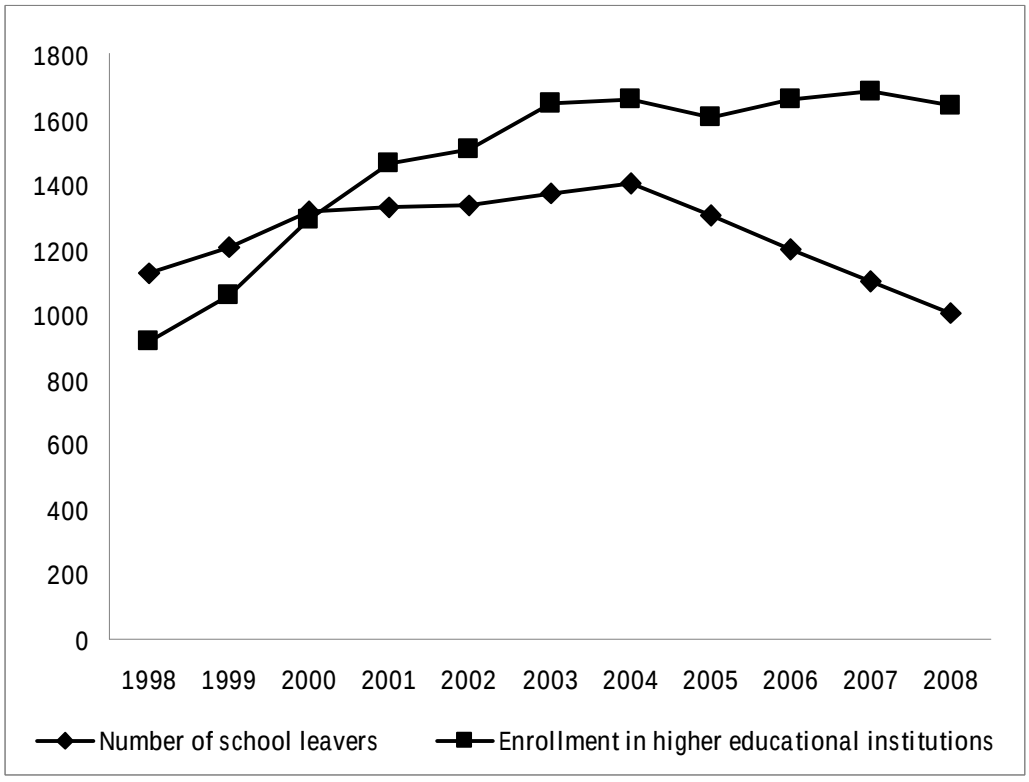
Distribution of 2008 enrollment in budgetary and paid places is presented in (*Fig. 4*).



Source: the Rosstat.

Fig. 4. 2008 Enrollment in State and Municipal Educational Institutions of Secondary Vocational Education at Budgetary Places with Complete compensation of Costs, thousand

It should be noted that starting with 2000 enrollment in higher educational institutions consistently exceeded the number of secondary school leavers (*Fig. 5*).



Source: the Rosstat.

Fig. 5. Enrollment in Higher Educational Institutions and the Number of Secondary School Leavers, thousand.

By the number of students per 10,000 of population which constitutes 525 individuals, Russia has taken second place in the world behind the USA. However, if we take into consideration the students of secondary vocational education, in that case Russia will be an absolute world leader by having 695 students per 10,000 of population.

In 2006/2007 academic year the share of students studied on a paid basis in the overall number of students in state and non-government higher educational institutions reached 66%. Thus, at present over 2/3 of the students of the Russian Federation study on a paid basis.

Recent data has exposed a one more important change taking place regarding admission in higher educational institutions: enrollment in daytime form of education is plummeting (*Table 10*).

Table 10

Dynamics of Enrollment in Daytime Form of Education in Higher Educational Institutions in 2000–2007

	Enrollment, thousand	
	Total	**Of which daytime education**
2000/01	1 292.5	687.4
2001/02	1 461.6	745.8
2002/03	1 503.9	774.7
2003/04	1 643.4	803.8
2004/05	1 659.1	841.3
2005/06	1 640.48	830.65
2006/07	1657.6	826.3
2007/08	1681.6	789.5

Source: the Federal Agency of Education

As it follows from *Table 10*, under constant growth of general enrollment numbers, enrollment in the daytime form of education was increasing only till 2004/05 academic year, and then started to fall. At the same time, if in 2005/06 academic year this reduction constituted only 1.3% in contrast from a year before, then in 2007/08 academic year it already constituted 4.5%. Thus, this trend tends to accelerate. Students opt for entering in the correspondence form of education.

It should be noted that this trend is mostly pronounced in the state and municipal higher educational institutions (*Table 11*).

Table 11

Dynamics of Enrollment in the Daytime Form of Education in State and Non-state Higher Educational Institutions in 2000–2007

	Enrollment, thousand			
	Overall		**Of which daytime form of education**	
	In state	**In non-state**	**In state**	**In non-state**
2000/01	1 140.3	152.2	621.9	65.6
2001/02	1 263.4	198.2	669.3	76.4
2002/03	1 299.9	204.0	698.3	76.4
2003/04	1 411.7	231.7	724.8	79.0
2004/05	1 384.5	274.6	758.2	83.1
2005/06	1 372.46	268.02	746.38	84.27
2006/07	1376.7	208.9	740.4	85.9
2007/08	1384.0	297.6	715.2	83.3

Source: The Federal Agency of Education.

Increased enrollment in correspondence form of education is connected both with the shortage of educational amenities and teaching personnel (their involvement is not so intense in case of correspondence form of education) and the growing cost of tuition which was recently increasing due to the growth of the budget expenses per a government subsidized student (at the correspondence form of education budgetary expenses are considerably lower; that is why, the cost of education for paid students is also significantly lower which allows students from low-income households to get a higher education, at the same time, obtaining not only a state diploma but also a diploma from a prestigious university).

General trend for enrollment in the full-time form of education in the state higher educational institutions reflects a general trend of enrollment in full-time form of education (*Table 10*). Prior to 2004/05 academic year there was growth of enrollment in the full-time form of education. Then the trend made a U-turn and there was a steeples slump. In 2007/2008 academic year decrease in the enrollment in the full-time form of education constituted 3.4% in comparison with the previous year. In the non-state higher educational institutions enrollment in the full-time form of education comes to far less than half: in 2006/07 academic year it fell down to 28.0% (in state higher educational institutions, on the contrary, enrollment in the full-time form of education during the period under review was over fifty percent). This trend is explained by the fact that non-state higher educational institutions have recently been focused to the implementation of inexpensive higher vocational education programs on so called “soft” specialties. Additional gains are achieved due to additional enrollment in the extra-mural form of education. Moreover, those who pay for their own education study in the non-state higher educational institutions. In state higher educational institutions the full-time form of education dominates due to public contract. Increase in budget expenditure on higher education results in the fact that full-time budgetary students become more profitable for the higher educational institutions.

Along with BVE and SVE, the higher vocational education right up to 2009 posted decrease in the share of unemployed graduates from the full-time form of education in the state and municipal higher educational institutions. However, in two Federal Okrugs, Sothern and Far-Eastern, the trend was opposite even prior to the onset of the global crisis. In the Far East, one should specially single out Jewish autonomous oblast and Sakhalin oblast where in 2008 this indicator posted correspondingly 27.9% and 28%.

In North Caucasus Federal Okrug the following Subjects North-Ossetia – Alania, the Chechen Republic and the Republic of Karachaevo-Cherkessia (however, present indicator is several times lower), as well as the Stavropol Krai where in 2008 over 20% of the graduates of the full-time form of education in state and municipal higher educational institutions were unemployed.

In the last few years a lot has been said about the need to increase the quality of the higher education. High demand for higher education graduates demonstrated by the labor market (on obtained specialization) is considered as one of the most important indicators of improvement of the situation. At the same time, growth of extra-mural education testifies to the fact that notwithstanding the need to improve the quality of higher education the real developments in this field are meanwhile unfolding in the opposite direction.

Financing of Education

In 2000–2009, both the public and private sources have been increasing their spending on education. From 2000 through 2003 the share of budgetary expenses on education in GDP significantly increased and then it started stabilizing under the growth of absolute volumes (*Table 12*). Private expenses of education are reflected in Russian statistics as the ”Volume of paid services for education” taking into account hidden and informal activities. Dynamics of paid services volume in the educational system post sustainable growth, in which connection its rates are overtaking the rates of growth of budgetary expenses on education (*Table 13*).

Table 12

Budgetary Allocations on Education in 2000–2009

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Consolidated budget on education, bn. Rb.	214.8	277.8	408.0	475.6	593.2	80.8	1033.3	1342.3	1664.2	1 691.9
Federal budget	38.1	54.5	81.7	99.8	121.6	162.1	201.6	278.5	354.9	413.1
Territorial budgets	176.7	223.3	326.3	375.8	471.6	628.6	831.7	1063.8	1309.3	1278.8
Share of expenditure on education in consolidated budget, in % of GDP	2.9	3.1	3.8	3.6	3.5	3.7	3.9	4.1	4.1	4.0
Federal budget	0.5	0.6	0.8	0.8	0.7	0.8	0.8	0.8	0.8	1.0
Territorial budgets	2.4	2.5	3.0	2.8	2.8	2.9	3.1	3.3	3.3	3.0
Share of expenditure on education in the RF consolidated budget, in %	9.7	9.7	10.2	12.0	12.7	11.8	12.3	11.9	11.8	10.5
Share of expenditure on education of the Federal budget in the RF consolidated budget expenditure, in %	1.7	1.9	2.0	2.5	2,6	2.4	2.4	2.5	2.5	2.6
Share of expenditure on education of territorial budgets in the RF consolidated budget expenditure, in %	8.0	7.8	8.2	9.5	10.1	9.4	9.9	9.4	9.3	7.9

Source: the Rosstat, the Federal treasury.

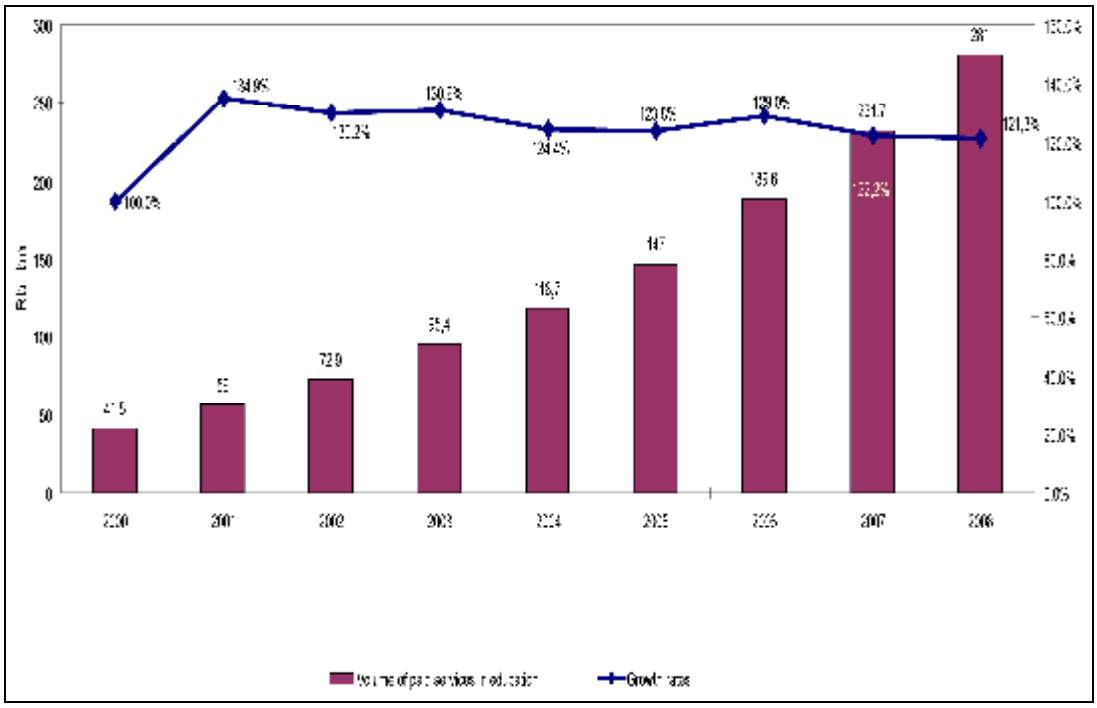
Table 13

Volume of Paid Services in the Field of Education in 2000–2008

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Volume of paid services in the system of education, bl Rb.	41.5	56	72.9	95.4	118.7	147	189.6	231.7	281.2
In % of GDP	0.6	0.6	0.7	0.7	0.7	0.7	0.7	0.7	0.7

Source: the Rosstat.

Dynamics of paid services in the field of education is represented in *Fig.* 6.



Source: the Rosstat.

Fig. 6. Dynamics of Paid Services in the Field of Education in 2000–2008

In 2009 was a turning point in this trend. As can be seen from *Table 12*, the share of education in the consolidated budget decreased from 4.1% to 4.0% of GDP, at the same time, the share of education in the federal budget went up from 0.8 to 1.0% of GDP, and the share of education in territorial budgets (consolidated budgets of the subjects of the Russian Federation) on the contrary, went down from 3.3% to 3.0%.

The share of expenditure on education in the territorial budgets in the expenditure of the RF consolidated budget has marked a return to the 2001 level, and the aggregate share of expenditure on education in expenditure of the RF consolidated budget has marked a return to the 2002 level.

Breakdown of budgetary expenses according to the levels of education in 2004–2009 is reflected in *Table 14.*

Table 14

Volume and Structure of Allocations of the Consolidated Budget According to the Levels of Education 2004–2009

	2004	2005	2006	2007	2008	2009 (estimate)
Consolidated budget expenditure on education, Rb. bn	593.4	801.8	1036.4	1342.3	1664.2	1691.9
Preschool education (PE), Rb. bn	91.7	113	145.3	189.7	254.5	260.6
Share of expenditure on PE in the consolidated budget, in %	15.5	14.1	14.0	14.1	15.3	15.4
General education (GE), Rb. bn	298.1	356	475.9	599	737.1	746.1
Share of expenditure on GE in the consolidated budget, in %	50.2	44.4	45.9	44.6	44.3	44.1
Basic vocational education (BVE), Rb. bn	35.6	39.4	47.4	57.6	65.5	64.3

	2004	2005	2006	2007	2008	2009 (estimate)
Share of expenditure on BVE in the consolidated budget, in %	6.0	4.9	4.6	4.3	3.9	3.8
Secondary vocational education (SVE), bn Rb.	30.5	43.3	55.3	70.4	93.9	93.1
Share of expenditure on education in the consolidated budget, in %	5.1	5.4	5.3	5.2	5.6	5.5
Higher and post-higher education, bn Rb.	76.9	125.9	169.9	240.2	294.6	328.6
Share of expenditure on higher vocational education in the consolidated budget, in %	13.0	15.7	16.4	17.9	17.7	19.4

Source: the Federal treasury.

As can be seen from *Table 14,* in 2004-2009 the share on expenditures on preschool, general education and secondary vocational education were rather stable in the consolidated budget on education. The share of expenditure on basic vocational education was decreasing during the entire period in spite of declared aim at developing basic vocational education system. Particularly sharply this share went down following the transfer of the basic educational institutions under the jurisdiction of the Subjects of the Russian Federation (in 2005 – 4.9% in comparison with 6% in 2004). In 2009 the share of budgetary expenditures on basic vocational education in the consolidated budget expenditure continued going down coming to 3.8%.

Regarding the share of expenditure on higher education then it grew noticeably during 2004-2007 from 13.0 to 17.9%. In 2008 it somewhat went down to 17.7%, and in 2009 according to preliminary estimate surged upwards to 19.4%.

On the whole, the regional and local budgets are financing general education. Dynamics of these expenses, as well as expenses per a pupil in presented in *Table 15*.

Table 15

Dynamics of Budgetary Expenditure on General Education, Including per a Pupil, in 2000–2007

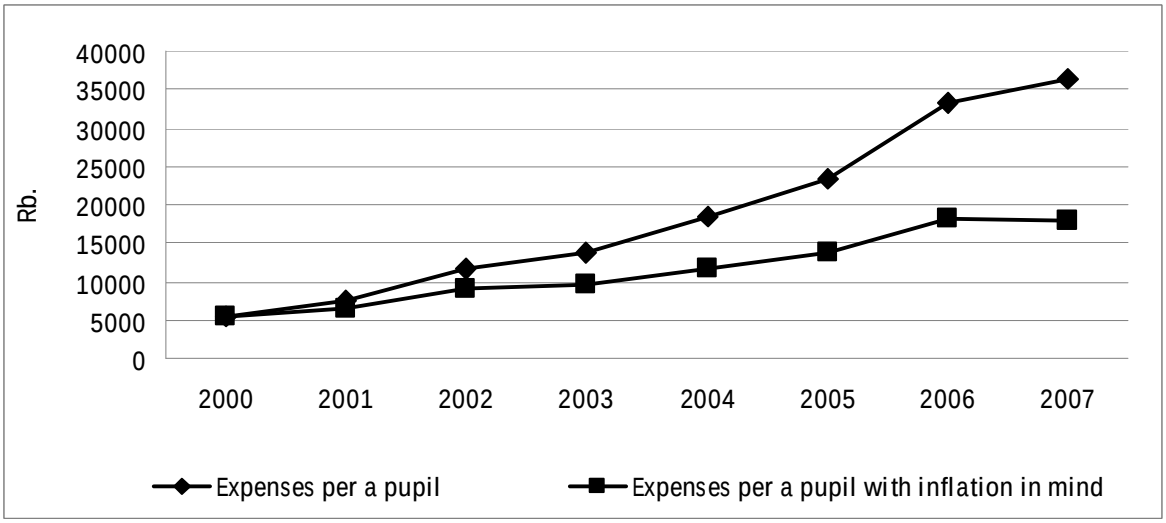
	2000	2001	2002	2003	2004	2005	2006	2007
Expenditure, mln Rb.	107931	143972.8	215261.2	236600	298100	356084.7	475900	398750.6
Number of pupils, thousand.	20073.8	19429.1	18439.7	17322.9	16168	15185.1	14362,3	13670.1
Expenses per a pupil, Rb.	5377	7410	11673	13658	18438	23450	33135	40851.98
Growth of expenses per a pupil in relation to the previous year, in %		37.8	57.5	17	35	27.2	41.3	23.3
Inflation level, in %		18.6	15.1	12	11.7	10.9	9	11.9

Source: Ministry of Education and Science, the Rosstat.

Taking into account the inflation, dynamics of budgetary expenditure per a pupil in the system of higher education is presented in *Fig.* 7.

Thus, real growth of budgetary expenditure per a pupil in the system of general education was practically half of the nominal one.

In 2008 expenditure of the federal budget on education went up by 20.9% in comparison with 2007. At the same time, expenditure on the higher vocational education constituted in 2008 263.2 bn Rb., thus increasing in comparison with 2007 by 22.9%.



Source: Russian Ministry of education and science

Fig. 7. Dynamics of Nominal and Real Budgetary Expenditure per a Pupil in the System of General Education in 2000–2007

Inasmuch as the budget quota in 2006-2008 grew slower than budgetary expenses on higher education, this resulted in the fact that budgetary expenses have grown significantly per a budget student in the state higher educational institutions (*Table 16*).

Table 16

Average Budgetary Expenditure per a Budget Student in Higher Education in 2004–2008

	2004	2005	2006	2007	2008
Budgetary expenses per a student in higher education, thousand Rb.	25.6	41.9	56.8	81.1	100.2
Rate of growth, in %		63.7	35.6	42.8	23.5

Source: Russian Ministry of Finance, the Rosstat, author's calculation.

At the remaining levels of the educational system budgetary expenses per a student in 2004-2008 has also increased appreciably (*Table 17*).

Table 17

Dynamics of Average Budgetary Expenses per a Pupil According to Levels of Educational System (without higher vocational education) in 2004–2008

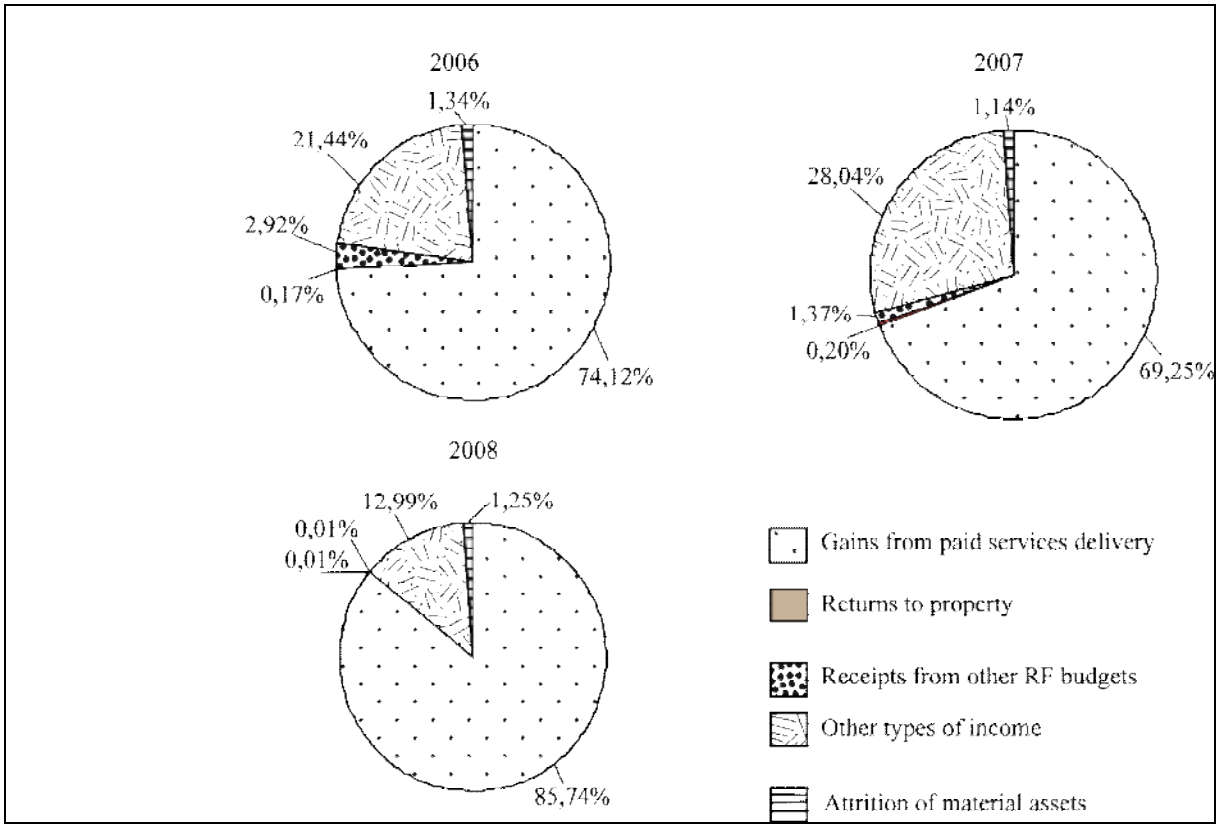
	2004	2005	2006	2007	2008
Budgetary expenses per a pupil in preschool institution, thousands Rb.	20.8	25.1	30.9	39.5	52.8
Growth rates of budgetary expenses, in %		20.5	23.1	27.8	33.6
Budgetary expenses per a pupil in general education school, thousands Rb.	18.4	23.4	33.1	43.7	55.0
Growth rates of budgetary expenses, in %		27.2	41.3	31.9	25.8
Budgetary expenses per a pupil in PVE institutions, thousands Rb.	22.3	26.3	33.9	44.3	54.6
Growth rates of budgetary expenses, in %		18.1	28.9	30.9	23.2
Budgetary expenses per a pupil in SVE institutions	30.3	42.2	53.1	66.8	87.7
Growth rates of budgetary expenses, in %		39.3	25.8	25.8	31.3

Source: the RF Ministry of Finance, the Rosstat, author's calculation.

As can be readily appreciated from *Table 16* and *17,* budgetary expenses per a pupil for the last 5 years were skyrocketing by more than 20% annually. The highest growth rates of budgetary expenses per a pupil in state higher educational institutions were recorded in 2005 when they went up by 63.7%.

All recent years the structure of extrabudgetary expenditure on education remains unchanged: 25% of extrabudgetary funds are allocated on preschool, general and basic vocational education, another 25% are allocated in secondary vocational training and 50% - on higher.

In 2006-2008 the structure of extrabudgetary expenses of higher educational institutions were subjected to major changes (*Fig. 8*).



Source: IRO SU-HSE data.

Fig. 8. Structure of Extrabudgetary Expenses on Higher Educational Institutions, under the Russian Agency of Education, in 2006–2008.

In 2006-2008 proceeds from students' tuition fees represented main source for the extrabudgetary revenues of the higher educational institutions of the Russian Agency of Education. At the same time, in 2007 in comparison with 2006 other revenues of higher educational institution also went up (from 21.44 to 28.04%), where proceeds from R&D represented the lion's share. In 2008, on the contrary, this share went down sharply (to 13%), and the share of proceeds from paid services boomed. 2008 changes were a reaction to the onset of the global crisis when higher educational institutions got fewer orders for R&D coming from private (non-state) sector. Thus, public-private partnership in the sphere of academic research went down in volume.

By and large, this fact demonstrates certain economic instability of higher educational institutions, which are more geared to research and development in comparison with higher educational institutions which were geared to teaching paid students.

Institutional Changes in the System of Higher Education

In 2009 out of all institutional reforms which were recently taking place in the system of education, major attention was attracter to the standard state examination.

Standard State Examination

On February 12, 2007 the President of the Russian Federation signed a Federal aw "On the Introduction in the Law of the Russian Federation 'On Education' and the Federal Law 'On Higher and Postgraduate Vocational Education' with Regard to Holding a Standard State Examination." According to this Law since 2009 standard state examination (SSE) has been introduced in a regular mode and has become main form for education certification of general school leavers which will serve as a basis for subsequent enrollment into higher educational institutions. Higher educational institution will accept both school leavers with high SSE grades and champions of all-Russia and international competitions.

On September 5, 2008 the Russian Ministry of Education and Sciences issued an order #256 which approved the list of specialties subject to additional entry exams of creative and/or professional nature at the enrollment to the state and municipal institution of higher vocational education for bachelor course and occupational program.

Where the SSE of the olympiads' results on a par with the SSE's results is substantiated by unconventiality of a pat of entrants (correspondingly they are not to be subjected to standard approaches and procedures), then the introduction of additional exams and tests is substantiated by a higher level of a higher educational institution, by particular properties of its curricula.

It appears, that equating the results obtained at a strictly particular olympiads to the results of SSE is rather acceptable. At this point, it is only necessary stipulate the status of such olympiads. For instance, they may be Russia-wide or international olympiads with independent judging. However, they may not be different regional or republican olympiads where the level and independence of judges are difficult to verify. Introduction of additional tests and exams by a number of higher educational institutions (except of creative and professional nature), from our point of view, may seriously discredit the idea of SSE in the eyes of the population. First, it will be impossible to enter those higher educational institutions by simply sending the documents, entrant's personal presence will be required which will increase the costs for entering such high-status educational institutions and will make that unattainable for the children from low income households. Second, emergence of additional barrier may breed corruption, to eradicate which the SSE was designed. By no means unimportant is the fact that corruption may breed in the most prestigious higher educational institutions, which, undoubtedly, yet again will disappoint people's expectations. As to the SSE, its results for this part of higher educational institutions will be highly devalued. It seems that, in principle, it may undermine trust to the (and to the SSE) of school leavers and their families.

In 2008 all subjects of the Russian Federation were already subject to the SSE. However, by far all the higher educational institutions where sticking to its results at the enrollment. Part

of higher educational institutions was taking into consideration SSE marks, but the marks got at their entrance exams were paramount.

2009 was the first year when the SSE was held in standard mode and enrollment into all higher educational institutions was exercised according to the USE results (at the same time, 24 higher educational institutions were allowed to hold additional tests in major subjects).

The 2009 standard state examination results are represented in *Table 18*.

Table 18

The 2009 SSE Results in General Subjects

Subject	Number of pupils taking SSE	Percent of those who took SSE and got test score		Of which, percent of the current year school taking the SSE and getting test score		Of which, percent of past years school leavers taking the SSE and getting test score		Average test score
		Above minimum number of points	Below minimum number of points	Above minimum number of points	Below minimum number of points	Above minimum number of points	Below minimum number of points	
The Russian language	1030236	96.99	3.01	97.24	2.76	94.35	5.65	56.88
Maths	976486	96.27	3.73	96.96	3.04	85.18	14.82	43.58
Physics	239037	93.05	6.95	93.55	6.45	88.41	11.59	47.88
Chemistry	84854	88.24	11.76	89.61	10.39	78.72	21.28	52.68
Informatics and ICT	74402	87.08	12.92	87.94	12.06	76.47	23.53	55.43
Biology	183792	91.01	8.99	91.25	8.75	89.29	10.71	51.32
History	208099	90.51	9.49	90.83	9.17	87.89	12.11	47.30
Geography	37495	89.06	10.94	89.20	10.80	86.96	13.04	49.09
The English language	83778	93.56	6.44	94.30	5.70	86.68	13.32	57.79
The German language	5371	88.61	11.39	89.76	10.24	79.57	20.43	43.11
The French language	2399	97.54	2.46	97.78	2.22	94.87	5.13	58.87
Social studies	484377	94.33	5.67	94.52	5.48	92.15	7.85	56.33
The Spanish language	198	100.00		100.00		100.00		73.90
Literature	63976	91.61	8.39	92.51	7.49	87.60	12.40	50.36

Source: the Russian Federal Service of Supervision in the Sphere of Education and Science.

Due to the standard mode of operation of the standard state examination the following procedure for issuing a certificate of secondary general education has been determined. In the event a school leaver does not pass one of the two compulsory standard state examinations, in other words, has received score below the set out minimum, he/she may resit the examination once. Where he/she has not managed to score a required minimum simultaneously in two compulsory examinations (in the Russian language and Maths), then the school leaver may not resit the examinations and may attempt to pass these subjects only the next year. In this event the leaver does not receive a SSE certificate and instead a secondary school diploma he/she will get a reference of school attendance.

In the event a school leaver when taking any examination of his/her choice (not the Russian language no Maths) does not receive a mark below the minimum number of points, then he/she may resit this SSE only the next year.

Where a school leaver on two compulsory examinations scores the number of points above the set out minimum threshold and in the subject of his/her choice – below the set out minimum, then he/she all the same will receive a secondary school diploma.

Thus, procedure for passing the SSE implicitly determines that in order to obtain a secondary school diploma from a Russian secondary school one has to pass two compulsory exams: in the Russian language and Maths.[1] For mastering other subjects the school actually may not be held responsible. Moreover, procedure for passing the SSE does not specify where and how school leavers who have not paused the Russian language and Maths can improve their knowledge which they failed due to various reasons to obtain. At that, it is not clear how it will be determined where it was due to poor efforts of a pupil or teachers. It also remains unclear the situation with the choice subjects, it is not determined where and how a school leaver can improve his/her knowledge in these subjects in order to able to pass them. Meanwhile, on July 24, 2007 a Law "On Introduction of Amendments into Separate Legislative Acts of the Russian Federation Due to the Introduction of Compulsory General Education" which holds the state responsible for delivery of educational services. Transfer of this task to pupils and their families jeopardizes first of all pupils from low income households who can not afford to get additional knowledge to prepare for the SSE on a paid basis. Correspondingly, these young people do not have roadmap for their subsequent education carrier. To be more precise, secondary school diploma is required to enroll in a secondary vocational education institution; those who have not paused compulsory subjects may consider solely BVE institutions for their subsequent educational carrier. Those who have received secondary school diploma but had not scored required number of points in the choice subjects, most likely, will enroll in SVE institutions.

To a considerable extent, many uncertainties resulting from the introduction of the SSE led to the fact that years 2008 and 2009 can be called of the Standard state examination. Efforts against the USE were enhanced in spring-summer of 2008. Publication of 2008 SSE results to a large extent contributed to this. In 2008 23.5% of pupils failed to pass Maths and 11.2% - the Russian language. The worst results in choice subjects were posted in literature – nearly 25.5% of pupils got low grade.[2] This signified that nearly one third of school leavers would not have received a secondary school diploma and would not have been able to enter a higher education institution had it not been for the rule effective in 2008 "plus one point" according to which a higher mark in general subjects is entered into a secondary school diploma where the difference the difference between annual mark and the SSE mark amounts to one point. Taking into account the fact that getting higher education in Russia has become a social norm, such result has shocked the society not because the quality of school education has done down but due to the fact that entering a higher educational institution has again become an unattainable dream for many families. Standard examination instead of widening excess to higher education as it was always underlined during the SSE test period, in a single stroke has tuned according to public opinion into a barrier between school and higher educational institution.

This fact, from our point of view, has become a major reason for the onset of a fierce fight against the SSE. Remaining reasons - insufficiently qualified preparation of control and measuring materials, corruption, etc. – would not have aroused support of parents and pedagogical community in the fight against the SSE. A lawsuit has been filed against the SSE to the Supreme Court. Signatures were collected in support of calling off the SSE (in the Kemerovo oblast, for example, more that 40 thousand signatures have been collected), a draft law has

[1] Procedure does not specify in what way issue of a secondary school diploma and the SSE score is connected with the results showed during the course of secondary education.
[2] Official data of the Russian Federal Service of Supervision in the Sphere of Education and Science.

been prepared which envisaged strictly voluntary character of the SSE for the school leavers as well as acceptance by higher educational institution of its results. In the wake of the global economic crisis opposition to the SSE was careful on the part of the government bodies in charge of education management. They became aware of the fact that in the event when 25-30% of school leavers were unable to pass the SSE, there would be a threat of mass youth unemployment, criminalization of young people, increase in the number of drag addicts, etc. In the wake of the crisis shortfall of significant number of students (up to 200 thousand persons) would have led higher educational institutions to negative economic and social results, taking into consideration decrease in extrabudgetary revenues and a reduction in teaching staff.

At the same time, the SSE remains a sole symbol of educational reform in Russia. (In addition to the Standard state examination to key reforms in the sphere of education one may attribute introduction of per capita financing in the system of general education and the implementation of the new wage system. However, implementation of these measures has not been completed yet in the wake of the reduction of budgetary expenditure is loosing its meaning, first of all it is true of the stimulating role of the salary).

In 2009 the SSE results may be considered as a significant, however, not definite, defeat of the standard state examination. Only 2.76 and 3.04% of low grades in the Russian language and Maths were posted by the school leavers in 2009. This fact testifies not to the improved situation in general education but to a sharp decline in requirements to the examinee, especially if we compare this results with dynamics of those who got low grades in USE (according to traditional five-grade scale) on these subjects within last four years (*Table 19*).

Table 19

The Share of School Leavers Who Got in the SSE Compulsory Subjects a Low Grade According to Five-grade Scale in 2006–2009, in %

Subject	Number of those who got low grade (according to five-grade scale)			
	2006	2007	2008	2009
The Russian language	7.91	8.81	11.21	2.76
Maths	19.99	21.14	23.48	3.04

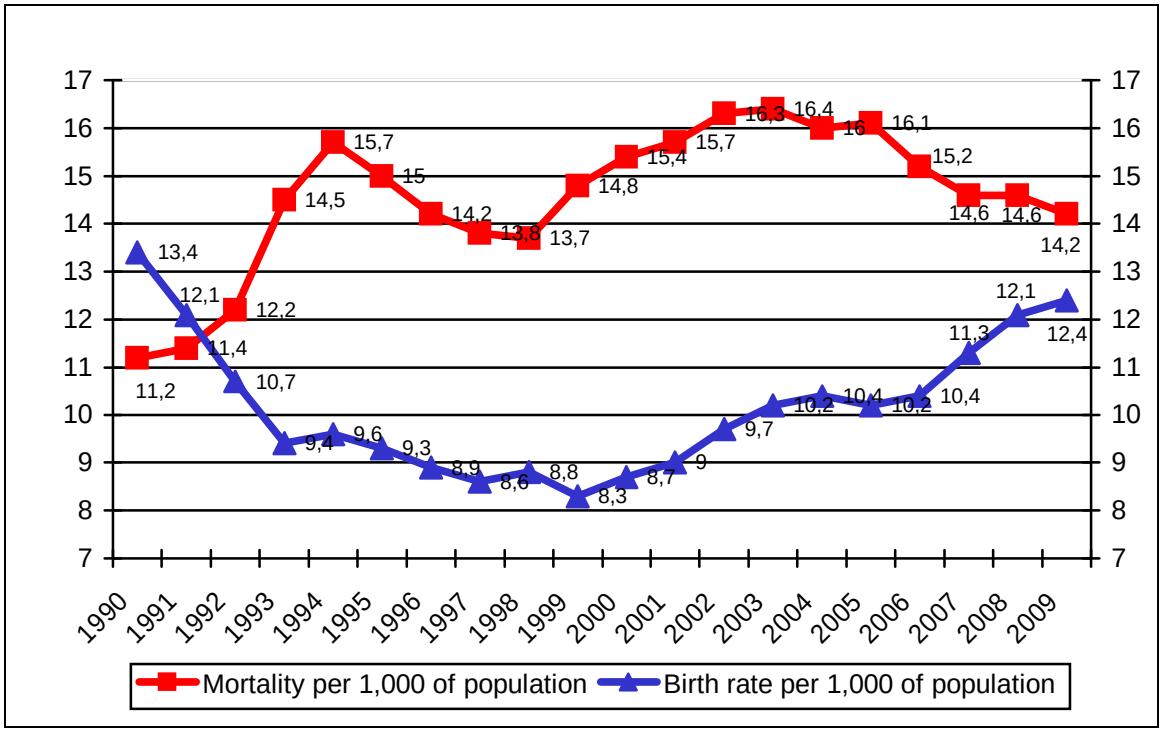
In the meantime, one may not reject the SSE without grounds. This mechanism for certification of school leavers which corresponds to the present stage of development of Russian higher education – transition to universal higher education when 80% of school leavers enroll in higher educational institutions. However, this mechanism needs improvement so that the society stops mistrusting it. Many negative issues regarding the SSE could have been eliminated at the test stage.

One of the negative issues is sending the SSE results to an unlimited number of higher educational institutions which resulted in a mess during the enrollment in higher educational institutions. Sometimes, higher educational institutions were loosing rather strong would-be students and were forced to enroll less knowledgeable ones. This issue became obvious at the stage of experiment. At present the examinee can not send his/her SSE results to more than 5 higher educational institutions.

On the whole, one can draw a conclusion: although an experiment with the SSE has ended, its approbation and adaptation to real conditions carries on.

4.3.2. Health Care in 2009

The year 2009 is noted for an improvement in the demographic indices: the birth rate went up from 12.1 per 1,000 (2008) to 12.4, and the mortality rate fell from 14.6 per 1,000 in 2007–2008 down to 14.2 (*Fig.)*. The trend in the fall of mortality was noted since 2006 and is attributed by the government to its concerted efforts in the field of public health, as well as its growing funding, and to the implementation of the National Project "Health" together with the program of medication supply. Healthcare remains a priority in the budget policy, expansion of the state programs implemented in the field of public health, obviously, have a bearing on the life span of the population. Reduction in the number of deaths from cardio-vascular diseases by 56 thousand (from 1,186 thousand in 2008 down to 1,130 thousand) have mainly contributed to the decline in the mortality rate (from 2,076 thousand in 2008 down to 2,014 thousand). If we observe relative figures of the fall of mortality due to natural causes, then the most positive indicators in reduction of the number of deaths were posted by accidental alcohol poisoning – down by 32% compared to 2008 and by road accidents – down by 15%. These results can be rightfully attributed to the implemented measures of the government control over alcohol production, as well as strengthening administrative responsibility for violation of Highway Code since 2009. At the same time, the number of deaths from tumors (second largest to cardio-vascular diseases) went up by 2%, despite introduced in the National Project measures aimed at the improvement of medical assistance to oncological patients.

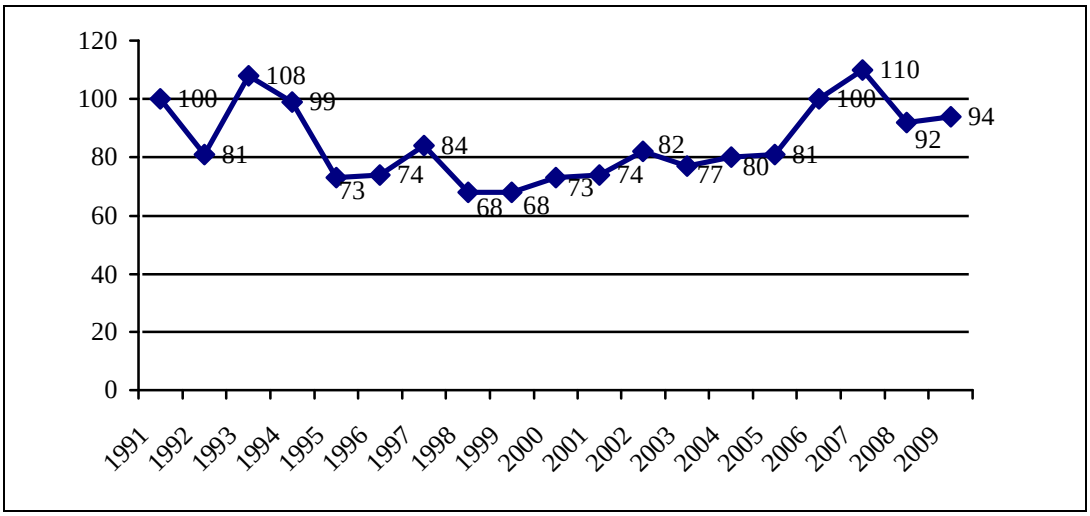


Source: the Rosstat.

Fig. 1. Birth Rate and Mortality in Russia from 1990 to 2009

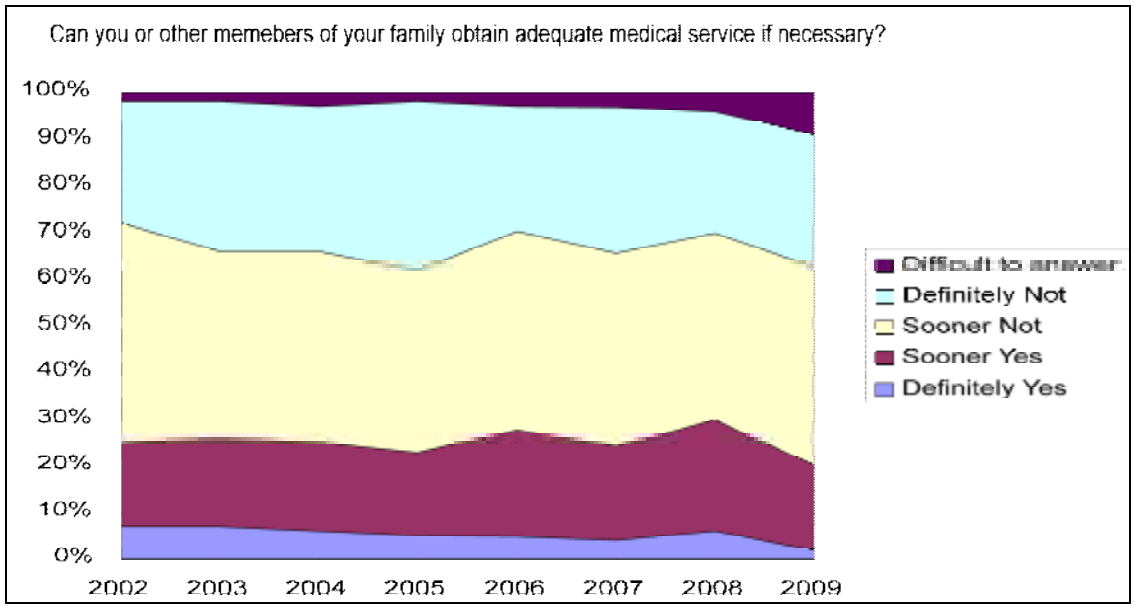
In 2009 in spite of the economic crisis, the federal budget expenditure on public health went up in the nominal terms by 25% - from Rb231.4 bn to Rb289.5 bn. Expenditure from the

budgets of the Subjects of the Russian Federation remained practically untouched: Rb518.7 bn against Rb520.1 bn in 2008. Taking into account contributions to compulsory medical insurance (CMI) made by economically active population, state financing of the health care system went up in 2009 by 5.6% (2.9% in real terms) and reached Rb1, 060 bn. (*Fig.2*).



Source: calculations according to Rosstat data and the Federal Fund of CMI by using GDP indices-deflators.

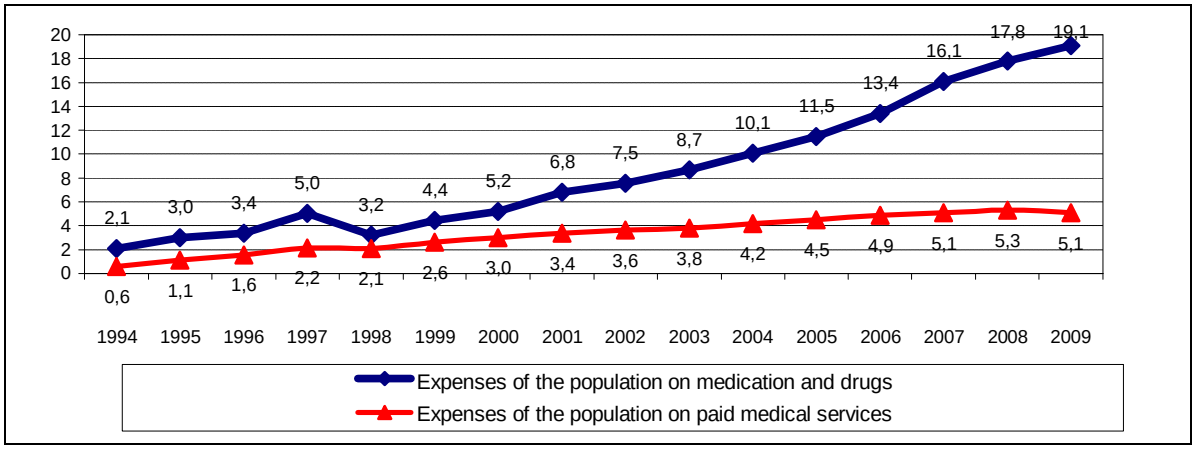
Fig. 2. Dynamics of Government Expenditure on Public Health in Real Terms (1991 = 100%)



Source: Public opinion-2009. Moscow: Levada-Center, 2009. p. 66.

Fig. 3. Dynamics of People's Evaluation of Accessibility of Medical Assistance (according to surveys by Levada-Center)

In spite of these circumstances, people's evaluation of the accessibility of high quality medical assistance was less promising (*Fig. 3*). Obviously, this was due to a reduction in the ability of the population to pay for required medical assistance: the volume of provision of paid medical services to the population declined in real terms (*Fig. 4*). In reference to the expenditure on medicine and pharmaceutical products, there was no data available regarding volumes of retail sales for the time of this article. According to estimates, they went up in real terms; the economic crisis has solely slowed down growth rates of these expenses. This distinguishes 2009 situation from 1998 crisis when both the government expenditure on public health and people's expenses on pharmaceutical products and medication plummeted.



Source: calculation on Rosstat data; Expenditure of population on medicine and pharmaceutical products in 2009 – estimation on the DSM Group forecast (http://www.dsm.ru/marketnews/1061_24.11.2009)

Fig. 4. Expenses of the Population on Drugs and Paid Medical Services in 1994–2009 in 1994 prices.

In 2009 as during three previous years (2006-2008) government policy in the field of public health focused on the implementation of the priority National Project "Health".

The National Project "Health"

At the beginning of 2009 the government took a decision to continue implementation of the National Project "Health" up to 2012. Its financing is provided from the federal budget and from extrabudgetary funds: Federal Fund of Compulsory Medical Insurance and the Fund of Social Insurance. Despite the economic crisis and associated with it significant contraction of government expenditures, outlays for the national project "Health" were not only subjected to reduction but were increased by 20.2% compared with 2008. This goes to prove that the government gave this national project a priority status in its budget policy.

Since 2009 the project was supplemented with measures aimed at formation of healthy way of life, tuberculoses screening of the population, preventive control aimed at improving medical assistance to oncological patients, improving network of perinatal centers, prophylactic medical examination of orphans and children who live in difficult situations and who stay in permanent establishments of the healthcare system, of education system and social security system.

In 2009 the project comprised 4 components:

- Formation of healthy way of life;
- Development of basic medical and sanitary aid and improvement of disease prevention;
- Increase of accessibility and quality of specialized including hi-tech medical assistance;
- Improvement of provision of medical attendance to mothers and children.

In 2009 the national project's expenditure structure has undergone a series of significant adjustments. Expenses on basic medical and sanitary aid and improvement of disease prevention substantially fell in absolute and relative terms: the share of this component in the overall expenditures of the project decreased from 54.5% to 38.4%. In the first year of the project implementation (2006) this component was a major one: it accounted for 82.6% of the overall expenditure. However, recently the Ministry of Public Health and Social Development invariably placed a priority on the provision of the population with hi-tech medical assistance. The share of expenditure on this component went up from 16.5% in 2006 to 42% in 2009. We should take note of an increase in expenditure on the improvement of medical assistance to mothers and children: the share of these expenses in the project's budget went up from 11.9% to 17.4%.

In 2010 expenditure on the national project as a whole and on its main components remained at approximately the same level as in the previous year.

Distribution of expenditure across the project's directions and undertakings in 2006-2010 is presented in *Table 1*.

Table 1

Expenditure on the Implementation of the Priority National Project "Health", Rb bn.

Directions of the national project, types of expenditure and sources of funds	2006	2007	2008	2009	2010 (plan)
Total expenditure, in % of GDP	0.29	0.42	0.29	0.37	
Overall expenditure, Rb bn.	78.9	139.5	120.7	145.2	146.3
Of which:					
Formation of healthy way of life	–	–	–	0.7	0.8
Development of basic medical and sanitary assistance and improvement of disease prevention	65.2	90.5	65.8	55.7	60.5
Training and re-training of general practitioners (family doctors), therapeutists (district doctors) and general pediatricians (district doctors)	0.15	0.3	0.3	0.3	–
Salaries and wages to general practitioners (family doctors), therapeutists (district doctor) and general pediatricians (district doctor) and nurses working with them	14.6	21.9	19.5	21.6	21.2
Salaries and wages to medical staff of feldsher-midwife stations, doctors, feldshers and nurses of ambulances	4.1	11.2	8.0	9.4	9.7
Supply of diagnostic equipment to municipal dispensaries and outpatient clinics	14.3	15.4	0.05	–	–
Provision of ambulances to departments and emergency and immediate care institutions	3.6	3.9	0.2	–	–
Vaccination	4.5	6.1	5.0	6.5	5.6
Prevention of AIDS, of hepatitis B and C, and identification and treatment of AIDS-infected individuals	2.8	7.8	8.0	9.3	13.5
Tuberculoses screening, treatment of tuberculoses patients, prevention measures	–	–	–	2.7	4.1
Prophylactic medical examination of the working population	5.5	7.0	5.7	3.9	4.4
Additional payment for medical and sanitary aid provided to the non-working pensioners	4.3	–	–	–	–
Additional medical examinations of employed in industries with occupational hazards	1.9	2.0	2.0	2.0	2.0
Provision of the population with hi-tech medical assistance	13.0	46.3	51.3	61.1	60.0
Construction of hi-tech medical technological centers	3.2	28.8	9.5	11.6	6.9
Provision of hi-tech medical assistance	9.8	17.5	24.0	28.2	36.2
Development of new hi-tech medical technologies	–	–	7.7	5.1	–
Undertakings aimed at the improvement of medical assistance to cardio-vascular patients	–	–	3.6	3.0	3.1

Directions of the national project, types of expenditure and sources of funds	2006	2007	2008	2009	2010 (plan)
Undertakings aimed at improvement of medical assistance to those injured in road accidents	–	–	3.2	2.3	3.4
Undertakings aimed at the improvement of oncological assistance to the population	–	–	–	6.7	5.9
Undertakings aimed at the development of blood banking service	–	–	3.3	4.2	4.5
Improvement of medical assistance to mothers and children	9.4	14.9	17.0	25.3	24.9
Payments on birth certificates in the framework of medical assistance provided to women during pregnancy and birth, dispensary observation of a child in his first year	9.0	14.5	16.6	16.8	17.5
Development of perinatal centers	–	–	–	7.1	6.0
Examination of newborn babies for galactosemia, adrenogenital syndrome, mucoviscidosis	0.4	0.4	0.4	0.6	0.6
Prophylactic medical examination of orphans and children who are in difficult situations and who stay in permanent establishments of the healthcare system, education and social protection				0.8	0,8
Implementation of the pilot healthcare modernization project	–	2.0	3.4	–	–
Provision of information support and project management	0.6	0.7	0.2	0.3	0.1

Source: the RF Ministry of Public Health and Social Development data.

During the project's implementation in 2009 tangible accomplishments in provision of various types of medical assistance to the population were achieved. However, it should be remembered that expenditure on the project in 2009 amounted only to 13.7% of the overall government expenditures on health care system and the implementation of such project does not exclude the need for the health care system reform on the whole. Due to its design, the national project was unable to ensure significant progress in the solution of key problems of the Russian public health system. Declarativity and inconcrete character of guarantees of free medical assistance, low efficiency of the chosen model for compulsory medical insurance, insufficient protection of the population from payment risks for medical treatment, inequality in accessibility to medical assistance among different social and territorial groups, low structural efficiency of the system for medical services provision, weak medical staff motivation – solution of all these issues is impossible without major reforms in the organization, administration and financing of the public health system. The national project has cleared the road for these reforms. However, they have not stated. In the framework of the national project, the government financed implementation of the pilot project designed to introduce new public health financial vehicles in 19 Subjects of the Russian Federation in 2007-2008. However, there were no major institutional breakthroughs affecting entire public health system. It is not envisaged in the national project in the future.

Provision of Medicines to the Population; Strengthening Government Price Control over Medications

The state of drugs provision has become one of the hot buttons in the wake of the economic crisis. According to the data of Russian official statistics, in 2009 growth of retail prices on medicinal drugs amounted to 13.9% exceeding overall consumer price index growth, which for the same time interval constituted only 8.8%. Most rapidly prices grew in the first quarter 2009 – then the growth constituted 14.2% in relation to December 2008. At the same time, there was significant price dispersion on one and the same medication, and this range increased. For example, in St. Petersburg maximum price exceeded minimum one on similar medication 5fold an average, and by March 2009 this ratio went up to tenfold.[1]

[1] The World Bank. Russian Economic Report 19. June, 2009, http://siteresources.worldbank.org/ INTRUSSIANFEDERATION/Resources/305499-1245838520910/rer19-eng.pdf

Prices on pharmaceutical products are subject to government regulation in Russia. It is worth noting that the price regulation on pharmaceutical products represents a widespread practice in the countries with developed market economies. However, abroad only prices on those pharmaceutical products which are reimbursed (in total or in part) by the government are subject to state regulation. In Russia a different approach to this issue has been chosen: those pharmaceutical products which are in the list of essential and vitally important pharmaceutical products are subject to price regulation. This list is regularly updated. Its latest version was approved on 30 December 2009 and it includes 500 international nonproprietary names for pharmaceutical substances. Sales volume of these pharmaceutical substances amounts to about 40% of the pharmaceutical market. The government purchases about half of these pharmaceutical substances for distribution among medical institutions and in the framework of programs of drugs distribution for several categories of population: social security beneficiaries and certain types of patients (program – provision of necessary drugs and program – high-cost nosology).

Effective prior to 2010 the system of price regulation envisaged registration according to declarative principle of wholesale factory price of producers and importers on essential and vitally important drugs and authorized Subjects of the Russian Federation to set independently wholesale and retail markups on prices of essential and vitally important drugs. At the same time, there was no control over set prices. Actually, in the regions marginal markups were not applied on a cumulative basis – to the wholesale factory price of the producer but to the price of each subsequent distributor. A chain of middlemen emerged in the pharmaceutical market. Each middleman applies corresponding marginal wholesale markup and as a result prices on the same drugs turn out to be dependant on the number of middlemen and may substantially differ in the same region.

Such regulation system of drugs provision to the population turned out to be unable to withstand pressure, as a result of the ruble exchange rate depreciation, on the prices of imported drugs (in 2008 these drugs constituted 77% of the sale volume on the pharmaceutical market[1]) and imported substances used by the domestic pharmaceutical producers. Price growth on drugs turned out to be impressive for the population.

The state with drugs provision and distribution became a subject for discussion at the RF government session. At the session of the Government commission on the increase of the Russian economy sustainability, which took place on 10 March 2009 instructions were issued which were reflected in the Order of the RF Ministry of Public Health and Social Development as of 27 May 2009 № 277H, aimed at regulating price and drugs assortment monitoring, and in the Government Ordinance as of 8 August 2009 №654 "On Improvement of Government Price Regulation on Essential and Vitally Important Drugs." This document introduced significant amendments in the regulation procedure of essential drugs price fixing. The new procedure was put into effect from January 2010. It envisages:

– ceiling wholesale factory prices on the essential and vitally important drugs are fixed in accordance with procedure approved by the RF Ministry of Public Health and Social Development together with the Federal Tariff Agency.[2] This procedure envisages determination of

[1] *Source:* TSMI "Pharmexpert" (www.pharmtech-expo.ru/.../zip/production_for_HARMTEH_241109.ppt)

[2] Order of the RF Ministry of Public Health and Social Development № 983H and the Federal Tariff Service № 447-a of 14 December 2010. "On Approval of Methodologies for Setting Marginal Release Producer's Prices on Essential and Vitally Important Drugs."

ceiling wholesale factory price of domestic producers on the basis of average weighted real wholesale factory prices for the set preceding time interval (in 2010 – for the period from 1 July to 31 December 2009) and forecasted inflation rate. Formation of ceiling wholesale factory prices of foreign producers is based on comparison of submitted for registration ceiling price levels with the volume of minimal prices on these drugs in the producer country and other countries where these drugs were registered as well as with the volume of their average weighted real import prices for the same preceding time interval;

– in the event of state registration of the ceiling wholesale factory price, prices on similar (according to the international nonproprietary name, form of production and dosage) home-produced drugs shall be taken into account. The Federal Control Service of public health and social development was commissioned with monitoring the assortment and prices on essential and vitally important drugs in compliance with the terms and conditions approved by the RF Ministry of Public Health and Social Development, as well as create and introduce monitoring electronic database for assortment and prices on essential and vitally important drugs. Earlier the Federal Control Service in the field of healthcare and social development conducted price monitoring solely of part of drugs from the effective list of essential and vitally important drugs and/or minimum assortment list of drugs. Drugs of 81 international nonproprietary names represented in 118 pharmaceutical forms were subjected to monitoring. Meanwhile, the minimum assortment list of drugs which are necessary for provision of medical assistance 148 international nonproprietary names of pharmaceutical substances are presented. Effective in 2010 list of essential and vitally important drugs comprised 500 international nonproprietary names of pharmaceutical substances. Thus, the scale of monitoring of prices on drugs must significantly increase;

– ceiling wholesale factory prices are coordinated by the Federal Control Service in the field of healthcare and social development with the Federal Tariff Service. Earlier the following rule was effective: a coordination of ceiling wholesale factory price stated by the producer could not be rejected where it was a minimal wholesale factory price of the same producer according to the statistical data for six months prior to the date of the data submission for the state registration. From 1 January 2010 this rule was rescinded. Until 1 April 2010 which is the set date for termination of price re-registration, producers had to coordinate prices with two different agencies and in the event of disagreement turn to a special commission on dispute resolution which emerge in the event of state registration of ceiling wholesale factory prices on essential and vitally important drugs, which was set up in compliance with the Order of the RF Ministry of Public Health and Social Development of 9 October 2009 № 820.

As long as presently effective list of essential and vitally important drugs contains drugs produced by only one supplier, introduction of new procedure for the price registration creates risks of termination from 1 April 2010 of provision and distribution of those drugs prices for which will not be registered. Refusal in registration will mean that these drugs will be unavailable in pharmacies and inaccessible for patients;

– ceiling wholesale and retail markups on drugs will be determined by bodies of executive power of the Subjects of the Russian Federation with regard to organizations of wholesale commerce of drugs and pharmacies. These markups will be in percentage points and will be differentiated depending on the price of drugs and taking into account geographic remoteness, transport accessibility and other characteristic properties. The Federal Tariff Service by the Order of 11 December 2009 № 442-a approved Procedure for determining by executive au-

thorities of the Subjects of the Russian Federation of ceiling wholesale and retail markups on actual wholesale factory prices on essential and vitally important drugs. This Procedure envisages markups determined on the basis of information on costs incurred and profit margin of wholesale organizations and pharmaceutical institutions and there differentiation across three price groups (up to 50 Rb inclusive; over 50 Rb and up to 500 Rb inclusive). With account of actual level of markups in comparable conditions formed during the reporting regulation period in order to avoid disappearance of cheap drugs correcting coefficients are introduced and applied to the wholesale and retail markups;

– sale of drugs by wholesale organizations will be carried out on condition of compulsory formalization of a protocol on price coordination for the supply of essential and vitally important drugs according to a form approved by the RF Government Decree № 654. Sale of drugs by pharmaceutical institutions should be carried out upon availability of the aforementioned protocol. However, timelines for issuing such protocol for distributors working with foreign drug producers may be unacceptably long.

Decree № 654 does not envisage price regulation on drugs' substances. In the meantime, in the structure o drugs' prime cost expenses on substances (raw materials and inputs) account for 40-80%. At the same time, upon the production of domestic drugs Russian producers mainly use imported substances: they represent 87% of the pharmaceutical substances market in Russia.[1] As a result of price fixing on the ready products where there are no restrictions on markups for foreign substances providers may result in serious negative effect for domestic producers.

New mechanism for government price regulation will have restrictive effect on their growth and reduce their assortment for similar drugs. At the same time, this mechanism of price regulation generates risks for reducing economic incentives of producers to distribute a number of drugs and correspondingly the consumers may find out that these drugs are unavailable in the pharmacies.

One should become aware of the fact that the task of drugs availability for the population by means of price regulation on sought-after drugs is hard to solve. In order to achieve an intended effect it is necessary to modify the approach itself to the drugs supply regulation. More effective seems an approach which engages the drugs insurance system. At the first stage it can be formed on the basis of existing programs essential and vitally important drugs. Implementation of this approach can be commenced in 2011 in the pilot mode in several Subjects of the Russian Federation with gradual increase of the number of regions – projects participants. In the future when Russia overcomes the crisis, it will be feasible to expand categories of the population included in the insurance patterns.

[1] Торгово-промышленная палата Российской Федерации, Союзэкспертиза, МФБ, 2008. Организация биржевой торговли фармацевтическими субстанциями. Пояснительная записка, Москва, октябрь 2008. http://www.mse.ru/comm_ex/pharma/docs/pz.doc

4.4. The State of Research and Innovation Sphere

4.4.1. New Political and Technological Priorities in Scientific and Innovation Development

In the wake of the global crisis the issue of innovation development is mentioned more often than in previous years, despite the fact that "innovation" context has greatly contrasted with the actual results of the formation of the national innovation economy. The principal difference last year was that, first, the innovation vector of development (at least at the level of strategic plans) has appeared in virtually all key ministries and departments, and secondly, in the issues of technological progress, i.e., based on the achievements of science and innovation, the President of the country started to pay much more attention to it.

In 2009 a special Commission has formulated a concept on modernization and technological development of the Russian economy which task is to review public policy in the issues of modernization and technological development, the selection of priorities, forms and methods of government regulation and coordination of activities of executive authorities in this field. Issues of innovation promotion in general and R & D funding in particular became one of the central problems in its work.

At the first meeting of the Commission, the President of Russia declared 5 trends of the "technological breakthrough"[1]:

- Energy efficiency and saving;
- Nuclear technology;
- Space technologies, including the transmission infrastructure of all kinds of information;
- medical technologies, including diagnostic equipment and medicines;
- strategic information technology, including the creation of supercomputers and software development.

In the context of modernization and technological development, particular emphasis was made to encourage businesses to innovation, improvement of the work of development institutions and technical regulation. Moreover, the President[2] also stressed the importance of addressing such issues as the creation of a favorable environment to foreign companies and research organizations to build the research and design centers, the development of ties with the scientific diaspora and invitation of top scientists and engineers to Russia.

In the annual speech of the RF President to the Federal Assembly[3] there was proclaimed the need to:

- establish a permanent mechanism to attract to Russia the prominent Russian and foreign scientists, and entrepreneurs who have experience in commercialization of new developments (including the simplification of rules of recognition of academic degrees and diplomas of higher education received in the leading universities of the world, as well as facilitating visa regime);
- expansion of grant support to the developers of new technologies on a competitive basis;
- creation business incubators on the basis of modern universities;

[1] http://www.kremlin.ru/transcripts/4506 June 18, 2009.
[2] Russia, go Ahead! Dmitry Medvedev's article. http://www.kremlin.ru/news/5413 September 10, 2009.
[3] http://www.kremlin.ru/transcripts/5979 November 12, 2009.

- establishing in Russia a powerful center for research and development, which would be focused on the support of all the priority areas;
- oblige large companies to participate in the formation of advance order for the results of research.

In particular, two key measures of "enforcement" nature in respect to public companies were discussed at a meeting of the Commission on Modernization. The proposals were formulated as follows[1]:

- introduction of mandatory corporate innovation development programs for public companies according to the approved by the government requirements that should be taken in line with, rather than as a part of investment programs;
- introduction of a “standard share” to each individual public company to be allocated for of R & D, basing on its industry specifics and comparison with similar companies abroad.

As per the message results, there was formed a list of instructions to the Government, which should be performed by March 1, 2012. The documents to be prepared are covering the following range of tasks:

1) expansion of the support to the developers of new technologies by providing grants on a competitive basis;
2) simplification of the rules of recognition of academic degrees and diplomas of higher education received in the leading universities of the world;
3) simplification of the rules of employment of the needed in Russia foreign specialists, reducing the time frames of issue and extension the term of visas issued to them;
4) introduction of international expertise in the implementation of priority research projects.

In the above list there are clearly identified priority areas to the State, which currently include: cooperation with compatriots (three out of four assignments are devoted to this issue), expansion of grant financing, incentives to business for a greater support of research and development. It is clear from the lists, that the chosen priorities are variable in scope. On the one hand, there is a quite particular problem, as the creation of a super center to work on all areas of research, but on the other hand, in fact, a new policy is planned in regard to the large business. It should be noted that the discussed measures of "enforcement" to business remind principles of the Soviet economy. The proposed approach is not practiced in countries with developed innovation systems. In some countries there is indicative planning, but there is no detailed “standards” for each state-owned company (or companies where the state owns the "golden share") for expenditure on R & D and no requirements draw up a plan for innovation development. These issues are in the authority of companies’ management, rather than in the federal government competence, and company management is carried out according to market principles.

The issue of technological priorities deserves special consideration. Until now, the priority trends of scientific and technological development and the corresponding critical technologies were defined basing on estimates (in the last year – foresight ones), formed by the Ministry of Education and Science and later approved by the President. Another revision of priorities was made in 2009, and by September was prepared a draft, developed by the RF Ministry of Education, which contains the revised list of priorities (see *Table 1*).

[1] Minutes of the meeting of the Commission on modernization and technological development of economy of Russia. December 25, 2009. http://www.kremlin.ru/transcripts/6460
[2] http://www.kremlin.ru/news/6001

Table 1

The Lists of Priorities for Science, Technology and Engineering Development in the Russian Federation

List of 2006	List of 2009 (draft)	List of the RF President
Information and Telecommunication Systems	Information and Telecommunication Systems	Information technologies
Environment conservancy	Environment conservancy	–
Industry of nanosystems and materials	*Industry of nanosystems*	–
Living system	*Life sciences*	Medical technologies
Energy and Energy Efficiency	*Energy efficiency and conservation*	Energy efficiency and conservation
Transportation, aviation and space systems	*Transportation and space systems*	Space technologies, including the infrastructure of all kinds of information transmission
-	–	Nuclear technology

Source: 1. Priorities for the development of science, technology and engineering in Russia and the List of critical technologies in the Russian Federation. Approved by the President on May 21, 2006, by the Order Pr-842. 2. Priorities for the development of science, technology and engineering in Russia and the List of critical technologies of Russia. Draft of the Ministry of Education and Science. September 30, 2009 3. The first meeting of the Committee on Modernization and technological development of Russian economy. June 18, 2009. http://www.kremlin.ru/transcripts/4506

As can be seen from the *Table 1*, the presidential priorities differ from the old formats not only informative, but in terminology. Traditionally, the priorities are formulated in terms of broader areas and disciplines ("living systems", "transportation and space systems") or industries ("nano technologies"). Presidential priorities are formulated more narrow and specific, in terms of *technologies.*

As a result, there is developed an unprecedented situation, when, in fact, there are two lists of priority scientific and technological areas: one, which is structured as existing federal targeted programs (FTP), and first of all, the federal program for R & D support – "Research and development on priority directions of scientific-technological complex development of Russia" for 2007-2012, and the new "presidential" priorities, which, according to the reports on the meetings of the Committee for Modernization and Technological Development of Russia's economy, various ministries and agencies[1] should increasingly focus their work. Probably, one should expect a revision of programs and a number of activities aimed at supporting the development of various technologies. In particular, RAS has already responded to the new list, has revised the subjects of research and found that for the projects on 5 areas of technological breakthroughs it is currently spent approximately 23% of funding for Basic Research Program. It was determined that this figure can be increased to 35%.[2]

If we compare the policy speeches of the President on the issues of science and technologies development with the main provisions of the speech of the US President Barack Obama on April 27, 2009 at the National Academy of Sciences of the United States, which became extremely popular in Russia, it becomes obvious, that the development priorities of the two countries coincide in many ways. First, the thematic priorities are overlapping. In the US a top priority, which is linked with a number of other initiatives (both financial and institutional ones), there named the ecologically safe energy and energy efficiency. A priority remains for the United States in a traditional area - health care, in particular the fight against various diseases, and the quality of health care ("best service at lower prices"). Among the 5 "presidential" pri-

[1] See, for instance: Poisk, No. 49. December 4, 2009. P. 5.
[2] We can do without a sledgehammer. RAS will help to provide a fundamental basis to modernization//Poisk. No. 3–4. January 22, 2010. P. 5.

orities of technological development there are energy conservation, and new medical technologies.

Secondly, in his speech, the US President stresses the importance of international cooperation, especially in the specified priority areas, as well as establishes a policy of increased openness and the validity of scientific policies and their implementation. These trends can be found in the Russian strategic documents as well. Thus, we can say that the development of innovation systems are increasingly transparent, and countries with different levels of economic development are beginning to choose more and more similar strategic directions of science and innovation support.

However, unlike Russia, the United States and West European countries, the government in the time of crisis has provided substantial additional funding for research, including basic research, while Russia has begun and continues to tighten the budget for research and development[1]. At the same time, the development of anti-crisis measures was much delayed - in fact, intensive discussions began in the first half of 2009. Moreover, both, approaches and measures were non-system, contingency approach in a way. Government policy was based on the concept of efficient use of existing mechanisms and instruments, rather than creating new ones. There was started a review of instruments and measures, which showed that many elements of the innovation system are in place, but communication is not developed, and there are significant gaps between various components. In general, it became obvious that the innovative system is ineffective in each of its components. Therefore, a trend to the use of existing mechanisms after appropriate adjustments is correct, but it cannot be attributed to the rapid response measures.

As a result, there did not appear such trends of scientific policy, which could be interpreted as a anti-crisis ones. Measure of the pre-crisis period were continued. Among the main directions of the government the following ones should be highlighted: support of science in universities, assignment of "status" to organizations and joint structures (federal universities, former industrial associations of industrial and academic research institutes, facilitation of obtaining the status of the State Scientific Center);

- HR policy: measures to attract the Russian scientific diaspora in keeping young people in science;
- support to innovation small business and development of the relevant infrastructure;
- Improvement of tax incentive measures for R & D.

Before the estimation of the effectiveness of the measures imposed, it is important to consider, what was the economic crisis impact on the overall situation in the field of science and technological innovation.

4.4.2. Crisis Impact on the State of Research and Development

The impact of crisis in the sphere of science and innovation was evident in the first place in the reduction of private sector spending for research and development and reduction of the number of employees in R & D departments of companies. By the end of December 2008, ex-

[1] Policy Responses to the Economic Crisis to Restore Long-Term Growth: Results of the OECD Questionnaire. OECD: DSTI/IND/STP/ICCP(2009)1/ADD. February 20. 2009.

penses of private companies to implement innovative projects declined by nearly 80% since the beginning of the crisis, business angels – by 50%, venture capital funds - by 40%[1].

For projects performed in the framework of the Federal Target Program "Research and development on priority trends of scientific-technological complex of Russia in 2007-2012", the companies began to violate their financial liabilities, what has led to the termination of some contracts that were carried out in cooperation with academic institutions (universities). According to the Ministry of Education and Science, in 2009 commitments to extrabudgetary funding of R & D projects in the framework of the federal program were implemented by 60-70%[2].

It is indicative, that the reduction in their own R & D departments in companies has not led to more active cooperation of companies with public scientific organizations. In the crisis situation, when optimization of resources spending is required, the existing problems of interaction become more acute. Companies generally negatively assess their experience with public sector scientific organizations[3]. The arguments against cooperation is weak human resource capacity of research institutes and universities, the virtual absence of scientists of the most productive working age (35-50 years), the slow rates of performing orders for research and development. The problem in many cases is unclear allocation of intellectual property rights, as well as the quality and the form of results. As a result, when the need arises in outsourcing, the companies prefer to deal with individual professionals, rather than organizations.

In general, according to the estimates of Russian Science Agency (Rosnauki), by September 2009 the share of innovation-active enterprises has decreased by 1 / 3 as compared to 2005, and the number of small innovative companies has decreased by half.[4] Many small firms were working on the principle of outsourcing, performing R&D works for large and medium-size companies. The latter in response to the crisis considerably reduced the volume of R & D orders. In turn, banks have stopped lending to small high-tech companies, as the least stable in their development. All this has created a serious threat of losing a "critical mass" of small innovative enterprises.

As a second feature of the crisis one can consider changes in the staffing situation, characterized by sharply increased outflow from science, among both, researchers and other categories of employees. If in 2006-2007 the outflow of personnel from the science was rather insignificant (0.7% per year), and the number of researchers even increased from time to time (for example, in 2006 compared with 2005, the growth amounted to 1.7% of researchers), then in 2008, as compared with the previous year, the number of researchers has decreased by 4.2%, while the total number of employees engaged in research and development reduced by 5%.

Therefore, there was no temporary overflow of personnel to the sector research and development, as it was during the 1998-1999 crisis. Herewith, this sharp decline in the number of employees in R & D can not be explained by the reduction of funding for science, since these

[1] National Association of Innovations and Development of Information Technology Assessment (NAIRU). *Source:* In the hope of government support // Expert, Siberia. December 22, 2008. http://inno.ru/press/news/document33157/

[2] We are doing everything possible. http://strf.ru/material.aspx?d_no=19500&CatalogId=221&print=1 April 29, 2009.

[3] Based on the results of interviews conducted by the author of this section in June - July 2009 in a number of high-tech companies of Moscow.

[4] From the report of I. Bilenkina, Deputy Head of Federal Agency for Science and Innovation, presented at the X-th Russian Venture Fair. Moscow, September 24, 2009. Estimated data: Science, Technology and Innovation of Russia: 2009. Short publication. M.: INRA Sciences, 2009. P. 12-13.

processes started in 2009 and will grow in 2010. Most likely, the current HR situation is the result of the low efficiency of government scientific policy.

The third sign of the crisis was the reduction of the public budget funding for research and development. The share of budgetary R & D expenditure in 2009 amounted to an average of 30%, varying depending on the agency, specific program and activities performed within the programs. In 2010, it is planned to reduce the costs further - at 7.5 billion rubles, as compared with 2009, when the reduction in funding for basic research amounted to 3 billion rubles, for applied research - by 4.5 billion rubles; financing of the RAS and its regional branches was decreased by to 5.6 billion rubles.[1]

Reductions will be uneven - funding priorities will be grants and awards to young scientists (presidential and government ones) and grants for the support of leading scientific schools. However, the number of such grants will be reduced (with some increase in their amount). In terms of expenditure the Ministry of Finance of Russia has decided not sequester the so-called norms of costs for wages. Therefore, the level funding for wages, scholarships and allowances for the ranks of full members and corresponding members of the state academies of sciences will be maintained. In this regard, for example, in the RAS other cost items decreased by 40-50%,[2] including expenses for utilities, maintenance of equipment, purchase of consumables. The new positions will be suspended.

Financial support of a number of federal targeted programs will be also significantly reduced. In the first turn, the Federal Program "Research and development on priority directions of scientific-technological complex of Russia for 2007-2012" and the Federal Program "Development of infrastructure of the nanotechnology industry in 2008-2010". There will be no new tenders for this programs in 2010, and funding will be provided only for the concluded contracts.[3]

Herewith, in 2009 the cost of some contracts have already been reduced by 10-15%, while maintaining the originally approved scope of works. However, funding for the Federal Program "Scientific and scientific-pedagogical staff for innovation Russia for 2009-2013" remains at the planned level. Under this program, financing is provided, in particular, for the scientific and educational centers, collaborative projects with domestic scientists, and various academic events and conferences. Financing for public research funds will be reduced by at least 10%. In this regard, for example, Russian Public Research Fund already faced with significantly increased competition for projects. It reached the level of 1:10, while in the previous 15 years it did not exceed 1:5[4].

Therefore, the reaction to the crisis was the reduction of the national budget financing, with its simultaneous redistribution in favor of certain items (directions). Priority was conservative support of personnel, including scientific schools, and the reduction of those programs, in the framework of which research on priority areas of science and technology are financed.

[1] The next is the less. Research budget will be reduced / / Poisk. No. 1-2, January 15, 2010, P. 3.
[2] For one salary. RAS budget funds for research are getting less / / Poisk. No. 5. January 29, 2010, P. 3.
[3] Congratulations with the new grant! What does Rosnauka offer to the scientists in the coming year? / / Poisk. N0. 3-4. January 22, 2010, p. 4.
[4] From distress to inspiration// Poisk.No. 48. November 27, 2009. P. 4.

4.4.3. Measures to Support the Best Universities and Organizations that Perform Research and Development Works: "Progressive Inequality" Development

In 2009, one of the main priorities was to support university research, in particular, by giving special status (rank) to the selected universities. There appeared so many statuses, that no one can immediately tell the differences between them. At the present time, there are federal, national research universities, there are also universities - participants of innovative educational programs and, finally, Moscow and St. Petersburg State University (MSU and SPSU), which in 2009 there was established the status of "unique scientific and educational complexes"[1]. MSU and SPSU (along with the N.E. Bauman MSTU) can now set up their own educational standards and requirements for the educational programs, implemented by themselves.[2]

In fact, the selection of the best universities began in 2006 when the Government has initiated an innovative educational program (IEP) in the framework of the national project "Education". As a result of the tender, there were selected 57 high schools, which within two years received a substantial budget financing. The aim was to increase support to the high-quality educational and research activities through the purchase of new equipment, staff development, development of new training materials and manuals. This was the first major experience of universities' training in project management, selection of development priorities, as well as the skills of procurement in cases of force majeure, because the budgetary funds were late and time was short for the correct execution of all formal procedures. IEP can be regarded as a first step in the policy of raising the status of higher education institutions – in public opinion, universities, which won the tender, are considered the strongest one in the country.

Then, in 2006 there was formed two federal universities - Siberian Federal and South Federal (SFU and YuFU). They were created by joining several different-profile schools, thus becoming the largest in the country. The federal universities have regional relevance: according to official documents of the universities, they were created to improve the competitiveness of leading industries in the regions. Giving the status of "federal" is accompanied by a significant budgetary financing, which can be spent for certain (but not all) issues. Herewith, Southern Federal University identifies itself also as "research university", which is essentially true. The federal universities, in contrast to the objectives outlined in the IEP, should pay considerable attention to the development of science and its integration with education, in particular, by inviting foreign teachers and researchers, increasing the share of undergraduate and graduate students from abroad and other activities. For all these trends there approved target indicators for universities towards which they should aspire to. Since the initiative to give a "federal" status actually involves the creation of entirely new organizations, this status is permanent. Moreover, in early 2010, federal universities moved to the new organizational and legal form of an autonomous institution.[3] For them, a transitional three-year period is established, during which the government will provide support to the universities in various forms, including the

[1] Federal Law No.259-FZ of November 10, 2009 "On the Moscow State University named after M.V. Lomonosov and University and St. Petersburg State University".

[2] The list of federal government educational institutions of higher professional education, self-setting educational standards and requirements for ongoing educational programs of higher professional education. Presidential Decree No.732 of July 1, 2009.

[3] Regulation of the RF Government Prime Minister, dated January 16, 2010 No. 12-p. http://government.ru/gov/results/9056/

possible provision of the equalization grant, which will cover the funding gap the state targeted financing.

A completely different picture is typical for the research universities - the third initiative, which is started in pilot mode in late 2008. In 2009 a tender was announced, and 12 schools were selected, which received this status.[1]

Many of these schools have previously been involved in the IEP and the experience of crisis management was not in vain: the results of the tender for research universities were assessed at the beginning of October, and the allocated to the universities annual amount of funding was to be spent by 15 December. Research universities will be supported from the budget within 5 years, and they have to implement their development programs by 2018. Herewith funding from the budget is rather significant - thanks to it, the budgets of universities actually doubled. It is assumed that up to 70% of allocated funds will be spent on the purchase of equipment, so that as a result, every university would create 5-7 world-class laboratories. It is certainly important and necessary, though the experience of the IEP shows that the purchase of modern equipment does not yet provide a quality breakthrough in scientific and educational activities.

The status of "national research" university in some way confusing, because behind it there is a temporary, although long-term, project financing of development programs of universities, base on a slightly adjusted principles of IEP. Research universities obtain an additional budget funding in the framework of traditional mechanism for federal programs – on the terms of 20% co-financing (as in the IEP) and are allowed to spend funds on certain items to implement their stated development programs.

Similarities and differences between the IEP, research universities and federal universities are displayed in *Fig. 1*.

How effective can be the given status? It depends, firstly, on how universities have been selected, which have received the status. Secondly, it depends on the conditions created to the status universities in order to enable them to achieve their goals.

The decision to establish federal universities can be regarded as purely political, adopted at the highest government level, without extensive coordination and discussions. This was once again confirmed in 2009, when President Dmitry Medvedev signed a decree on the establishment of five federal universities[2] in Russia, selected with regard to the regional factors, but unknown to the public criteria. Moreover, as follows from numerous discussions, the transformation of higher schools in the federal ones was surprise to their employees.

If the main criterion for the selection of universities to transform them into federal ones consisted in the uniformity of the distribution of federal universities through the regions, then one should not expect special effect from the fact that some universities will be merged and they will receive an additional funding. This is confirmed by available foreign experience. In addition, nearly three-year development history of SFU and YuFU has identified a number of challenges, primarily related to the existing administrative and bureaucratic restrictions which could be eliminated (such as was done for MSU and SPSU). The transformation to the autonomous agencies removes only part of the problems and at the same time becomes a source of new ones (for example, it is not clear how scientific research will be supported, how relationships with the founder will be built, etc.). Therefore with regard to the experience of

[1] Federal Government Order No. 1613-p from November 2, 2009.

[2] Presidential Decree No.1172, dated October 21, 2009 "On establishment of federal universities in the North West, Volga, Urals and Far Eastern Federal Districts".

SFU and SFU, granting of federal status to the new universities should be accompanied by non-financial measures as well. Otherwise there automatically arises low efficiency of budget spending.

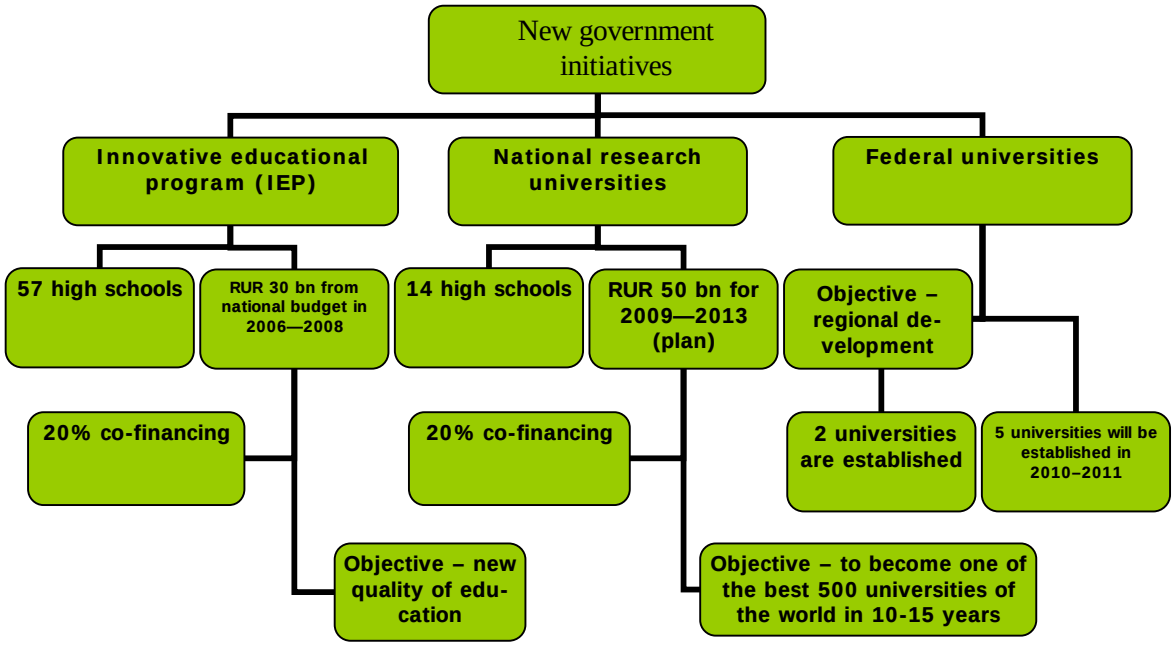


Fig. 1. Types of Universities with a New Status

Selection of universities can also be considered as political decision, as 12 universities were selected from 136 applicants. It is known from the practice of expert selection that when the level of competition is more than 10 nominations for one "place", the choice is not based on the quality of applications as there will be obviously more high-quality projects than the number, which can be financed. What happened as a result? On the one hand, there were selected strong high schools - from 14 universities, which today acquired the status of "national research" (12 selected through a tender in October 2009 and 2 pilot universities that have received this status in late 2008 - National Nuclear Research institute (MEPI) and National Technological University "Moscow Institute of Steel and Alloys (MISA NITU), 12 were the winners of IEP. On the other hand, in the rating of Russian universities *in terms of scientific achievements*, which was made for the education agencies in 2009 by an independent rating agency "ReytOR, newly emerged "research" universities occupy a good but not the best position: only 5 universities of the 14 belong to the first twenty ones. However, if we take into account that the research university is not "real" title, inconsistent with the Western standards, granted not for the inventions and achievements of the universities, but only the support to universities in the form of the five-year development programs, everything falls in place. In 2010, a tender is planned to select 16 more universities, which will be awarded the status of a national research university.

It is distinctive, that great hope assigned by the Government to the intensification of innovation in the activity of research universities, the creation of new scientific results and their commercial efficiency in the industry. Meanwhile, it is known from foreign experience that there is no direct relationship between extended funding to the institutes and universities and

research "output". In particular, the estimates have shown that there is no direct correlation between the doubling of the budget of National Institutes of Health in the United States, which took place in 1998-2003 and the dynamics of patenting, licensing and agreements on joint research with the business. Herewith, the absence of a clear correlation is typical not only for the period of the budget doubling, but for the next 5 years, when based on the new discoveries made during abrupt budget increases on biomedical research and development, patenting and licensing could be significantly increased.[1]

Basic provisions governing the activities of Russian research universities, remain the same as for other universities. In this regard, there is a difference between Russian initiatives and similar programs implemented in several countries with growing economies. For example, in Kazakhstan, 9 universities have the status of national ones, which means not only additional national budget funding, but also the introduction of a number of specific guidelines, including those that wages are higher than the average rate. With regard to the Western experience, particularly that of the best universities in the world, the USA and Britain, where no status is not provided for the universities. The category "research university" is not awarded, but established by the fact of its activities as a result of *voluntary* participation in the ranking and its position by a number of criteria - such as the amount of research funding per one tutor, publications, citations and international awards (Nobel and Fields awards), the demand for graduates in the labor market, the development of their careers.

As a result, the question naturally arises: why there is a need for statuses, such as "national research university"? Will the artificial creation of "inequality" contribute to improve the quality of education and science in high schools? And would not the policy be more effective, if the government preferred creation of favorable conditions for work, including the development of science for all universities? And they could have then apply for budgetary financing of research projects depending on their capacity to receive or not this additional funding on a competitive basis. Thus, ultimately, an "elite" group would emerge among the total mass of universities, which will be a natural result of the development in a competitive environment and equal opportunities.

By all appearances, Russia remains committed to the path of "status" with the aim to "rise in the ratings" - the mentality, that goes beyond the strictly scientific or innovation activity, but rather capturing them. In fact, the idea of assigning a status has a historical trend, if we recall a number of other distinguished and well-established titles (the leading scientific schools, public research centers). Thus, in the course of time the concept of status and level of prestige get smeared out. This happened with the status of leading scientific schools, the same thing happens with the status of the State Scientific Center (SSC). In January 2010, the Federal Law "On Amendments to the Article 5 of the Federal Law "On Science and State Science and Technology Policy" entered into force[2]. Now the status can be assigned to the organization of any form of ownership, which has a unique equipment and the ability to demonstrate the international recognition of its scientific and technological activities. Thus, currently the SSC is not a unique organization of the former industrial science, responsible for the development of certain industries (technologies) in the country, but the successfully operating organizations with unique equipment.

[1] http://ott.od.nih.gov/about_nih/statistics.aspx
[2] Federal Law No. 358-FZ of 27 December 2009 "On Amendments to Article 5 of the Federal Law "On Science and Government Science and Technology Policy".

The policy of creating a "progressive inequality" has involved not only universities, but also a number of organizations in other sectors of science. The selected principle is the same: the new status, And in view of it - merger of organizations, creation of conglomerates, and the support of the new structure through a significant surplus budget funding, allocated on the basis of a special government order. Under this scheme a new National Research Center - Kurchatov Institute was established in 2009. By the Decree of the RF President 3 organizations were joined to the Institute, one of which is an academic institution, and two others are Federal State Unitary Enterprises.[1] By the same decree Kurchatov Institute becomes the chief manager of budgetary funds, as "the most remarkable institution of science", and then by the order of the Government of Russia receives additional budget funding for the program of its development.[2] As in the case of federal universities, with the formation of new organizations the administrative arbitrariness was observed, since the staff of the number of “merged” organizations were not aware of the impending reorganization.

For the new structure quantitative performance indicators of development are established, many of which seem too low (for example, to increase the percentage of young scientists and experts in the total number of employees to 10%), especially against the background of the allocated additional budget funds (RUR 10 billion for 3 years).[3] A similar approach is likely to be used in the enlargement of the Central Aerohydrodynamic Institute (TsAGI) - under its management Ministry of Industry and Trade plans to join all the other research institutes, relevant to the development of aircraft technologies.[4] All in all, it is planned to establish 5.7 national research centers under such scheme.[5]

On the one hand, the additional support of the best universities and “centers of excellence" can contribute to the emergence of qualitatively new scientific results. On the other hand, consolidation of structures means to some extent the growth of monopolies in science, which, as experience shows, leads to a decrease in the quality of scientific research. Therefore, such a critically important procedures for the selection and formation of status organizations, as well as the balance between the support for advanced institutions and the creation of an overall favorable environment for the development of scientific research.

In the past year, systemic organizational reform of the sphere of science has not been initiated,[6] despite the issue of the governmental regulation "On the performance evaluation of scientific organizations, performing research, development and civil engineering works" (No. 312 as of April 8, 2009). Under this decision all organizations after a proper inventory will be divided into three categories - the leaders, stable and those that lost the scientific profile and development prospects. Then, measures have to be taken to optimize the organizational structure

[1] RF President’s Decree No. 1084, dated of September 30, 2009 "On additional measures to implement a pilot project to establish a National Research Center "Kurchatov Institute".

[2] RF government Order of ratifying the “Programs of support and development for the research, technology and engineering infrastructure of the National Research Center "Kurchatov Institute" No. 1730-p of November 16, 2009.

[3] National Kurchatov Institute http://strf.ru/material.aspx?d_no=26643&CatalogId=221&print=1 January 13, 2010.

[4] Boris Alyoshin will take care of aerodynamics // Commersant. No. 225. December 2, 2009. P. 9.

[5] At the start of five years. Preme Minister instructed the Kurchatov Institute experts / / Poisk.No. 1-2. January 1-2, 2010. P. 3

[6] More information on the initiative to assess the organizations, see: Russian Economy in 2008. Trends and Prospects. Issue 30. Moscow: IET, 2009. P. 408-410.

of science structure and funding flows. In fact, this work has been substituted by project for the status granting.

4.4.4. Priorities of National HR Policy in Science

In 2009, the priorities of the last year are totally preserved in HR policy: the main focus was sustained on the issues of supporting and involving young people in science, as well as the development of relations with former Russian scientists, who are working abroad to attract them, either temporarily or permanently, to the Russian science.

In 2008, for the first time in the last 10 years was observed an upward trend in the share of academic staff aged 30-39 years (*Table 2*), in the background of in the continuing decline in the two subsequent cohorts. This can be explained by a considerable number of government initiatives, aimed at supporting the young (under 35) scientists.

Support of young people in science in the period under review was characterized by two different processes. On the one hand, the amount of government grants was increased (grants of the RF President were increased 4 times!) for the young scientists, while reducing their total number. However, payments of monetary assets have been greatly delayed and started only in autumn, i.e., the youth programs were also characterized by force majeure conditions of national budget financing. On the other hand, young people did not have more opportunities to stay in science for a long time. Thus, the end of the pilot project in the RAS, resulting in the reduction of 20% of jobs, has not led to the release of seats for young scientists. For social reasons, many scientists of retirement age were not transferred to part-time or temporary contracts, but retained their jobs. As a result, the number of the young scientists, annually employed in the institutions of RAS has decreased from 1,012 persons in 2005 to 630 in 2008[1]. RAS Management is planning to implement a new approach that could lead to an increase of the share of young scientists. Actually it means the annual reduction of the number of employees of RAS institutions by 3-4%, and providing the released jobs to the youth candidates[2].

Table 2

Researchers Age Structure Dynamics, %

Year	Under 29 years old	30–39 years old	40–49 years old	50–59 years old	60 years old and older	Total
2000	10.6	15.6	26.1	26.9	20.8	100
2002	13.5	13.8	23.9	27.0	21.8	100
2004	15.3	13.0	21.9	27.8	22.0	100
2006	17.0	13.1	19.0	27.8	22.1	100
2008	17.6	14.2	16.7	26.3	25.2	100

Sources: Science in Russia. Statistical handbook. Moscow: HSE, 2005. P.35; Science Indicators: 2007. Statistical handbook. Moscow: HSE, 2007. S. 63; Science Russia in Figures: 2008. Statistical handbook. Moscow: CSRS, 2008. P. 17.

Position of Sciences is also in the fact that the scientific foundations, Russian Foundation for Basic Research (RFBR) and Russian Humanities Research Fund (RFH) - could provide more funds to the young people, in particular, funding temporary positions in the institutions. Taking into account the fact that the budgets of research funds are many times less than the

[1] Poisk. No. 21. May 22, 2009. P. 4.
[2] In the phase of activation. Young Scientists RAS are alerted. Poisk. No.47. November 20, 2009. P. 9.

RAS budget, one should have formulated the problem in another way: to expand the system RAS "program for post-graduates," according to which there would be allocated surplus rates for young scientists. Meanwhile, in the framework of this program there were opened only 400 positions[1] only for the core staff of the RAS.

It should be noted that in 2009 there were new factors, contributing to the outflow of young people from science. Russia joined the Bologna process, exchange programs were expanded, which inspired the outflow of students from the country, rather than the circulation of personnel. Unexpectedly, a negative impact on the staffing situation in science and innovation was provided by the activities of public corporations. The State Corporations (Rosatom, RUSNANO) attract the most active graduates and post-graduates, offering them much higher salaries as compared with academic institutions or small innovative enterprises. Therefore, the scope of scientific innovation began to suffer not as much as only from insufficient inflow of the young staff, as from the low-quality human resources. And here there is not only the impact of the outflow of the active staff outflow to the corporations capable to the departure abroad, but also a general weakening of school education, a decline in training in several disciplines, especially natural science.

In regard to the incentives to the circulation of personnel and increased interaction with fellow countrymen one could note the beginning of implementation in 2009 of the Subprogram "Research performed by scientific teams under the guidance of visiting researchers", aimed at mobilizing Russian scientists working abroad. This is a part of the Federal Target Program "Research and scientific-pedagogical staff of innovative Russia for 2009-2013". The Subprogram is providing funding for projects that are implemented by Russia's scientific teams on a competitive basis under the guidance of famous Russian scientists working abroad. Each year, approximately 100 two-year research projects will be selected, funding for which is 2 million rubles per year. Herewith, the Project Manager will spend two calendar months of the year in Russia. The objectives of this subprogram are: development of a sustainable and effective cooperation with the Russian scientists working abroad on a permanent and temporary basis, their involvement in the Russian science and education, implementation of their experience, skills and knowledge for the development of national systems of science, education and high technology.

As of 2009 results, it is decided to finance 110 projects, which are carried out in 84 Russian organizations. The distribution of project managers by countries has little difference from the projects of other tenders (in parameters): 60% - are scientists from the USA, Germany and France. This foreign scientists are quite respectable and, as a rule, keep permanent positions: 33% are professors, 25% are the Heads of Divisions, Departments and Laboratories. 52% of Project Managers have the second (Russian) citizenship. Thus, half of the participants have no visa problems, which facilitates the development of cooperation.

In 2010 it is planned to start another program on attracting foreign scientists, not only representatives of the Russian Diaspora, the idea of which is to finance the best foreign scientists willing to come to work to the Russian universities to carry out their research projects. Herewith, the application should be filed by the Russian university, which undertakes to create the best conditions for the foreign specialist in the project, in the framework of the tender there

[1] (or the same.) In the Phase of Activation. Young Scientists RAS are alerted// Poisk. No. 47. November 20, 2009. P. 9.

will be evaluated as the scientists themselves (by the number of publications and citations), as the application for funding prepared by them with the university. Experts should be both, Russian and authoritative foreign scientists, and the final decision will be made by a specially created committee, whose membership is approved by the Government. For the realization of this program it is expected to allocate about 12 billion rubles for 3 years (2010-2012).[1] Apparently, in the development of this program it was taken into account the available experience in the support of joint projects (for example, in the adjustments of evaluation criteria in regard to the invited specialists, as well as procedures for project assessment). Attention is drawn to the fact that the program would be applicable only to universities and foreign scientists wishing to work in any of the institutions of RAS, Russian Academy of Medical Sciences or scientific research institutes, will not be able to do so. Thus, the program clearly demonstrates the Government's commitment to supporting it is high school science.

In connection with the unfolding activities to attract the Russian diaspora, it is important to assess to what extent the scientists who left the country are ready for cooperation, in what forms, in their view, such cooperation should take place, as well as whether - and under what conditions - the return of those who left.

Exhaustive and unambiguous answers to the set up questions can not be obtained, because the scientific diaspora is very diverse. Intentions and estimates depend on age, the time of departure, the field of science. Nevertheless, some idea of what opinions of scientists who left the country on cooperation with Russia, what forms of cooperation are most attractive to them, can give the in-depth interviews with the members of Russia scientific diaspora. The information presented below is the result obtained on the basis of personal interviews of the author of this section with the Russian scientists working abroad, held in November 2008 and again in May 2009 in the U.S.[2]

Results of interviews indicate that in Russia attracts the diaspora representatives by an opportunity of communication, including friends and relatives, while other countries attract and retain basically in terms of social arrangement, and science as its integral part.

Unanimous negative assessments were given on two aspects - the organization of science in Russia and Russian state of society in general. Poor resource base, as well as low wages in the science, were mentioned not as often as the problem of its organization and the state of the Russian society in general. Bureaucratization of academic life is the factor that significantly reduces the optimism about the prospects of cooperation with representatives of the scientific diaspora. The level of bureaucracy for filing applications for project lots, procedures for generating tender documentation and reporting is so high that for the scientists working abroad, where the application for funding can be justified quite briefly and clearly, have no sufficient motivation to participate in the Russian tenders. Moreover, the understanding of the emigrants of bureaucracy and inflexibility of the scientific system in Russia is even incomplete in comparison with what actually expects them in connection with a possible visit to Russia for a short, or even more so for the long term of work. And these are serious problems, in particular, in connection with the peculiarities of the projects financed from national budget funds, with the is-

[1] Yu.Medvedev. Attractive million. Will the best scientists of the world go to the Russian universities//Rossiyskaya Gazeta. February 3, 2010. http://www.rg.ru/2010/02/03/nauka.html

[2] In-depth interviews were attended by scientists of natural sciences: physics, geologists, chemists, material experts, working in national laboratories in the U.S.. All respondents are men in the age from 35 to 60 years old. .

sues of integration in the existing hierarchical structure of the institutes and universities, with adaptation to the peculiarities of research management, etc.

At the same time, there are most powerful factors of attraction overseas - the system of social organization, children who grow up in another country and gradually forgetting the Russian language, the work to enjoy and very well paid. However, virtually any emigrant keeps up relations with Russia on an individual level, but all official cooperation is far more rare, and only few experts are involved in the Russian science.

The most common form of cooperation are joint projects, including with those experts who temporarily come to work to the United States and other countries. It is gradually beginning to develop such kind of interaction, as the expertise of projects under the order of the Russian entities (primarily RUSNANO), as well as foreign funds that have a program of support for the Russian science.

For Russian scientists living abroad, the most attractive in decreasing order of frequency of mentioning are the following forms of cooperation with Russia:

- trips to Russia for consultations and participation in conferences. This allows to combine specific research interests with an opportunity to visit the motherland;
- expertise (of scientific projects, public programs and plans, projects at the regional level), reviewing articles;
- joint projects with parallel performance thereof in Russia and abroad;
- lectures in the Russian universities;
- establishment of joint structures - departments in universities, laboratories in research institutions;
- arrival of Russian students in foreign laboratories in order to enable them to gain experience with modern equipment and an idea how differently can the science be organized.

The most popular are consulting and expertise. In the support of these activities there were cited arguments such as knowledge of immigrants of different systems (including Russian one), with all their strengths and shortcomings, and skills to work in those systems, as well as personal relations and direct contacts. However, gradually there develops such trend as the establishment of joint structures or the involvement of Russia in the advanced centers of leading scientists from the Russian diaspora. Under this scheme there was established a new Research and Education Center "Bionanophysics" based on Moscow Physics-Technical Institute (MPTI). More than 30 former Russian scientists agreed to take part in its activities. The concept of the center implies that each of its laboratories will work in close cooperation with foreign scientific institutions - leaders in their fields[1]. The remuneration for the young scientists is funded in the center at the expense of the Sub-program of support for the scientific and educational centers of the Federal Program "Scientific and scientific-pedagogical cadres of innovative Russia for 2009-2013", and the purchase of equipment is planned from the funds, transferred by MPTI upon the receipt of the status of a research university. A similar center, operates for several years on the basis of the Nizhny Novgorod State University,[2] but still, for the scale of Russia, this is a minimum.

[1] They don't let the stars to work / / Expert. No. 44. November 16, 2009.
[2] See fro details: Russian economy in 2007. Trends and Prospects. Issue 29. Moscow: IET, 2008. p. 445-446. .

In general, from the survey of the opinions of scientists living in Russia and abroad, we can conclude that both parties have incentives for cooperation and interaction on a rather pragmatic basis.

The success of government initiatives to attract foreign scientists and tutors will largely depend on the extent to which the bureaucratic barriers to cooperation will be removed. Thus, currently a contract with the foreign experts, invited to Russia by universities as professors can be concluded only for one year. Therefore, foreign scientists have annualy to undergo the procedure of dismissal and then reemployment, what takes time and makes the overall situation unstable.

The ideology of expanding the contacts should be formed at the level of organizations and universities and encouraged by the State as part of standard scientific environment. We need to start with small steps: to invite representatives of the scientific community as experts, to organize joint seminars, provide grants for travel to Russia, but not only in order to communicate with friends and relatives, but also to devote part of the trip, for example, lecturs to students and post-graduates. Given the growing problem of the quality of higher education, this measure is relevant.

In connection with the already being implemented program of joint projects, it should be noted that if the objective is the greatest contribution of foreign researchers in the development of the Russian system of education, science and high technology (that is the way it is formulated as one of the objectives of the subprogram), it would be useful to modify several terms of the program. In particular, it makes sense to oblige the visiting scientists to read a short course of lectures, to conduct several workshops, as well as to announce tenders on topics of relevant priority trends in of science and technology of the RF. Herewith, the task of "retention" of foreign researchers should not be the main purpose, because it deprives the event of flexibility. On the one hand, there may arise a pressure on the participants in the projects, which will repel, rather than attract them, and on the other hand, those who will stay, may be not only those who are needed for a long time. Ideally, for the two-year research projects there should not be the task of foreign investigators retention in Russia. Instead, the goal might be further development of scientific and other relations.

Finally, stimulating the circulation of personnel means also the expansion of Russian scientists ability to work and have probation abroad. The first step in this direction can be the financing of post-doctoral positions for the Russian researchers, interested to undergo three years of training in foreign laboratories of their compatriots and other foreign scientists.

4.4.5. Development of International Relations

Work to attract the diaspora representatives can be regarded as one of the aspects of the government international activities in science and technology. Meanwhile, one of the main trends in this area was the development of relations with the EU, in particular, the discussion of the conditions for Russia joining the 7-th EU Framework Program as an associate member.

There are grounds for Russia to become an associate member. Among the "third" countries, Russia has been the most successful member of the 6-th EU Framework Program and continues to lead in the 7-th Framework Program in terms of number of projects in which the country participates, and the amount of funding obtained by the Russian teams. By these indicators Russia is ahead of such countries as China, India and Brazil. However, in terms of industries, participation of Russia is irregular; the highest "presence" of Russia is noted in such areas as

sustainable development, global reforms and ecosystems, nanotechnology and nanoscience, as well as information communication technologies[1]. In the 7-th Framework Program similar trend persists (the most active participation of Russia is noted in such areas as ICT, nanoscience and environment). However, this statistics does not provide an answer to the question of economic feasibility of Russia entry into the 7-th Framework Program, as the volume of funds received as a result the won tenders may be lower than the financial contribution to the country as an associate member of the Program.

What are the advantages of an associate membership as compared with the status of the "third" country?

The first one is an opportunity to be the coordinator of projects, rather than just their party. However, in order to be able to perform the functions of the coordinator, in Russia there must be organizations (structures) that can work in compliance with the standards and rule of the EU, including financial, accounting, auditing, etc. Regulations. There is relevant infrastructure in Russia yet.

Second one is participation in all tenders of the Framework Program. For example, currently grants of the European Research Committee to independent scientists and grants to advanced researchers are provided only to the scientists-residents of the European Union and associated countries,[2] whereas such grants would be very helpful as a tool to attract the leading scientists, including our former compatriots.

However, the associate membership in the 7-th Framework Program does not allow to participate in identifying the topical areas of cooperation, what would be very important for Russia. Other countries, willing to become the associate members, have the goal of the subsequent entry into the EU. Therefore, associate membership in the Framework Program can be considered as one of the steps to achieve it. Russia has no such goal, and therefore, the issue of associate membership should be discussed in the context of reasonable economic benefits. From this point, the bilateral agreements and cooperation are equally important. The fact that Russian scientific teams can obtain, by participating in the Framework Program, the experience of modern project management, access to modern equipment and information, exchange of ideas, the ability to access the European markets with high-tech products - can be obtained in the framework of bilateral and multilateral cooperation.

Multilateral cooperation could potentially lead to a fundamentally new scientific findings as a result of a synergistic effect, however, bilateral relations are much easier for administration. It is no accident that the country-members of the Framework Program are allocating for its implementation significantly less funding than for the development of bilateral international scientific and technical relations. Thus, Russia's accession to the Framework Program as an associate member deserves support, but not to the detriment of other forms of cooperation.

In the situation of the budget reduction the programs of support to science and innovation, realized through foreign scientific foundations, which have their representative offices in Russia, become relevant again. Meanwhile, upon the adoption in June 2008 of the RF Government Decree No. 485 "On the List of international organizations receiving grants (free assistance) as a taxpayer, are not taxable and not excluded from the income for tax purposes for the Rus-

[1] According to the results for the 6-th Framework Program. *Source*: European Commission, FP6 Data, 2008.

[2] 7-th Framework Program for Research and Technological Development of the European Union. M., 2007. P. 8.

sian organizations - grant recipients", have lost their force in exempting the international organizations from income tax. Other international and foreign organizations-grantors addressed to the authorized agencies with an application for inclusion in the new List. By 2010, there were no new foreign organizations-grantors, whose payments were not taxable. As a result of delays with the approval of the List, from January 1, 2009 everything is subject to taxation, including payment of individual grantees and the purchase of equipment from the grant funds. Therefore, the conditions of foreign scientific foundations in Russia deteriorated, which led to the freezing of a number of programs, including innovative ones.

Thus, the benefits of international cooperation are not used to the full extent. At the governmental level, there is no clear position on the development of national priorities for science and innovation, and hence, the priorities for international cooperation, as well as coordinated inter-agency and intra-organizational and financial policies of international cooperation. There is no monitoring and assessment of international cooperation within the country. Actually, there is no information about the strengths and weaknesses of instruments and forms of cooperation.

In addition, international cooperation can not be developed outside the broader economic and political context, and its success depends on what conditions are created inside the country to carry out research activities. Among the important conditions are such provisions as the state of scientific equipment, the work on which would be attractive to foreign partners, the level of legislation elaboration in terms of intellectual property rights, working conditions of foreign organizations and scientists coming to work to the country. The failure to resolve all those issues limit the scope and form of international scientific cooperation.

4.4.6. Support to Small Innovative Enterprises and Innovation Infrastructure

Increased attention to the supporting of small innovative business and related technological infrastructure was due to the fact that small firms were, first, the least protected elements of the innovation system in crisis situation, and, secondly, a small business is regarded as one of the most important "intermediaries" of the transfer of knowledge and transformation of enterprises into new products and technologies. It should be noted that the second provision is only partly true, because in the absence of large high-tech companies the support to small businesses will have a relatively low efficiency, either because small firms usually work on outsourcing, or they are buying big companies, or they die. The transformation of small firms in the medium and large ones is a relatively rare phenomenon. In other words, support to small firms cannot be the basis for the development of large business.

In a crisis situation, the problems associated with the mechanisms of support for small innovative entrepreneurship get aggravated. First, the government's attention was drawn to the inconsistency between the organizational and legal form of the basic national Fund supporting small innovative companies - the Foundation for Assistance to Small Innovative Enterprises in Science and Technology (Assistance Fund) to the norms of the Civil and the Budget Codes.

Secondly, new technological infrastructure did not start to work to full extent (technical-promotional zones (TIZ), technology parks), and in late 2009 there was started interagency transfer of responsibility for its development.

Currently the Assistance Fund is guided in its activities the Fund Regulations,[1] according to which it is a public non-profit organization, without specifying the organizational and legal form. On the one hand, it gives the Fund a certain freedom of action. On the other hand, it brings the Assistance Fund outside the norms of the Civil and Budget Codes. The Fund is the manager of budgetary funds, but according to the Budget Code (Article 38.1 "The principle of departmental distribution of the budgets expenditures"), it can allocate funds only to those organizations that are under its supervision. Assistance Fund has no subordinate organizations and allocates funds for R&D on the basis of tenders, making contracts (under the Federal Act No. 94-FZ of July 21, 2005 "On Procurement of goods, works and services for national and municipal needs ") with the winning organizations, regardless of their affiliation.

Nevertheless, the activities of public funds support for science and innovation (primarily in regard to the Russian Fund of Federal Property (RFFI) and Russian Government National Fund (RGNF) was legitimate because federal law No. 63-FZ of April 26, 2007 "On Amendments to the Budget Code of Russian Federation in terms of regulating the budgetary process and bringing in line with the budget legislation of the RF some legal acts of the Russian Federation" gave them a deferral until January 1, 2010 to bring the documents in compliance. Strictly speaking, The Assistance Fund was not affected by those provisions, but acting on the basis of its Regulations which does not specify, if the Fund is a budgetary or autonomous agency, or acts in any other legal-organizational form, it is found within the area of regulatory uncertainty and hence risk.

In this situation there are several possible solutions.

First choice: Assistance Fund can be converted into an autonomous institution. On the one hand, it removes an obstacle in the form of requirements to allocate funds only to subordinate organizations and makes it possible to receive funds from the federal budget subsidies. On the other hand, autonomous institutions can not be the main managers of budgetary funds, and because in this case the Fund is deprived of a separate budget line and would receive funding indirectly, through the ministry or department. Accordingly, it would be difficult to guarantee the preservation of the Fund's current standard of funding (1.5% of budget allocations for civilian science). This is especially true in view of the economic crisis, as the legal basis of autonomous institutions functioning is not well developed. Subsidies, with help of which autonomous institutions are financed are vulnerable budget lines and can be cut down in the first place.

The second option would be to amend the Budget Code, namely the provisions which gave special status to the Fund, and allow it to be the main manager of budgetary funds and allocate these funds through grants. Permission to the Assistance Fund to fund R&D through grants, rather than under the law on public procurement would simplify many of the procedural aspects.

The third option is an extension of the current statuses of funds, but that is not a solution of the issue. However, namely this way was chosen, and at the end of December 2009 the Federal Act was adopted to extend for another year the existing procedure for financial support through grants and budgetary subsidies.[2]

[1] Regulations of the Assistance Fund to Small Innovative Enterprises in science and technology (approved by the RF Government No.65 dated February 3, 1994) (as amended on January 5, 12 December 1995, March 6, 1996, 31 March 1998.).

[2] Federal Law No. 314-FZ of December 17, 2009 "On Amendments to Certain Legal Acts of Russia in connection with the federal law" On federal budget for 2010 and the planned period for 2011 and 2012".

Technology infrastructure, which was developing in the form of special projects since 2006 - IT Parks in nine regions of the country, as well as four technology-innovative zones - has proved to be so ineffective that the management of those projects was transferred to the new agencies. Federal Agency for Management of Special Economic Zones (RusSEZ) was dissolved and its powers transferred to the Ministry of Economic Development. Herewith, the changes were quite unexpected, with no public justification, in fact carried out without prior arrangement. The situation with IT parks is similar - apparently, this program will be transferred from Ministry of Communications to the Ministry of Economic Development.[1] In regard to Technical Innovation Zones it was noted that the general economic climate is so unfavorable for innovation, that the creation of "closed zones" is unable to change the conditions for innovation. In addition, zone residents have no tangible economic incentives to be engaged in technological innovation.

At the same time in the field of legal regulation and the formation of a new financial infrastructure to support small innovative businesses, especially those in the starting stage, there have been some changes that can be estimated positively.

One of the major changes is the adoption in August 2009 a new Federal law,[2] under which the budgetary academic institutions, including the state academies of science, as well as universities, non-budgetary institutions, by the notification procedure can become the founders of business entities, created for commercialization of intellectual activity. Despite the existence of various risks and serious shortcomings, including gaps between the Act and the Budget and Tax codes, its adoption should contribute to the growth sector of small innovative enterprises.

As a contribution to the authorized capitals of small firms, agencies can transfer to them the rights for the objects of intellectual property. The adoption of this Law is successfully completed with new rules on limited liability companies (LLCs).[3] According the entered into force on July 1, 2009 new edition of the Law on LLCs allowed to make contributions to the authorized capital in the form of property rights.

The measures provided by the Federal Law № 217-FZ, should create incentives for the development of small innovative businesses. However, meanwhile their practical implementation is complicated by inconsistency with a number of other existing regulations and established accounting practice of intellectual property (incomplete registration of intellectual property, registration of undervalued property).

1. Only the right to use to intellectual property can be transferred to the authorized capital, rather than the exclusive rights. Newly established companies cannot grant license rights for the results of intellectual activities to the third parties. This limits the ability of companies in business structuring, including the placement of production at existing production areas, belonging to third parties.[4] This provision also allows research institutes and universities to establish multiple companies, which will have right to use the same results of intellectual activity.

[1] Technology parks have replaced their profile / / Kommersant. No. 225. December 2, 2009, P. 13.
[2] Federal Law No.217-FZ of August 2, 2009 "On Amendments to Certain Legislative Acts of Russia on a budget research and educational institutions, business entities working for practical application (implementation) of the results of intellectual activity".
[3] The relevant changes were introduced by the Federal Law No.312-FZ of December 30, 2008 "On Amendments to the first part of the Civil Code of Russia and some legislative acts of Russia".
[4] Innovations in Russia: legal challenges and legislative initiatives. Salans LLP. 2009.

2. The difficulty is in identifying those objects of intellectual property, for which research institutes and universities have exclusive rights. Many developments were created through the budget funds and the allocation of rights in this case is not always clearly defined in contracts. There arise some problems in the system RAS concerning the origin of intellectual property rights: they can be claimed by both, a scientific institution - the establishment of RAS, and by RAS itself.

3. According to the Law, the share of the institution in the authorized capital should be at least 25% in joint stock companies and at least one third in the LLC. This limits the development of partnership projects between research institutes and universities, where a number budget-funded agencies jointly establish a small business, because then the investor's share will be below 50%, which is unlikely to be acceptable to it.

The problem is also, where will be located and under what conditions will operate the created small firms. There is insufficient vacant space in the existing incubators and industrial parks, and the development of conditions for granting them a beneficial rent is only started. In this case, it should be noted that the government has reacted to this problem promptly, and is currently reviewing proposals of the RF Ministry of Education and Science to introduce benefits for the rent for small innovative enterprises, created by scientific and educational institutions. Under those rules in the first year there will be paid 40% of the market value of the rented premises, in the second year - 60% and in the third year - 80%.

In addition, the Ministry of Education and Science plans to hold two tenders to support the innovation infrastructure of the leading universities of Russia. In the framework of the first tender it is expected to implement a three-year program of infrastructure in 50-60 universities (business incubators, technology parks, etc.), legal protection of intellectual property, as well as advanced personnel training in the field of innovation. Herewith, among the selection criteria will be the number of established of small businesses in the university under Federal law No. 217-FZ. The second tender is aimed at supporting business entities through the provision of additional subsidies. Each business entity, established with the university under the Federal Law N. 217FZ, will be able to obtain on a competitive basis up to 100 million rubles per year from federal funds in case of 100% cost sharing.[1] In general, the Ministry of Education and Science pays special attention to the Federal Law No. 217, and even going to assess the effectiveness of scientific and educational activities of budgetary institutions, created by small innovative firms.[2] The Assistance Fund, also participates in the support of established scientific institutions and business entities through the program START for special financing of small businesses, created by the Federal Law N0. 217.

With this "attention" from the federal government, universities have begun actively to create small businesses. By the end of 2009, from 364 high schools, administered by the Federal Agency of Education, 44 have established 116 business entities with 881 workstations[3]. It takes only a few days to register a small business, so the real impact is yet to come - namely, how long the established small businesses will survive and how well they will work.

[1] Ministry of Education is preparing two new tenders for high schools.
http://www.strf.ru/material.aspx?d_no=26704&CatalogId=223&print=1 January 15, 2010.
[2] 217-FZ: the law is adopted, but is it working? http://strf.ru/organization.aspx?CatalogId=221&d_no=25423 November 19, 2009.
[3] Innovations in higher education: sluggish mode.
http://www.strf.ru/material.aspx?d_no=26759&CatalogId=223&print=1 January 18, 2010.

Another positive development can be seen in the changes taking place throughout the year in the Russian Venture Company (RVC). It has gone from nearly a closure (because of the placement of free funds on deposit at the banks, what was classified by the General Prosecutor's Office as the gross violations and ineffective use of public funds[1]) to the development of a new performance strategy and establishment of Seed Stock.

RVC was also accused of inflating their expenses for administration in 2008. RUSNANO state corporation was blamed for the same failure in late 2009. According to the results of audits, the state corporation received 130 billion rubles, spent only 10 billion, of which 5 billion rubles of them were spent for its own activities.[2] There are many ways to interpret what happened. On the one hand, it is to some extent a lack of understanding on the part of auditing authorities of the specifics of those structures, which cannot and should not spend all funding as soon as possible. On the other hand, it is the result of the slow unfolding of the work and indeed its low efficiency in terms of organization and management.

The RVC Head was replaced, and the Head brought a new concept of the fund operation, based on good understanding of the problems and deficiencies of the established innovation infrastructure, which primarily include the lack of commercial potential of projects and skilled teams, interest in the origin of intellectual property rights, the lack of qualitative technology and business expertise, strategic investors, as well as the lack of service organizations (consulting, legal and others).[3]

In order to partially compensate for the above failures, RVC made a strategic decision to establish the Investment Fund of Seed Stock. The Fund establishment in the form of limited liability company with capitalization of 2 billion rubles was made in late November 2009. Investment in projects on the part of the Fund will not exceed 75% of project cost. Herewith, RVC expects to receive a 25% share in the financed venture project. It is expected that within 2-3 years there will be funded 80 start-ups. A notable feature of the new fund organization is that the selection of projects and presentation thereof the RVC Investment Committee will be implemented through a system of the so-called venture partners, i.e. organizations which will seek and "package" the projects. To become a venture partner, one has to meet a number of not very difficult conditions, but if after a year of work the venture partners are not be able to submit projects for consideration, it will be deprived of that status. This approach is quite reasonable from two perspectives. First, the RVC takes off the burden of the direct search for projects, negotiations with their authors, and secondly, through the system of venture partners, potentially there could be built a system of intermediary companies, qualified teams, which are currently very few.

In general, this direction of innovation support can be effective in the long run, if it results in creation of a reserve for new products and technologies, serving as a basis for favorable conditions for overcoming the crisis and the further innovation development.

However, when speaking about the development of venture capital industry in general, it should be noted that in the absence of the stock market and large high-tech companies, an ex-

[1] Prosecutor General's Office proposes to suspend the activities of RVC..
http://strf.ru/material.aspx?d_no=17999&CatalogId=221&print=1 February 26, 2009.
[2] Public corporations simply do not fit in the "shady' economy.
http://www.strf.ru/organization.aspx?CatalogId=221&d_no=25258 November 12, 2009.
[3] Igor Agamirzyan. Three priorities in development.
http://strf.ru/material.aspx?d_no=23349&CatalogId=223&print=1 August 31, 2009.

cessive focus on the creation of numerous venture capital funds in financing the high-tech projects will not be efficient. According to the RADVI (Russian Association for Direct and Venture Investments), the majority of created in the country most venture capital funds (today there are 155 of them) are primarily the funds of direct investments. They invest in late stages of consumer market development, and investment in IPO (initial offering of shares in the market) is statistically close to zero.

4.4.7. Tax Incentives for R&D Development

Measures of tax incentives for innovation were actively introduced in 2007-2008, and in 2009 the government was paying close attention to this trend of innovation policy.

In 2009 an amendment was introduced, providing a possibility of recognition for certain single R&D expenditures, including effect less, and their writing-off by 1.5 index. The introduction of writing-off standard for R & D by a specified index is a progressive step at first glance. However, the effect of this measure may be lower than in developed countries. Overseas there is a progressive income tax rate, and reducing the tax base also reduces the tax rate. However, this exemption is applied only to certain types of R&D, the list which is approved by a special government decree.[1] It consists of 32 advanced technologies. At the same time, the list does not include research and development works aimed at developing technologies in traditional industries, what hinders them in innovative activity. In general, this measure could cause problems for tax administration and increase the risks of abuse on the part of taxpayers and tax authorities.

Another measure is the exemption of the grant recipients, including two government research funds - Russian Fund of Federal Property (RFFP) and Russian Humanitarian Science Foundation (RFSF), from income tax[2]. In the situation of sequester of the amount of grants for innovative projects this measure can be regarded as a partial compensation for losses. However, the absurdity of the situation lies in the fact that there is no term "grant" in the Minutes of Association of public research Funds, so they can not apply this regulation .

In general, tax incentives for innovation activity is developed and becomes more diverse. However, a number of problems in tax regulation are more clearly revealed.

First, often imposed measures are inconsistent with other rules and regulations, therefore, they are either immediately become ineffective or rarely used by the taxpayers. Secondly, the terms and conditions of tax benefits applicability are set worded in the legislation so that allow various interpretations. To clarify the rules for the use of benefits and the interpretation of the law, the RF Ministry of Finance regularly publishes letters, but they do not always provide an unambiguous interpretation. This is one reason why experts give restrained and critical assessments of recently introduced measures: the rules of applicable benefits are ambiguous and open ways to different interpretations, and therefore, there is arbitrariness in their application and administration.

[1] The RF Government Resolution No. 988 of December 24, 2008 "On approval of the list of scientific research and experimental developments, the expenses of the taxpayers for which, in accordance with Paragraph 2 of Article 262 of the Tax Code of the Russian Federation are included in other expenses in the amount of actual costs with coefficient of 1.5".

[2] The RF Government Resolution No. 602 of July 15, 2009 "On approval of the list of Russian organizations, on taxpayer's grants (subsidies), provided to support science, education, culture and art in Russia, which are not taxable".

Third, the "privileged" groups (organizations, products), in respect of which certain tax incentives are applied are often ignored in the norms of general tax regulations, which nullifies the provided benefits. A typical example is the support of small innovative businesses, which enjoys the priority attention on the part of the state. On the one hand, there are permanent discussions of the tools for the support and promote innovation of small businesses, a variety of measures aimed at reducing their tax burden are proposed. Thus, currently the issue is under discussion of canceling some restrictions for organizations wishing to apply the simplified taxation system, including the following measures:

1) to increase the upper threshold of annual income for eligibility to use the right for simplified taxation system to the innovative small businesses, to 200 million rubles;
2) to remove restrictions for the subjective part of founders, shareholders, scientific organizations and innovative companies;
3) to reduce the tax rate to all the innovation of small businesses from 6 to 3% for the simplified tax system, if the object of taxation is the total income, and from 15 to 5%, if the object of taxation is income, reduced by the amount of costs;
4) To provide an open list of deductible expenses for those taxpayers who use the system of "income minus expenses".[1]

On the other hand, from January 1, 2010, the Federal Law No. 212-FZ of July 24, 2009 came into force "On the insurance premiums to the Pension Fund of Russia, Social Insurance Fund of Russia, the Federal Fund for Mandatory Medical Insurance and territorial funds of obligatory health insurance, according to which from January 1, 2010 the unified social tax is replaced by insurance premiums to the Pension Fund of Russia, Social Insurance Fund of Russia, the Federal Fund for Mandatory Medical Insurance and territorial funds of obligatory medical insurance. At the same time, in 2010, the rates will remain the same, but from 2011 they will be increased so that the tax burden on businesses using the simplified taxation system will grow by 2.4 times. Therefore, the discussed and introduced tax incentives for small innovative companies can be nullified by changes in the basic system of taxation of enterprises.

* * *

The crisis has aggravated the existing problems in the field of scientific innovation. Public funding, which is the main source of support to scientific research is getting reduced, while business has also reduced its expenses for R&D. The established development institutions are unable to cover the gaps, as the mechanisms of their work are far from perfect, the overall environment for innovation promotion, is underdeveloped. This situation is partly due to the imbalance of public policies. In general, specific measures to counter fight the crisis have not been adopted, and developed primarily through the available tools. New measures, introduced or proposed in 2009 - the establishment of research institutes and university status through the merger of organizations, permission to research institutes and universities to create small innovative enterprises, introduction of a new list of priorities, development of measures of "coercion" for business to participate in innovation activities cannot be regarded as crisis-counter fighting.

Herewith, government authorities expect and even demand too quick feedback from the new measures, and such pressure is likely to adversely affect the field of science and innova-

[1] State Duma proposes to cut down taxes for innovative small businesses. October 25, 2009. http://www.bashinform.ru/news/220910/

tion. In addition, a major obstacle in the implementation of the adopted measures is that during their development the prevailing legal regulations were disregarded in regard to both, the sphere of innovation, as well as the relations outside its scope. Therefore, being theoretically promising and significant, those measures can not provide a the rapid positive effect in the near future.

The nature of the majority of the new measures indicates, that the decision-making process is increasingly based on the direct government interference in the innovation sector, whereas a number of approaches resembles the Soviet practice of "management". Meanwhile, government policy should be based on participation in the creation and dissemination of various incentives, forming a fair competitive environment, increasing the degree of freedom for the participants of the innovation system and encouraging cooperation and collaboration between them, rather than on direct interference. Important principles of government policy, which are currently omitted or insufficiently implemented are the maximum publicity in the preparation and implementation of new projects and initiatives, consistency of actions, account for the possible negative effects of new initiatives and measures to address them.

Chapter 5. Institutional Problem

5.1. Property relations and the role of the public sector and privatization

5.1.1. The size, integral components and main features of the public sector

Last year the Russian economy developed in a crisis situation, and this resulted in a delay in passing a successive privatization program. In 2009 this document was approved as late as the end of November while during six previous years privatization programs were usually approved late summer – early autumn[1].

The Forecast privatization plan (program) of federal property for 2010 and the main trends of federal property privatization for 2011 and 2012 approved by the respective Resolution of the RF Government of November 30, 2009 No 1805-r, as the previous similar documents contained data on the number of unitary enterprises in federal ownership (FGUPs) and joint-stock companies with the share of the Russian Federation in their capital at the beginning of the calendar year only. Therefore we do not have sufficient information yet to assess objectively the dynamics of these components of the public sector in 2009. Let us review in detail the changes that occurred in the key categories of the business entities in federal ownership.

Federal government unitary enterprises

Dynamics and the sector structure of FGUPs in 2004 – 2008 are tabled below. In 2008 the total number of unitary enterprises in federal ownership reduced by 1/3 (almost 2,000 enterprises) and amounted to 3.8 thousand entities by early 2009. Such reduction of the sector was the largest one during recent years (for comparison: the number of the unitary enterprises reduced by 1/% or by less than 1,500 from June 1, 2006 to January 1, 2008).

Table 1

Dynamics and the sector structure of the federal government unitary enterprises in 2005 – 2008

Sector	As of June 1, 2005		As of June 1, 2006		As of January 1, 2007		As of January 1, 2008.		As of January 1, 2009	
	units	%	units	%	units	%	units	%	units	%
Non-productive sectors	3617	43,6	1817	25,3	1670	25,6	1151	20,2	988	26,25
Industry	1870	22,55	1624	22,6	1539	23,55	1744*	30,5	476	12,65
Agriculture	1111	13,4	913	12,7	826	12,65	618	10,8	611	16,2
Construction	903	10,9	752	10,5	668	10,2	…	…	300	8,0
Transport & Communications	725	8,75	612	8,55	536	8,2	409	7,2	249	6,6
Forestry	67	0,8	53	0,75	49	0,75	37	0,65	…	…
Other sectors	–	–	1407	19,6	1245	19,05	1750	30,65	1141	30,3
Total	8293	100,0	7178	100,0	6533	100,0	5709	100,0	3765	100,0

* –industry plus construction .

Source: 2006 Forecast plan (program) of federal property privatization and the main trends of federal property privatization for 2006 – 2008; 2007 Forecast plan (program) of federal property privatization and the main trends of federal property privatization for 2007–2009; 2008 Forecast plan (program) of federal property privatization and the main trends of federal property privatization for 2008 – 2010; 2009 Forecast plan (program) of federal property privatization and the main trends of federal property privatization for 2010 and 2011; 2010 Forecast plan (program) of federal property privatization and the main trends of federal property privatization for 2011 and 2012; calculations made by the authors.

[1] The Forecast plan (program) of federal property privatization for 2008 was the only exception as well the main trends of development of federal property privatization for 2008 – 2010 approved in spring 2007.

Early 2009 the enterprises in the category of "other sectors" that were not included in the base classification (30.3% of the total number of FGUPs) remained the most numerous category in the FGUP sector structure. The non-productive sectors (26.3%), agriculture (16.2%) and industry (12.7%) were largely represented; 8% of FGUPs represented construction and 6.6% - transport and communications.

In 2008 a sharp decline of the absolute number and share of enterprises in the industry and construction manifested a major trend of changes in the FGUP sector structure. If early 2008 30.5% of the federal unitary enterprises were in the industry and construction, a year after this figure dropped to 20.7%. The reduction of the share of the transport and communications sector was insufficient: from 7.2% down to 6.6%. The specific weight of the non-productive sector and agriculture increased by 5-6 per cent points.

The dynamics of FGUPs number by sectors illustrates well the size of the shift in the FGUP sector structure. Thus, for two years between January 1, 2007 and January 1, 2009[1] the absolute number of the unitary enterprises in the industry reduced by 3.2 times, in the construction, transport and communications sectors by 2.2 times while in the non-productive sectors by 1.7 times, in agriculture – by 1.35 times and in other sectors (outside the base classification) by 1.1 times.

Joint-stock companies (JSC) in federal ownership

It is worth noticing that by early 2009 the number of JSC which shares were owned by the federal government reduced by more than 9% (or by 337 companies) vs early 2008; thus their number was 3,3337 companies which is the lowest figure for the entire period 1999 to 2008.

Now let us review the dynamics of the number of JSC which shares were owned by the federal government for the last years, by sectors (see *Table 2*).

Table 2

Dynamics and sector structure of the joint-stock companies which shares are in federal ownership or in relation to which a special "golden share" right is used, in 2005 through 2008

Sector	As of June 1, 2005		As of June 1, 2006		As of January 1, 2007		As of January 1, 2008		As of January 1, 2009	
	unit	%	unit	%	unit	%	unit	%	unit	%
Non-productive sectors	685	18,1	356	9,6	405	10,1	638	17,4	383	11,5
Industry	2078	54,9	1772	47,6	1797	44,95	1878*	51,1	1583	47,45
Agriculture	287	7,6	380	10,2	404	10,1	…	…	234	7,0
Construction	459	12,1	396	10,6	353	8,9	397	10,8	280	8,4
Transport & Communications	229	6,1	363	9,7	534	13,35	761	20,7	522	15,65
Forestry	45	1,2	99	2,7	88	2,2	–	–	…	…
Other sectors	–	–	358	9,6	416	10,4	–	–	335	10,0
Total	3783	100,0	3724	100,0	3997	100,0	3674	100,0	3337	100,0

* – including industry and construction (695 units or 18.9%), fuel and energy complex (597 units or 16.25%) and military industrial complex (586 units or 15.95%).

Source: 2006 Forecast plan (program) of federal property privatization and the main trends of federal property privatization for 2006 – 2008; 2007 Forecast plan (program) of federal property privatization and the main trends of federal property privatization for 2007–2009; 2008 Forecast plan (program) of federal property privatization and the main trends of federal property privatization for 2008 – 2010; 2009 Forecast plan (program) of federal property privatization and the main trends of federal property privatization for 2010 and 2011; 2010

[1] The selection of the two-year interval between January 1, 2007 and January 1, 2009 was justified by that early 2008 the industry and construction were quite pronounced in the FGUP sector structure; this impedes making correct comparison of the FGUP structure as of early 2008 and early 2009. Besides in the 2009 data forestry is not segregated.

Forecast plan (program) of federal property privatization and the main trends of federal property privatization for 2011 and 2012; calculations made by the authors.

As of the beginning of 2009, in the JSC sector structure (federally owned) the largest weight was that of industrial enterprises (about 47.5% pf all the JSC). The industry was followed by agriculture (15.7%), non-productive sectors (11.5%) and other sectors (10%). The total weight of the construction, transport and communications sectors was less than 10%.

While speaking about changes in the JSC sector structure which shares are federally owned, one can notice a pronounced increase of the share of industry and agriculture (2.5 and 2.4 per cent points accordingly) in 2007-2008.[1] . The specific weight of the non-productive sectors was somewhat less pronounced (by 1.4) while the share of construction, transport and communications, and other sectors in the general JSC structure with federally owned stocks decreased; mostly in construction (by more than 3 points).

Distribution of JSC with the state participation depending on the federally owned share is another important feature of such JSC (*Table 3*).

Table 3

Dynamics and the structure of joint-stock companies with the government participation in 1999 – 2008 (including the use of the "golden share" right) with account of the government share size

Date	Total		by 25%		25 to 50%		50 to 100 %		100%		«Golden share»	
	unit	%	unit	%	unit	%	unit	%	unit	%	total	No shares
1999 г.	3316/ 3896*	100	863	26,0	1601	48,3	470	14,2	382	11,5	580 **	
January1, 2001	3524***	100	1746	49,55	1211	34,4	506	14,35	61	1,7	…	…
August 2001	3949 ****	100	1843	46,7	1393	35,3	625	15,8	88	2,2	542**	
January 1, 2002	4407	100	2270	51,5	1401	31,8	646	14,65	90	2,05	750**	
January 1, 2003	4222 *****	100	2152	51,0	1382	32,7	589	13,95	99	2,35	1076	118
June 1, 2003	4205	100	2148	51,1	1339	31,8	600	14,3	118	2,8	…	…
October 1, 2003	4035	100	2051	50,8	1308	32,4	552	13,7	124	3,1	640	148
January 1, 2004	3704	100	1769	47,75	1235	33,35	540	14,6	160	4,3	591	251
June 1, 2004	3905	100	1950	49,9	1183	30,3	499	12,8	273	7,0	…	…
March 1, 2005	4075/ 3791#	100	1697	44,8	1154	30,4	487	12,85	453	11,95	…	284
June 1, 2005	3783/ 3524##	100	1544	43,8	1093	31,0	474	13,5	413	11,7	…	259
June 1, 2006	3724/ 3481##	100	1063	30,5	885	25,4	397	11,4	1136	32,6	…	243
January 1, 2007	3997/ 3816##	100	932	24,4	814	21,3	368	9,6	1702	44,6	…	181
January 1, 2008	3674	100	771	21,0	645	17,6	269	7,3	1989	54,1	…	…
January 1, 2009	3337	100	769	23,0	510	15,3	200	6,0	1858	55,7	…	…

* – The Concept of management of the state property and privatization in 1999 mentions 3,896 business entities (including 3611 OJSC, 251 CJSC and 34 LTD and LLC), in which capital the federal government participates. 3316 units is an estimate and a result of summarizing the blocks of shares of various size mentioned in the Concept;

[1] The selection of the two-year interval between January 1, 2007 and January 1, 2009 was justified by that at the beginning of 2008 in the JSC sector structure (with federal ownership of stocks) the group of other sectors was absent; at the same time the industry and construction (jointly), fuel and energy complex and military industrial complex were quite marked. This makes difficult reasonable comparison pf the JSC structure with federal blocks of stocks as of early 2008 and early 2009. Besides forestry ceased being shown separately after 2007.

** – total number of JSC using the "golden share" special right; JSC with no government share are no shown separately;
*** – JSC without consideration of 48 interests and blocks of shares in foreign companies; data are available that Russia owns 119 interests, shares and blocks of shares in foreign companies which book value is $1.4 bln;
**** – the data from the draft Privatization program for 2002 presented by federal Ministry of Property to the federal government; according to the data of the Ministry of Property Register, 4308 blocks of JSC shares were federally owned as of September 1, 2001;
***** – only open joint-stock companies with no account of 118 OJSC where the special "golden share" right was used (no shares available), blocks of shares of 102 JSC transferred to FGUP Rosspirtprom for operational management , 75 CJSC and interests in the LLC charter capitals, transferred by the RF Government Regulation of April 2, 2002 No 454-r "On the termination of state participation in the charter capitals of credit organizations" or received in the form of succession, gift or on other grounds;
3791 units is an estimated number of JSC which shares are federally owned, with no account of 284 JSC where the special "golden share" right is used (with no block of shares available). The weight of a JSC with a particular share in the capital for comparison with the previous period data is calculated based on this number. For reference: as of January 1, 2005, the shares of 3767 JSC were federally owned not considering the above 284 JSC with the "golden share" and interests in the charter capitals of 24 LLC companies transferred to the treasury following the RF Government Regulation of April 2, 2002 No 454-r "On the termination of state participation in the charter capitals of credit organizations" ;
– the calculated number of JSC which shares are federally owned; with no account of the JSC where the special "golden share" right is used. The weight of a JSC with a particular share in the capital for comparison with the previous period data is calculated based on this number.
Source: www.mgi.ru; Russian economy in 2001. Trends and prospects (Edition 23) Vol. 2 M, IEPP, March 2002, p. 62; A. A. Braverman. On measures to improve efficiency of federal property management and the criteria of its evaluation. //Bulletin of the Ministry of Property of Russia. 2003. No 1, p. 13-14. Enterprises with the state participation. Institutional and legal aspects and economic efficiency. Series "Scientific reports: independent economic analysis. № 155. M.: Moscow Public Research Foundation.; Association of Researchers of the public sector economy, 2004, p. 47; 2004 Federal Property Privatization Program and main trends of federal property privatization by 2006// Bulletin of the Ministry of Property of Russia. 2003. No 3. p. 4–5. Key problems of improving management efficiency of federal property and main directions of the dividend policy of the Russian federation// Bulletin of the Ministry of Property of Russia. 2003. No 4. p. 8; V, Andrianov. Russia in global economy// Society and Economy 2003, No 11, p. 84;; 2005 Federal Property Privatization Program// Materials for the RF Government meeting on March 17, 2005 "On measures to improve management efficiency of federal property; 2006 Forecast plan (program) of federal property privatization and the main trends of federal property privatization for 2006 – 2008; 2007 Forecast plan (program) of federal property privatization and the main trends of federal property privatization for 2007–2009; 2008 Forecast plan (program) of federal property privatization and the main trends of federal property privatization for 2008 – 2010; 2009 Forecast plan (program) of federal property privatization and the main trends of federal property privatization for 2010 and 2011; 2010 Forecast plan (program) of federal property privatization and the main trends of federal property privatization for 2011 and 2012; calculations made by the authors.
The number of the FGUPs to be incorporated has been constantly growing, however the mid-2005 trend of increasing share of blocks of shares that would help the government to exercise a full-fledged corporate control due to a sharp growth of the number of full (100% shares) blocks ceased gradually and did not developed further in 2008.

As of January 1, 2009, likewise early 2008, the government was able to exercise a majority or complete control in more than 61% of all the companies. The share of the minority stakes (up to 25% of the capital) has been growing in the overall structure of the federally owned stocks while the share of blocking (25% to 50%) or majority stakes (over 50% but under 100%) was decreasing.

The absolute number of minority stakes in federal ownership has changed insignificantly while the number of blocking and majority stakes reduced obviously: by more than 1/5 and ¼ accordingly. This trend affected the full stakes to a lesser degree and the number of full stakes reduced by 6.5%.

Rosstat monitoring is another source of data about the growth of the public sector[1]. According to Rosstat, the growth dynamics of business entities in 2008 and in 1H of 2009 developed as follows (*Table 4*).

Table 4

Number of enterprises in the public sector of economy registered by territorial divisions of the Federal Property Management Agency and the Property Management Agencies of the RF subjects in 2008 – 2009

Date	Total*	GUPs -State unitary enterprises- including treasury enterprises	Government agencies	Business entities which charter capital has over 50% of shares in	
				federal ownership	in ownership of business entities that operate in the public sector of economy
As of January 1, 2008	80570	10598	64440	4111	1410
As of July 1, 2008	77461**	9864	62571	3930	1089
As of January 1, 2009	75878**	9144	61831	3795	1101
As of July 1, 2009	77082**	8706	63019	4007	1350

* – including organizations which foundation documents after registration in government authorities do not specify types of activities, but excluding joint-stock companies in which more than 50% of shares (stakes) are in joint federal and foreign ownership; the total number of public sector entities can exceed the number of GUPs, institutions and business entities;

** – federal property is registered under Resolution of the RF Government of July 16, 2007 No 447 "On improvement of registration of federal property";

Source: On the development of the public sector of economy of the Russian Federation in 2007. M., ROSSTAT, 2008, p. 123. On the development of the public sector of economy of the Russian Federation in 1H 2008, M., ROSSTAT, 2008, p. 87; On the development of the public sector of economy of the Russian Federation in 2008. M., ROSSTAT, 2009, p. 7.; On the development of the public sector of economy of the Russian Federation in 1H 2009. M., ROSSTAT, 2009, p. 7.

In general the number of organizations of the public sector of economy decreased by 5.8% in 2008; however in 1H 2008 it grew by 1.6%. As a result, as of mid-2009 this number roughly corresponded to the similar indicator a year ago – July 1, 2008.

The development dynamics varies by different sub-sectors of the public sector. The number of state unitary enterprises was going down (a stable trend): in 2008 – by 13.7%, in January-June 2009 – by 4.8% (for the year and a half - by 17.9%).

At the same time the number of state enterprises having reduced by 4% in 2008 grew up by 1.9% in 1H 2009. Those business entities in which charter capital more than 50% shares (stakes) are owned by the government demonstrated a similar trend. In 2008 this figure went down by 7.7% while in January-June 2009 it went up by 5.6%. In 2008 the number of business entities in which charter capital more than 50% shares (stakes) are owned by the public business entities dropped most dramatically as compared to other categories of companies in the public sector (almost by 22%), however in 1H 2009 it went up also dramatically by 22.6%.

[1] According to Resolution of the RF Government of January 4, 1999 No 1, Rosstat includes the following business entities of the federal and regional levels: (1) state unitary enterprises under the right of operating and economic control; (2) state institutions; (3) business entities which charter capital has over 50% (stakes) in federal ownership; (4) business entities which charter capital has over 50% of shares (stakes) in the ownership of business entities in the public sector.

5.1.2. Mid-term privatization plans

While considering the Forecast plan (program) of federal property privatization for 2010 and the main trends of federal property privatization for 2011 and 2012 approved by RF Government Resolution of November 30, 2009, No 1805-r, certain variations from the similar documents of the previous years can be noted.

Primarily this relates to the financial and economic crisis situation where a regular privatization program was approved.

The Program did not appear by the end of summer thus breaking the established tradition, and autumn announcements by the competent Russian officials of the possibility to expand 2010 Privatization program vs the initial version with the expected budget revenues from privatization of RUR7.1 bln[1] in a new context of budget deficit (the first deficit since early 2000'es) demonstrated a forced backslide to using privatization tools for recharging the budget exactly as it was done in the 1990'es.

Nevertheless, in spite of the ambitious statements on the initiation of a new wave of privatization and initial optimistic estimates (the federal budget was expected to receive RUR 100 bln from sales of the state property in 2010) 2010-2012 Privatization program does not look too radical.

The following issues should be pointed out in this document.

Firstly it has another reference to the official government document that sets development shapes for the future – Main directions of activity of the Russian Federation Government for the period ending 2012 approved by Resolution of the RF Government of November 17, 2008 No 1663-r[2] where it states that *by 2012 the public sector will reduce, the composition of the state property will conform to the authorities and functions of the state and structural changes in the respective sectors of economy; the work will be continued to reduce the list of strategic enterprises that are not subject to privatization; the process of corporatization (converting enterprises into joint-stock companies) of federal unitary enterprises that are not necessary for exercising public authorities will be completed.*

With account of the above, in 2010 – 2012 the work will continue to remove restrictions on privatization of certain types of federal property that have lost their relevance, and to reduce the number of strategic enterprises and joint-stock companies according to the decisions of the President of Russia. A most acceptable and efficient method of management of these property and enterprises including their privatization will be determined.

Secondly, among the objectives of the government policy for federal property privatization in 2010-2012, in addition to the traditional objectives there is a target to create environment for getting off-budget investments for joint-stock companies development.

This means a much broader application of the mechanism of charter capital increase in the open joint-stock companies established in the process of privatization which 25% or more shares are owned by federal or municipal authorities, while keeping the threshold limits for the state owned shares. This procedure was defined in 2006, and the effective Law on privatization was amended accordingly.

[1] M. Momot. Large clearance. V. RBK, No 11, 2009, p.46-51. .

[2] The main directions of activity of the Government of the Russian Federation for the period ending 2012 address mainly implementation of the first stage of the Concept of the long-term economic and social development of the Russian Federation for the period ending 2020.

Rosgosstrah company (the government share is 25%) is a good example of such scheme: the company was excluded from the list of strategic JSC by Decree of the President of Russia in September 2009. The Decree points out that the RF Government may well take a further decision to increase the charter capital of the company provided the government stake remains to be at least 13.1% of votes at the general shareholders meeting with a possibility to consider the use of a special right of the Russian Federation to participate in the company management ("golden share").

Thirdly, the current Privatization program mentions major facilities in federal ownership subject to privatization as it was done in the similar documents for 2007 and 2008. Such major (budget-making) facilities subject to privatization are stakes of such open joint-stock companies as TGK-5, Rosgostrah, Moscow Metrostroi, Iskitimcement (Novosibisk region), Tyretsky Solerudnik (Irkutsk region)[1].

Besides, to raise additional revenues to the federal budget, the RF Government may pass resolutions to privatize blocks of shares of companies that are highly attractive for investors. As the document suggests, such are the shares of sea and river ports, shipping and steamship companies including the stock of OJSC "Modern Commercial Fleet (not more than 25% minus 1 share from the federally owned stock), Murmansk Sea Commercial Port, Novorossiysk Sea Commercial Port, Anapa Airport (Krasnodar Krai) Koltsovo Airport (Ekaterinburg) (Tolmachevo Airport (Novosibirsk)[2].

A necessary condition for this is Resolution of Russia's President on termination or reduction of the participation share of the Russian Federation in management of the joint-stock companies included in the list of strategic enterprises and JSC.

The presence in the list of the airports, sea and river ports as potential objects for privatization[3] follows the recent trend when certain restrictions emerged to include in privatization the enterprises in traditional sectors of production (primarily in industry where integrated entities were actively built up); attempts were made to raise private capital for infrastructure development. It is enough mentioning the sale of full stakes (100%) of the Sochi and Tyumen airports, and identification of the Ufa and Salekhard airports as major targets of privatization in the 2007 Forecast plan (program) of federal property privatization and the main directions of federal property privatization for 2007-2009.

Expectations associated with allocation of budget funds for modernization and construction of airports and primarily their flying fields were a significant factor that heated up the interest of the Russian business to invest in the airports. More serious budget limitations that

[1] In the final version of the 2010 Privatization program there is no OJSC SG-Trans which is a larger railway shipper of liquid gases. It was planned to auction this company in 1H 2010 with expected revenue of RUR 8 bln.
SG-Trans privatization was planned in 2006, however it failed because a larger part of the company's property was not registered (for ownership). At the end of 2007 RFFI assessed 100% shares of the shipper owned by the government as worth RUR14.8 bln. Moscow Metrostroi was also included in the Privatization Plan earlier.

[2] Tuapse and Vanino sea commercial ports and several shipping companies (Murmansk, North-West, Volga, Enisei and Sakhalin) were also mentioned as possible facilities for privatization though they were not included in the Privatization program.

[3] An object for privatization in such cases is the airport terminal building or the property for rendering services by the sea terminal operators since the facilities used for supporting air or sea traffic, etc. are included in the property list not subject to privatization which are used by specialized government enterprises (FGUPs "State Corporation for Air Traffic Organization in the Russian Federation", "Administration of Civil Airports (Flying Fields), Rosmorport, Administrations of Sea Ports that are deemed agencies).

are expected in coming years may strongly change this motivation and complicate the government search of investors. Another incentive for inclusion of sea and river ports in the Privatization program was, possibly, the size of the government stake in the capital which in many cases does not exceed the size of control stake.

Fourthly, for the first time in recent years after the current Law on privatization was enforced in 2002, and the government began approving annual Forecasted privatization plans (programs) the document under review does not contain a nominal list of federal unitary enterprises (FGUPs) to be privatized.

As in the similar documents of some previous years, the document states that in 2010 – 2012 those FGUPs that do not support the government functions of the Russian Federation will be privatized. About 250 FGUPs are to be privatized in 2010; their privatization procedures began in 2009.

If the President of Russia takes a respective decision in 2010, FGUPs that are excluded from the list of strategic enterprises including those that are parts of vertically integrated structures in the strategic sectors of economy may be converted into joint-stock companies; moreover, newly formed JSC may be re-included in such strategic list.

Literal understanding of this aspect gives grounds to assume that in the current year the privatization process (de facto, mainly, in the form of corporatization) of unitary federal enterprises in terms of their range expansion will slow down except for the earlier initiated procedures that would be brought to their logical end.

The other parameters of the Privatization program are as follows.

In 2010–2012 the blocks of shares of joint-stock companies established in the process of conversion of federal government unitary enterprises including those incorporated under the 2009 Forecast plan (program) of federal property privatization will be offered for sale except strategic JSC that are in the list of strategic joint-stock companies or participate in the formation of integrated structures.

In 2010 the following stakes will be offered for sale:

– blocks of shares which do not exceed 50% of the charter capital of the respective joint-stock companies except blocks of shares of strategic JSC or JSC participating in the formation of integrated structures;
– blocks of shares of joint-stock companies in construction, agriculture, chemical, petrochemical and polygraphic industries, public road system, geology, water and air transport, machine engineering, etc. (except strategic companies +JSC).

The work on establishment of integrated structures in the strategic sectors of economy using as a basis joint-stock companies which shares are in federal ownership will continue in 2010–2012.

The shares of 449 JSC and 56 property facilities of the Russian Federation Treasury including real estate, sea and river vessels are included in the 2010 Forecast plan of privatization approved by the RF Government.

By comparing the data describing the 2010 Forecast plan (program) of privatization and the data results of implementation of the previous Privatization plans (*Table 5*), one can state that in general its quantitative indicators are far from their maximum values reached in the middle of 2000'es.

Table 5

Benchmarking of the privatization dynamics of the federal government unitary enterprises and federal blocks of shares in 2000 – 2008

Period	Number of privatized enterprises in federal ownership (Federal Property Management Agency data, before 2004 – RF Ministry of Property data)	
	FGUPs privatized [1]	JSC blocks of shares sold
2000	2	320
2001	5	125[2]
2002	102	112[2]
2003	571[3]	630
2004	525	596[4]
2005	741	521[5]
2006	…	356[6]
2007	377	377
2008	213	209[7]

[1] –all preparations completed and decisions on privatization terms made;
[2] – with account of stock which sale was declared in the previous year;
[3] – without FGUPs which property was contributed to OJSC RZhD share capital;
[4] – including 31 blocks of shares which sale was announced in 2004 but the sale results were summarized in 2005;
[5] – with no account of 273 blocks of shares which sale was announced in 2005 but the sale results were summarized in 2006;
[6] – estimated value based on the report data of FAUFI (Federal Agency for Federal Property Management) "On privatization of federal property in 2007;
[7] – including blocks of shares of 135 JSC which sales were announced according to the 2007 Forecast privatization plan, but without 268 blocks of shares which sales were announced in 2008 with the results summarized in 2009;
Source: www.mgi.ru; Materials for the RF Government session on March 17, 2005 "On measures to improve efficiency of federal property management"; FAUFI report "On privatization of federal property in 2005", M, 2006; FAUFI report "On privatization of federal property in 2007", M, 2008; FAUFI progress report for 2008, M, 2009.

In 2010 the federal budget expects to gain RUR18 mln of privatization proceeds (out of those, RUR12 mln from major sales of the so-called budget-forming assets); in 2011 – RUR6 bln and in 2012 – 5 bln.

The revenues from the federal property sales can be much higher if the RF Government decides to privatize shares and other property that are highly attractive for investors.

In this context the Russian officials in their announcements made in November 2009 and related to the approval of the Privatization program for 2010 – 2012, mentioned more than RUR 70 bln of aggregated revenues of the federal budget from sales of federal property. Out of them, RUR 54–55 bln can be gained from sales of the federal stock in 28 JSC provided they are excluded from the list of strategic companies.

As for the 2009 Privatization program, its implementation, as had been expected, ran against a sharp drop of the purchasing power of the population and expectation of investors related to reduction of the assets value. Officials of the Federal Agency for Federal Property Management noticed that investors' interest began growing only by the end of summer – beginning of autumn. Potential investors showed their interest for the property auctions in 10% of cases while in the previous years it was 30%.

As of November-end, the Federal Agency for Federal Property Management passed Resolutions regarding the terms of privatization of 173 blocks of shares, published 158 information notices about sales, summarized the results of 100 bids (the annual plan provided for sell-

ing shares of 287 JSC)[1]. Major deals (over RUR100 mln) of the last year included auction sales of the government's stakes of OJSC Tobolsk River Port (25.5%, RUR188.456 mln, re-tenders, Tyumen region) and Gipromyasomolagroprom (100%, RUR188.380 mln, St._Petersburg), Hydrometallurgichesky zavod (HydroSteel Plant) (100%, RUR123.7 mln, Stavropolsky Krai). All the deals took place under selling and initial price parity [2].

5.1.3. Influence of the government presence in property on the government structural policy in various sectors, issues of strengthening of the government position

After stormy events and intensive processes in 2007 and 2008, where in mergers and acquisitions companies with the government interest in their capital domineered as buyers of assets, integrated structures were actively built up, six state corporations (GK)[3] were established, and RAO EES was liquidated, all Russia's economy has been hit by the world financial and economic crisis, and special government programs of urgent assistance to some Russian companies and banks has come to the forefront. Besides the issue of sourcing such programs (the budget system, off-budget funds, and Central Bank funds) and the terms of programs delivery in terms of their influence on the property relations, of importance was whether the state would elect acting directly or using agents (such as banks and development institutions).

If to take the period before the Anti-Crisis Action Program of the RF Government for 2009 was announced early April at the State Duma, decisions on increasing charter capitals of the following JSC received the highest resonance: OJSC Agency for Mortgage Housing Crediting (by RUR60 bln, November 2008), Russian Railway Roads (by RUR41.5 bln, December 2008), Risslkhpzbank (by RUR45 bln, February 2009), Rosagroleasing (by 25 bln, February 2009)[4].

The content of the 2009 Federal Anti-Crisis Program, namely, the priority given to subsidizing interest rates and state guarantees for credits may suggest (with caution) a minimal probability of direct expansion of the government when the government stake in some problematic companies may increase at the expense of the budget funds.

However, this Program among other actions to retain and increase the industrial and technological potential proposed allocation of considerable budget funds to additional capitalization of leading companies of the defense-industrial complex; examples are the buyout by the government of additional issue of stock of OJSC RSK "Mig" for RUr150 bln, respective decisions for FGUP GKNPC named after M. V. Khrunichev for RUR8 bln, OJSC KAPO named after S. P. Gorbunov for RUR 4.128 bln, OJSC MMP named after V. V. Chernyshev for RUR2.9 bln; this follows the trend to increase share capitals. The Program provides for addi-

[1] Interview of Deputy Head of the Federal Agency for Federal Property Management E. L. Adashkin, RIA Novosti, www.rosim.ru, 25.11.2009.
[2] www.rosim.ru.
[3] Federal Foundation for Assisting Housing Construction Development created in pursuit of Federal Law of July 24, 2008 No 161-FZ formally has a restricted form of incorporation (foundation) but in reality is very close to state corporations established earlier, since the Foundation and these corporations are considered non-commercial organizations. .
[4] The assessment of the anti-crisis actions to support the producitng sector of the Russian aconomy. GU-VShE and MATs report for the 10th International scientific conference of GU-VShE on the issues of development of the economics and the society, Moscow, 7-9 April 2009. – M, GU-VShE Publishing House, 2009.

tional issue of shares and bonds of certain strategic enterprises with their further buyout by the authorized agencies for RUR52 bln.

In addition separate items reflect compensation (as the increase of the charter capital of OJSC RZhD) of under-received revenues due to reduced pace of railway tariff indexation for 2009 by 8% (against 14% in the plan) for goods and passenger traffic tariffs (privileged categories)(total of RUR52.3 bln); increase of the charter capital of the Agency for Mortgage Housing Crediting (by RUR 20 bln), an interest-free loan to OJSC AVTOVAZ from the federal funds designated for property contribution to GK Rostechnology (RUR25 bln) [1]; another contribution to this company (RUR 2 bln) was declared as a state support to the air lines.

New examples of expansion of the state business include a decision to establish a state leasing company in the transportation complex on the basis of OJSC State Transportation Leasing Company (100% voting shares belong to the government)[2], which share capital was increased by RUR10 bln, and announcement of the establishment of an integrated leasing company to support coal mining enterprises with mining equipment (in this case the status and the level of government involvement has not been announced yet).

The available and announced cases of additional capitalization refer mainly to those companies where the government is the sole shareholder (e.g. Agency for Mortgage Housing Crediting, Russian Railways, Rosselkhozbank, Rosagroleasing), and the process of mergers and acquisitions is not affected. In principle the same can be said about a possible buyout of an additional issuance of shares by separate strategic enterprises of the defense-industry complex, though private shareholders are also present in some of these enterprises.

However, regardless of the significant influence of the federal budget policy on the property relations development, banks and development institutions as agents of support of the federal government have always played a more serious role in providing support to the companies.

In the context of the absence of officially announced plans of further comprehensive expansion of the state entrepreneurship sector, the scale and the format of the government support and the selected priorities in crediting the real economy and participation in the stock exchange market transactions have proved to be decisive factors.

The most urgent issue was that of the policy of Vnesheconombank (VEB) which began refinancing the external debts of the major Russian private companies in autumn 2008. Since VEB granted mainly short-term loans (for one year), in 4Q 2009 the issue of repayment of the granted loans emerged, and if no repayment, the issue of choice between granting new loans, restructuring the debts (de-facto it was renewal of the granted loans), initiation of bankruptcy procedures or obtaining property rights on the pledged assets. Formally this should not be deemed nationalization since the federal treasury is not going to receive any additional property, and VEB as a state corporation is a non-commercial entity.

Major banks with government stakes that received the government financial support face a similar choice. Mechel company, e.g. that was attacked by the federal government officials in

[1] Late 2009 MinPromTorg approved the Rules for granting subsidies from the federal budget to GK RosTechnologies in the form of a property contribution to provide financial support to OJSC AVTOVAZ by way of an interest-free loan for AVTOVAZ to execute the obligations before the suppliers, intermediary entities, crediting companies and other agents with a following increase of the GK RosTechnologies share in the AVTOVAZ charter capital.

[2] Converted from CJSC Leasing Company of Civil Aviation in 2006

July 2008 who were displeased by the company's failure to pay taxes in full volume and the use of transfer pricing mechanism disrupted the terms of 78.9% credit agreements (the loan value) in 2008 and early 2009. Among the Mechel creditors were: Gazprombank (under a $1.5 bln loan 35% of shares of the coal mining companies Yakutugol and Yuzhny Kuzbass were pledged); VTB (under a RUR15 bln loan part of the assets of Yuzhny Kuzbass and Chelyabinsk metal works were pledged) and Sberbank (RUR3.3 bln loan)[1]. The latter is also a creditor of the united chemical company Uralkhim having received for security against $700 mln loan the control stakes of OJSC Azot (Berezniki city, Perm region) and OJSC Kirovo-Chepetsk khimcombinat (chemical plant) (Kirov region).

Possible transition of the property rights to the state-owned companies and major banks with government stakes would have obviously marked a new stage of the state property expansion.

In real life, however, the government would tend to meet the business interests by following the previous practice of debt restructuring. In the first half of October 2009 the VEB Supervisory Board extended for another year the loans issues for repayment of external debts to such companies as Gazpromneft, Citroniks, Evraz Group, Rusal, GK PIK and Altimo. The prolongation was made without revision of the main parameters of the deals earlier recorded in the loan agreements (including the size of the security) except interest rates [2].

If such approach continues to be followed, the potential of possible expansion of the public sector would remain unrealized in large; however such situation would imply a certain revision of the principles of financial accountability, refusal from "soft" budget limitations in business entities' activities and consistency in application of the bankruptcy procedures which was implemented in the Russian economy from early 90'es with great difficulties and tremendous cost efforts.

The preliminary data for 2009-end results allows us making a cautious conclusion that the state has been less active in implementing the policy of integration of separate state-owned assets into holdings. An indirect sign of this is the lower number of clarifications in the list of strategic unitary enterprises and joint-stock companies vs two previous years: 12 clarifications vs 22 in 2008 and 42 in 2007 (for comparison: three clarifications were made as of 2004 end results, four – in 2005 and 12 in 2006). The bigger number of the clarifications was connected with building up integrated structures where initially the enterprises and the companies to be integrated are excluded from the list and later a newly-formed holding is re-included. As a result of this, 22 unitary enterprises and 16 joint-stock companies were excluded and 4 integrated companies were included in the list.

As a reminder, in 2008, following the decisions of the President and the RF Government, Federal Property Management Agency established 26 integrated companies, OJSC Oboronservice and GK RosTechnologies among them; these two companies integrated 440 unitary enterprises and 43 joint-stock companies. Since the Russian Government issued Resolutions on their privatization in November 2008, and these companies were included in the respective program in 4Q 2008, the procedure for their integration was to be completed in 2009.

To implement the 2008 resolutions, the first stage of the establishment of an integrated company OJSC Headquarters for Reproduction of Farm Livestock was completed on the basis of the Center for Artificial Insemination of Farm Livestock; this company integrated 19 farms

[1] D. Varaskin, Banks displeased. – Vedomosti, June 24, 2009, S. B. 02.
[2] Development Bank extended the loans for one year. : RBK daily, 9 October 2009 г., No 185 (748). p. 2.

located mainly in the Povolzhie (the river Volga), the Urals and in Siberia (Bashkiria, Mordovia, Idmurtia, Ekaterinburg, Tyumen, Altai, Kemerovo, Novosibirsk, Krasnoyarsk and Krasnodar).

In the previous year under the government property policy, OJSC Agency for Regulation of the Product Market was converted into United Grain Company; its charter capital received the shares of 31 enterprises of cereal products (milling plants, grain elevators, etc.) including 17 control stakes in the form of placement of additional shares.

Likewise the charter capital of the earlier created integrated company called Concern of Radio Engineering Vega will be increased by adding federal stocks of 14 joint-stock companies including 100% minus 1 share of 7 joint-stock companies established as a result of conversion of the earlier FGUPs.

The establishment of Rosgeology Holding is under consideration which charter capital will be formed as a result of establishment of joint-stock companies from FGUPs in exploration and by including the stocks of operating servicing JSC (49 companies altogether)[1].

In 2009 inconsistency of the government policy towards state-owned corporations became obvious, the establishment of state-owned corporations has become a new direction in the federal property and structural policies during the last two years.

Early 2009 the government began discussing extensively new plans of creation of state-owned companies (GK) and expansion of businesses of the state-owned companies in operation. Thus the Central Bank had to transfer the funds of National Wealth Fund and the Reserve Fund to a new GK Russian Financial Agency while VEB – pension deposits and also the internal and external debts of the country[2]. Consolidation of communications assets of VEB and integration of 11 air lines in Rosavia under Rosoboronexport was also considered as an alternative[3]. In the last case the situation changed early 2010: the consolidation now is to begin under the auspices of Airflot; however in terms of general federal government policy, this is not a new trend but a technical correction.

Decisions were taken to transfer GK Rostechnologies as a property contribution of the federal government in addition to a large package of the federal property transferred in 2008 of shares of another 3 joint-stock companies including 18.83% of AVTOVAZ stock that had been in management of FGUP Rosoboronexport; this corporation was to act as a customer in construction of 12 federal medical centers of high technologies under the respective national project. Rostechnologies was expected to receive federal budget allocations (as property input) at the expanse of the respective reduction of the budget allocations to the Russia's Ministry of Health and Social Development for construction of the said centers while in future subsidies would be granted to complete the construction and commission these centers. In this light another initiative of Rostechnologies to enter a pharmaceutical market by way of setting a holding with the government stakes of 35 companies looks quite logical.

In summer 2009 the Law on Establishment of the State Company Russian Motor Roads (Avtodor) was passed; Avtofor will be a national operator of the federal motor road network; simultaneously a new form of legal entity's incorporation oriented at the use of federal prop-

[1] E. Korytina, The State moved to exploration// RBK daily, October 2, 2009, p. 5; E. Korytina, Sechin helped geologists//RBK daily, October 15, 2009, p. 5.
[2] I. Zinenko. New state corporation will control all financial assets of the government, 13.01.09. – http://www.rb.ru.
[3] A. Khazbiev. Indecent proposal, - Expert, 2009 No 11, p. 26-27.

erty by the state-owned company was added to the RF Civil Code and the Law on Non-Commercial Organizations.

Avtodor is to render state services and perform other funcitons in the road sector by using federal property under trust management. This company will receive for trust management the federally-owned toll motor roads or the roads in general use and federal significance that have toll areas.

Such format will inevitably cause a lot of questions starting from expediency of the new form of incorporation with a pronounced focus on commercialization of public wealth and ending with obvious restrictions in using the term "state-owned company" (public company) in the economic and political vocabulary.

The Russian Motor Roads as a non-commercial entity is very close to the state-owned companies established earlier, the only difference being the trust management; however, this form has not been widely used for other types of federal property, e.g. blocks of shares.

On the other hand, criticism of the state-owned companies that has been growing since their establishment ended in development (by summer) by the initiative of the President of Russia of the "Concept of development of the legislation on legal entities" which contained proposals on changing the legal form of all existing state-owned companies, on refusal from their use in future and on repealing a number of "specific" provisions of the law that granted these companies "special" rights.

The President's Letter to the Federal Assembly of Russia in November 2009 pointed out that in future state-owned companies should be converted to joint-stock companies under the government control, while those companies that have specified periods of their operation should be liquidated in due time. These include Olimpstroi and Foundation of Assistance to Reform the Utility and Housing Sectors. According to A. Dvorkovich. Aid to the President of Russia, the prospects of transformation of Rosatom and Federal Agency for Deposit Insurance will depend on their long-term results. Most probable candidates for corporarization are VEB, Rosnano and Rostechnologies[1]. However, there are no specific dates set for such transformation. It is not clear whether the new vision of the state-owned company status applies to Avtodor and Federal Foundation of Assistance to Housing Construction Development.

The first step in this direction may become corporatization of airlines that have been transferred earlier to Rostechnologies and have the status of unitary enterprises, and their further transfer to Airflot – this was announced in February 2010. The airlines considered are GKT Russia, Kavminvodyavia, Orenburg airlines and Saratov airlines, Vladivostock airlines and Sakhalin Airlines where Rostechnologies received federal stakes. Thus the Rostechnologies plans to establish a new integrated air company Rosavia[2] comparable with Airflot in terms of traffic volume have not been implemented. It is quite possible that Rostechnologies will receive a stake in exchange for the said assets.

As a result of the current financial and economic crisis, opportunities to act on the market of corporate control as actively as in 2004-2007 have been restricted for the majority of companies with the government stake even with account of state support granted to them under the anti-crisis program.

The emergence of this trend may refer to 2008 when in the context of $120 bln worth M&A in Russia there was no major deal with a company having a government stake that

[1] www.prime-tass.ru, 12 November 2009

[2] Initially participation in Rosavia and Atlant-Soyuz airline controlled bu the Moscow authorities was expected.

acted as a buyer. Mechanical engineering is worth mentioning with acquisition by the United Avia Engineering Corporation (OAK) of 49.4% of shares of Scientific and Production Corporation Irkut (a major exporter of military and civil aerotechnics) for $420 mln and acquisition of the entire capital of Kriogenmash and 85% of the capital of KHIMMASH (for total $290 mln) by Gazprombank which also became the owner of 8.3% of the shares of National Telecommunications for $128 mln. Two more deals could be possibly mentioned as having reference to the companies with the government interest but with greater specifics related to external capital markets. Gazpromneft acquired a control stake in Naftna Industrija Srbije (NIS) for $560 mln, while Gazprom expected to receive 49% of CJSC Gerosgaz possessing 2.93% of Gazprom from German company E. ON AG that bought 25% stock minus 1 share in Severneftegazprom [1].

In 2009 communications was the "hottest" sector. At the beginning of the year a possibility arose for VEB acquisition from investment bank KIT Finance[2] of 40% shares in Rostelecom and 25% plus 1 share in Svyazinvest (a telecommunication holding) from AFK Systema where for many years the sale of the federal control stake (75% minus 1 share) was on the agenda; the state-owned corporation could receive this control stake directly from the federal government.

AFK Systema being the third largest private shareholder of the company since the outrageous sale by the government of the blocking shareholding in 1997[3], at the end of 2008 proposed that the government buys out its block of shares for $1.9 bln. This amount exceeded by almost 2.8 times the asset value assessed by Ernst & Young in spring 2008; this encouraged the AFK Systema to buy another 25% shares from the government thus increasing its stake in Svyazinvest up to the control stake. Some time later AFK Systema offered the government a counter-deal to exchange the blocking shareholding in Svyazinvest for the write-off of the debt (RUR26 bln) to Sberbank of a Systema daughter company, Komstar-OTS, and the Svyazinvest stake in MGTS (28% of voting shares) where Systema had already a control stake. It goes without saying that if the proposed deal fails, Systema will be able to keep its stake in Svyazinvest and will hope selling it profitably after the crisis is over[4].

As for Svyazinvest, this company began considering an opportunity of merging with one of the All-Russia mobile communications operator. Minister of Communications and Mass Media of the Russian Federation I. Shchyogolev addressing the Association of European Business late June 2009 said that one of the aims of the holding restructuring was to become one of the fourth major cellular operators in Russia; this could be achieved by not only getting control in one of "Big Three" operators (e.g. in Megafon) but also by merging the cellular assets with outside regional cellular operators' assets or with one of the second tear majors (Tele2, SMARTS, Motiv and Sky Link)[5].

[1] Review of the M&A market in 2008. Ernst & Yong, 2009, p. 8, 22, 24, 32.
[2] 90 % of its capital are owned by OJSC RZhD and ALROSA from autumn 2008
[3] At that time 25% and 1 share of Svyazinvest were bought by Mustcom of J. Soros and V. Potanin for $1.87 bln in expectation of further privatization. In 2004 this block of shares was sold Access Industries of L. Blavatnik and his partner V. Vekselberg for $625 mln, and in 2006 it was bought by AFK Systema for a double price registering the acquired asset to Komstar-OTS, its daughter company.
[4] A. Klyuchkin. Back to the wood. www.lenta.ru, 14.05.2009.
[5] A. Bursak. Svyazinvest thinks about an alliance; RBK daily, 24 June 2009 , No 108 (671). p. 10.

The merge of the major Russian private companies in metal works and mining sectors (Norilsk Nickel, RUSAL and Metalloinvest) with GK Rostechnologies involvement did not occur though the information about this merge appeared at the end of 2008[1].

It is reasonable to ask how the processes triggered by the crisis affected the positions of the federal government in the economy as a producer of goods (services and works). Rosstat monitoring results partially confirm the increasing weight of the public sector in the economic performance indicators (*Table 6*).

Table 6

The weight of the public sector by various indicators in 2006 – 2009, in %

Indicator	2006	2007	2008	1H 2009
Volume of shipped goods (own production), rendered services and performed works (by own efforts):				
- production of mineral resources	6.0	12.8	13.5	13.8
- production of fuel and energy resources	3.9	11.8	13.2	14.3
- manufacturing sectors	8.2	8.4	8.5	9.3
- generation and distribution of electric energy, gas and water	10.7	11.4	13.0	10.5
Construction work scope (by own resources)	4.4	4.0	3.6	3.3
Passenger traffic (transportation companies) *	68.5	65.9	63.9**	64.9
Commercial shipments of goods made by transportation companies (without pipelines)	67.2	72.9	71.1**	72 4
Commercial traffic of transportation comp(without pipelines)	93. 9	94.6	94.3**	92.6
Services of communications***	9.8	9.8	9.9	11,6
Internal R&D costs	70,4	72,4	72.6	75.4
Volume of paid services rendered to the community	17.2	16.4	16.3	16.1
Investments to main capital from all funding sources ****	18.1/14.4	19.5/15.0	21.5/15.9	18.1/13.6
Net proceeds from sales of goods, products, services and works (less VAT, excises and other similar payments)	10.2	10.2	9.8	10.1
Average headcount	26,0	24,9	24,0	24,2

* – without city passenger transportation (electricity) organizations;
** – data for January – September 2008;
*** – Net proceeds from sales of goods, products, works and services (less VAT. Excises and other similar mandatory payments);
**** in numerator: less small businesses
Source: Development of the public sector of economy in the Russian Federation in 2005, M, Rosstat, 2006, p.. 8, 85, 92–93, 94, 103, 137, 139, 146–147, 167; Development of the public sector of economy in the Russian Federation in 2006, M, Rosstat , 2007, p.. 8, 82, 89–90, 91, 100, 134,136, 143–144, 164; Development of the public sector of economy in the Russian Federation in 2007, M, Rosstat, 2008, p. 9, 42, 90–91, 92, 103, 134, 136, 143–144, 164; Development of the public sector of economy in the Russian Federation in 2008, M, Rosstat, 2009, p. 13, 43, 45–46,47, 53, 61–63, 67–68, 88; Development of the public sector of economy in the Russian Federation in 1H of 2009 , M, Rosstat, 2009, p. 13, 42, 44–45, 46, 49, 52–54, 58–59, 79.

As seen in *Table 6,* the share of the public sector in 2008 and in the 1H of 2009 was insignificant for the bigger number of the indicators (the similar trend was observed in all 2000'es) not exceeding 10%-15%. The share of the public sector was a little greater for investments (15–20%, without small businesses) and employment (24–25%), while the traffic (over 60–90% depending on the indicator) and internal R&D costs (over 70%) are obvious exclusions.

However, the official statistics agencies reported a considerable increase of the weight of the entire public sector in 2008 – 2009 vs 2006-2007 in production of mineral resources (pri-

[1] M&A market review in 2008, Ernst I Yong, 2009, p. 17.

marily, fuel and energy), in manufacturing, communications, R&D costs and investments into main capital [1]. As a result, the 1H 2009 share of the public sector in the production of fuel and energy resources which was obviously lower than the public sector input into the production of mineral resources on the whole, surpassed this indicator.

Going into a more detailed review of the situation, we can say that according to the 2008 year and 1H 2009 results, the public sector domineered on a few positions (cargo and passenger traffic by rail, forest restoration, caustic ash). In almost all other cases the unit weight of the public sector was less than 20% except production of sodium chlorite, ethyl alcohol from food staffs, railway packers for broad gage lines, certain types of machine building products (cargo cars, tractor grain drills, radio receiving sets), all types of paid services, where the public sector share did not exceed 50%.

It should be noticed that the Rosstat data based on the definition of the public sector as stated in Resolution of the RF Government of January 4, 1999 No 1 (the current version of this document adopted by Resolution of the RF Government of December 30, 2002 No 393) do not reflect the real unit weight of the public sector in the Russian economy[2].

5.1.4. The effect of the federal government property policy on the budget revenues in 2000 – 2009

The crisis that hit the Russian economy in autumn 2008, naturally led to reduction of budget revenues on almost all budget items in 2009. The revenues received by the budget as a result of the implementation of the government property policy were no exception.

Let us remind that all federal budget revenues generated by the property owned by the state can be divided into two groups depending on their nature and the source. One group comprises revenues generated by the use of the government-owned property (renewable sources). The other group comprises revenues generated by non-recurrent/one-off sources that can not be renewed because the government having sold the property transferred the property rights to some legal entities and physical persons including by way of privatization (non-renewable sources).

Below (*Table 7 and 8*) we show data on revenues that are (with minor exceptions) contained in the Laws on the execution of the federal budget for 2000-2008 pertinent to the use of the state-owned property and property sales (tangible objects only)[3].

[1] The 1H 2009 results did not confirm this trend for the last indicator.

[2] See for detail: Russian economy in 2007. Trends and prospects (Ed. 29), M, IEPP, March 2008, p. 485-490. An additional factor that negatively affects validity of data in the formal statistical reports is establishment of several state corporations that are given assets.

[3] Have not been considered the revenues of the federal budget received as payments for the use of natural resources (including water, biological resources, revenues from the use of the forest fund and subsoil), reimbursement of agricultural losses resulted from withdrawal of agricultural lands, financial transactions losses (revenues from investment of budget funds (revenues from the federal budget balance and their investment, since 2006 – also revenues from managing funds of the federal Stabilization Fund (in 2009 the Reserve Fund and National Wealth Fund), revenues from investment of funds accumulated during auctions of stock owned by the Russian Federation); interest received on budget credits granted inside the country from the federal budget funds; interest on state loans (funds received from foreign governments and foreign legal entities in the form of interest paid on loans granted by the Russian Federation; funds received from enterprises and organizations in the form of interest and guarantees payments on loans received by the Russian Federation from the governments of foreign countries and international finance agencies); revenues from paid services or compensation of the government costs; remittance of profits to the RF Central Bank; certain payments from federal and municipal enterprises and organizations (patent and registration fees for official registration of software programs, data-

Table 7

Federal budget revenues generated by the use of the state-owned property (renewable sources) in 2000 – 2009, in mln rubles

Year	Total	Stock dividend (2000–2009) and revenues from other forms of equity participation (2005–2009)	Land lease payments for state-owned land	Revenues from leasing of state-owned property	Revenues from remitted profit that remains after FGUPs have paid taxes and other mandatory payments	Revenues from Vietsovpetro JV business
2000	23244.5	5676.5	–	588.,7	–	11687.3[1]
2001	29241.9	6478.0	3916.7[2]	5015.7[3]	209.6[4]	13621.9
2002	36362.4	10402.3	3588.1	8073.2	910.0	13388.8
2003	41261.1	12395.8		10276.8[5]	2387.6	16200.9
2004	50249.9	17228.2	908.1[6]	12374.5[7]	2539.6	17199.5
2005	56103.2	19291.9	1769.2[8]	14521.2[8]**	2445.9	18075.0
2006	69173.4	25181.8	3508.0[8]	16809.9[9]	2556.0	21117.7
2007	80331.85	43542.7	4841.4[8]	18195.2[9]	3231.7	10520.85
2008	76266.7	53155.9	6042.8	114587.7[9]	2480.3	–
2009	31849.3	10114.2	647.,5	113507.3	1757.3	–

[1] – according to the Ministry of State Property of the Russian Federation, in the 2000 Law on the execution of the federal budget there was no separate item, the total amount of payments of government enterprises (RUR9,887.1 mln) was shown (with no break down);
[2] – the rental amount for (i) lands in agricultural use and (ii) city and settlements lands;
[3] – total revenues from renting property assigned to (i) research institutions (ii) educational institutions, (iii) health institutions, (iiii) state museums, state institutions of culture and arts, (iiiii) archives, (iiiiii) RF Ministry of Defense, (iiiiiii) organizations of the RF Ministry of Railways, (iiiiiiii) organizations of scientific services for Academies of Sciences with a government status and (iiiiiiiii) other revenues from renting of state-owned property;
[4] – according to the Ministry of State Property of the Russian Federation, in the 2001 Law on the execution of the federal budget there was no separate item, the amount coincided with the amount of other revenues in payments of federal and municipal organizations;
[5] – total revenues from renting of state-owned property (land rents are not shown separately);
[6] – rent amount for (i) lands of cities and settlements and (ii) lands in federal ownership after state ownership on land was delineated;
[7] – total revenues from renting property assigned to (i) research institutions, (ii) educational institutions, (iii) health institutions, (iiii) state museums, state institutions of culture and arts, (iiiii) state archives, (iiiiii) postal offices of the federal postal communications of the RF Ministry on Communications and Information Support, (iiiiiii) organizations of scientific services for Academies of Sciences with a government status and (iiiiiiii) other revenues from renting of state-owned property;
[8] – rent payments after the federal ownership to land was delineated and proceeds from sale of the right to conclude rent contracts for lands in federal ownership (for 2008-2009 – except land sites of federal autonomous institutions);

bases and topologies of integral microchips and other revenues which before 2004 had been a part of the payments by the state-owned enterprises (except revenues from Vietsovpetro JV activity since 2001 and remittance of part of FGUPs' profits since 2002)); revenues from PSA implementation; revenues from disposal and management of confiscated and other property converted into government revenue (including property converted into government property received by way of inheritance or gift, or treasures); proceeds from lotteries, other revenues from the use of property and rights in federal ownership (revenues from disposal of rights to intellectual property results (R&D and technological works) of military, special and dual purpose; revenues from maintenance and use of highway property and other proceeds from the use of property in federal ownership); also from the allowed activities of organizations to be accounted in the federal budget; proceeds from sales of government reserves of previous metals and stones.

[9] – revenues from renting of property in operating management of federal government authorities and institutions established by these authorities and in FGUPs' management: transferred to operating management to the following institutions with a government status: (i) research institutions, (ii) organizations of scientific services for Academy of Sciences and sector Academies of Sciences, (iii) educational institutions, (iiii) health institutions, (iiiii) federal postal offices of the Federal Communications Agency, (iiiiii) government institutions of culture and arts, (iiiiiii) state archives (iiiiiiii) other revenues from renting of property in operating management of federal government authorities and institutions established by these authorities and in FGUPs' management[1] (for2006–2009 without revenues from the allowed types of activity and federal property use located outside the Russian Federation gained abroad which had not been separated in previous years [2]).
Source: Laws on the execution of the federal budget for 2000 – 2008; Report on the execution of the federal budget as of January 1, 2010, www.roskazna.ru; estimates made by the authors.

As for the analysis of preliminary results of the budget effect of the government property policy in 2009 regarding renewable sources, first of all a considerable drop of revenues should be noted that is a direct consequence of the economic performance results (dividends and remittance of a part of profits of unitary enterprises).

The dividends on federal stock fell sharply, by 5.3 times vs 2008 being compared to the 2002 level (slightly more than RUR10 bln) [3], not mentioning the benchmarks outlined in 2008[4].

In this connection the Federal Property Management Agency was active in recovering debts from joint-stock companies which shares are owned by the Russian Federation and the companies that evaded from their obligations to transfer dividends to the federal budget or failed to transfer dividends in full volume for 2006 – 2008[5].

As of summer 2009, the Agency issued 20 claims against major debtors which total debt to the government was about RUR60 mln. Some of the debtors wishing to avoid court proceedings that would enforce them to pay outstanding dividends and interest on those dividends repaid their debts at once or expressed their intent in doing so. As for other debtors, the Agency lawyers prepared statements of claim for court prosecution. The aggregate debt amount (several hundreds million of rubles) does mot make us believe that the general situation with dividends payment to the federal budget can change for the better even if such debts are retired quickly and in full amount.

Certain parts of FGUPs profits demonstrated lower sensitivity to the crisis. They reduced roughly by 30%, and their absolute value (RUR1.75 bln) exceeded the 2002 indicator by almost two times though was lower than the transfers to the budget in all subsequent years.

[1] In 2008-2009 FGUPs as a source of revenues from renting of property in economic control were not mentioned while renting of property in operating management of federal authorities and institutions established by these authorities excludes the property of federal autonomous institutions..
[2] According to the RF Ministry of State Property, the revenues from the use of federal property being abroad (in addition to revenues due to the interest of the Russian participant of JV Vietsovpetro) amounted to RUR315 mln in 1999 and RUR440 mln in 2000. Further on FGUP "Predpriyatie po upravleniyu sobstvennostiyu za rubezhom (Company for managing property abroad) came to play a major role in the organization of commercial use of the federal property abroad.
[3] It should be noticed that in 2002 in addition to dividends on the shares of Russian joint-stock companies inside Russia the federal budget received about RUR13.4 bln as revenues on the stake of the Russian participant in JV Vietsovpetro. However, after completion of the actions for development of JSC Zarubezhneft which charter capital in 2007 in addition to stock of two joint-stock companies (research institutes) received a share (50%) of the Russian participant of JV Vietsovpetro., the federal budget ceased to receive revenues from this source which was not mentioned in the revenue structure from the renewable sources in 2008-2009.
[4] See Russian economy in 2009. Trends and prospects. (Ed. 31) M. IEPP.
[5] www.rosim.ru, 24.08.2009.

Against this background the situation with rent revenues looked quite favorable where the government received rent (for the use of real estate and land plots) not being involved in the organization of business processes of renting companies and building the relations with then on the contract basis concluded, as a rule, for a specific period of time at the earlier agreed rates. Rentals from the federal property (RUR13.5 bln) reduced slightly, by 7.4%, being pushed back to the level of 2003-2004. At the same time land rent proceeds did not shrink but rather increased by 7% in 2009 reaching their absolute maximum value since 2000'es.

Thus a certain reconfiguration of the federal budget revenue structure from the renewable sources occurred. The revenues from leasing of federal property became the most significant item (42.4% vs 19.1% in 2008). Dividends regardless of their sharp decline preserved their important place (31.8%) though in 2007 – 2008 they made half of all the revenues from the reviewed sources. Specific weight of revenues from land rent grew considerably (20.3% against 5–8% of all revenues from the renewable sources in 2006 – 2008) while the profit input transferred by FGUPs (5.5%) reached its highest value in 2003 (5.8%) for the period starting 2000.

In analyzing the revenues of the federal budget from privatization and sales of state property (*Table 8*) it should be noticed that from 1999 proceeds from sales of the major part of such assets (shares, and in 2003 – 2007 - land plots[1]) have been looked at as sources of funding of the budget deficit.

Table 8

Federal budget revenues from privatization and sales of property (non-renewable sources) in 2000 – 2009, in mln rubles

Year	Total	Sale of stock in federal ownership (2000–2009) And other forms of equity participation (2005–2009)#	Sale of land plots	Sale of various property
2000	27167.8	26983.5	–	184.3[1]
2001	10307.9	9583.9	119.6[2]	217.5+ 386.5+0.4 (intangibles)[3]
2002	10448.9	8255.9[4]	1967.0[5]	226.0[6]
2003	94077.6	89758.6	3992.3[7]	316.2+10.5[8]
2004	70548.1	65726.9	3259.3[9]	197.3+1364.6+0.04 (intangibles)[10]
2005	41254.2	34987.6	5285.7[11]	980.9[12]
2006	24726.4	17567.9	5874.2[11]	1284.3[13]
2007	25429.4	19274.3	959.6[14]	5195.5[15]
2008	12395.0	6665.2+29.6	1202.0[16]	4498.2+0.025 (intangibles)[17]
2009	4544.1	1952.9	1152.5[16]	1438.7[17]

–refers to internal financing sources to cover deficit of the federal budget, the amount of RUR29.6 mln for 2008 (Report on the execution of the federal budget as of January 1, 2009) refers to the federal budget revenues, but it is missing in the Law on the execution of the federal budget for 2008;

[1] – revenues from privatization of state-owned organizations included in the sources of internal financing of the federal budget deficit;

[2] – revenues from sales of lands and rent rights to lands in federal ownership (the land sites under privatized enterprises are shown separately) included in the federal budget revenues;

[3] – aggregate revenues from (1) sales of property in federal ownership included in the sources of internal financing of the federal budget deficit; (2) revenues from (i) apartment sales, (ii) sales of state production and non-production funds, transportation vehicles, other equipment and material values, also (3) revenues from sales of intangibles included in the federal budget revenues; ;

[4] – with RUR6 mln generated from sales of stock owned by the RF subjects;

[1] In 2003-2004 with account of sales of rent rights.

[5] – proceeds from sales of land and intangible assets which have not been shown separately; included in the federal budget revenues;
[6] – proceeds from state-owned property sales (including RUR1.5 mln from sales of property owned by the RF subjects) included in the sources of internal financing of the federal budget deficit;
[7] – includes proceeds from: (1) sales of land plots under real estate facilities that have been in federal ownership before their disposal; to be credited to the federal budget; (2) sales of other land plots and sale of rights to conclude rent contracts thereto; (3) sales of land plots after the land property rights have been delineated; also sale of rights to conclude rent contracts thereto; to be credited to the federal budget and treated as sources of internal financing of the federal budget deficit;
[8] – sum of (1) proceeds from federally owned property sales that are referred to the sources of internal financing of the federal budget deficit, and (2) proceeds from sales of intangible assets referred to federal budget revenues;
[9] – includes proceeds from: (1) sales of land plots under real estate facilities that have been in federal ownership before their disposal; to be credited to the federal budget, (2) sales of other land plots and sale of rights to conclude rent contracts thereto; (3) sales of land plots after the land property rights have been delineated; also sale of rights to conclude rent contracts thereto; to be credited to the federal budget and treated as sources of internal financing of the federal budget deficit;
[10] – sum of (1) proceeds from federally owned property sales that are referred to the sources of internal financing of the federal budget deficit, (2) revenues from (i) apartment sales, (ii) sales of equipment, transportation vehicles and other tangible property to be credited to the federal budget; (iii) sales of ships utilization products; (iiii) sales of GUPs' property, property of institutions and military property; (iiiii) sales of products of utilization of weapons, military equipment and ammunition; (3) proceeds from sales of intangibles to be included in the federal budget revenues;
[11] – includes proceeds from: (1) sales of land plots under real estate facilities that have been in federal ownership before their disposal; to be credited to the federal budget (2) sales of land plots after the land property rights have been delineated to be credited to the federal budget, (3) sales of other land plots owned by the government before the federal ownership on land have been delineated and not designated for housing construction (the last statement refers to 2006 only), the proceeds are included in the sources of financing of the federal budget deficit;
[12] – proceeds from sales of tangibles and intangibles (less federal budget funds from disposal of confiscated and other property converted to the state income) include proceeds (i) from apartment sales, (ii) sales of FGUPS' property, (iii) sales of property in operational management of federal agencies; (iiii) sales of military property, (iiiii) sales of utilization products of weapons, military equipment and ammunition; (iiiiii) sales of other property in federal ownership; (iiiiiii) sales of intangibles, referred to federal budget revenues;
[13] – proceeds from sales of tangible and intangible assets (less revenues in the form of profitable products of the state under PSA) and federal budget funds from disposal and sale of confiscated, heirless and other property converted to the state income, include revenues from (i) apartment sales, (ii) FGUPs' property sales; (iii) sales of property in operational management of federal institutions; (iiii) sales of military property, (iiiii) sales of utilization products of weapons, military equipment and ammunition; (iiiiii) sales of other federally owned property, included in the federal budget revenues;
[14] – proceeds from sales of land plots in federal ownership after the land property rights have been delineated , included in the sources of financing of the federal budget deficit;
[15] – proceeds from sales of tangible and intangible assets (less revenues in the form of profitable products of the state under PSA) and federal budget funds from disposal and sale of confiscated, heirless and other property converted to the state income, proceeds from sales of sequestrated lumber include revenues from (i) apartment sales (ii) FGUPs' property sales; (iii) sales of property in operational management of federal institutions; (iiii) sales of released movable and immovable military and other property of the federal executive authorities with the military service and the service equated thereto; (iiiii) sales of products of military designation available at the federal executive authorities within the framework of military and technical cooperation; (iiiiii) proceeds from sales of other federally owned property, included in the federal budget revenues;
[16] – proceeds from sales of lands in federal ownership (except lands of federal autonomous institutions) to be included in the federal budget revenues;

[17] – proceeds from sales of tangible and intangible assets (less revenues in the form of profitable products of the state under PSA) and federal budget funds from disposal and sale of confiscated, heirless and other property converted to the state income, proceeds from sales of sequestrated lumber. Proceeds from sales of special feed-stock and fissionable materials include proceeds from: (i) apartment sales, (ii) sales of property in operational management of federal institutions (except autonomous)[1], (iii) sales of released movable and immovable military and other property of the federal executive authorities with the military service and the service equated thereto, (iiii) sales of utilization products of weapons, military equipment and ammunition; (iiiii) sales of products of military designation available at the federal executive authorities within the framework of military and technical cooperation (2008 only), (iiiiii) sales of utilization products of weapons and military equipment under the federal target program "Industrial utilization of weapons and military equipment (2005-2010);», (iiiiiii) proceeds from sales of other federally owned property and proceeds from sales of intangible assets included in the federal budget revenues;
Source: Laws on the execution of the federal budget for 2000 – 2008; Report on the execution of the federal budget as of January 1, 2010; www.roskazna.ru; estimates of the authors.

In 2009 the federal budget revenues of property nature generated from non-renewable sources continued falling down sharply following the trend of the previous year.

Proceeds from stock sales fell almost by 3.5 times, from sales of various types of property – by more than 3 times. While the proceeds from the latter source appeared to be comparable in absolute values (over RUR1.4 bln) with those in 2004 and 2006 and exceeded the 2005 level by 1.5 times, the proceeds from stock sales (leas RUR2 bln) reached its absolute minimal value for the entire period of 2000'es. Unlike 2008, when the proceeds from land sales grew by almost 1/4, in 2009 they dropped though insignificantly (by 4%) reaching RUR1.15 bln. However this source (land sale proceeds) remained less valuable (in terms of weight) (about ¼ of all revenues from non-renewable sources, approximately at the level of 2006) vs the proceeds from stock sale (43%) and sale of various types of property (31.7%). The proceeds from stock sales made less than a half of all such revenues for the first time in the period of 2000'es; the unit weight of the proceeds from sales of other property also shrank vs 2008.

The year of 2009 demonstrated a more than double fall of the overall volume of federal budget revenues from privatization (sales) and use of the state-owned property (*Table 9*). Their absolute values (RUR 36.4 bln) vs 2008 reduced by more than 2 times and proved to be minimal for the entire period of 2000'es. Still we can state that this value has exceeded the target figure voiced out at the working meeting of the RF Government Chairman with Yu. A. Petrov, Head of Federal Property Management Agency held in the mid of July 2009 where the latter expressed his assurance in that the Agency would remit to the budget about RUR20 bln in 2009 [2].

[1] Also less proceeds from sales of FGUPs' property .

[2] www.rosim.ru, 16.07.2009. It should be noted, however, that the Federal Property Management Agency administers not all the revenues connected with the use of the state-owned property and its privatization.

Table 9

Structure of the federal budget revenues of property nature generated from various sources in 2000–2009

Year	Aggregate revenue from privatization (sales) and use of state-owned property		Revenue from privatization (non-renewable sources)		Revenue from the use of state-owned property (renewable sources)	
	RUR, mln.	% to total	RUR, mln.	% to total	RUR, mln.	% to total
2000	5041.3	100.0	27167.8	53.9	23244.5	46.1
2001	39549.8	100.0	10307.9	26.1	29241.9	73.9
2002	46811.3	100.0	10448.9	22.3	36362.4	77.7
2003	135338.7	100.00	94077.6	69.5	41261.1	30.5
2004	120798.0	100.0	70548.1	58.4	50249.9	41.6
2005	97357.4	100.0	41254.2	42.4	56103.2	57.6
2006	93899.8	100.0	24726.4	26.3	69173.4	73.7
2007	105761.25	100.0	25429.4	24.0	80331.85	76.0
2008	88661.7	100.0	12395.0	14.0	76266.7	86.0
2009	36393.4	100.0	4544.1	12.5	31849.3	87.5

Source: Laws on the execution of the federal budget for 2000 – 2008; Report on the execution of the federal budget as of January 1, 2010; www.roskazna.ru; estimates of the authors.

In 2009 the trend of increasing weight of the renewable sources in the structure of aggregate revenues from privatization (sales) and use of the state-owned property had further developed. The share of revenues from the use of the state-owned property was 87.5%, being the highest in the 2000'es. The share of revenues from privatization and sales of property was minimal – 12.5%.

If in 2008 the revenues from the use of the state-owned property played a buffer role, not going lower than the 2006 level, in 2009 they exceeded the similar figues for 2000-2001 only when the actions were performed under the Concept of Management of State-Owned Property and Privatization in the Russian Federation in 1999, while the revenues from privatization and sales of various types of property proved to be minimal for the entire period of the 2000'es.

5.1.5. Changes in the legislative and normative framework regulating the public sector

The year of 2009 was marked by introduction of a number of important innovations in the legislative and normative framework regulating activities of the unitary enterprises and economic entities where the government has its stake (participates). Indeed, these innovations are going to influence seriously the property policy of the federal government in the near future.

Of priority is Regulation of the RF Government of December 31, 2009 No 1188.

This Regulation demands from the executive federal authorities except President's Administrative Department, to present, within three months and according to the established procedure, draft acts for specifying the lists of federal government unitary enterprises (FGUPs) in their jurisdiction.

The Federal Property Management Agency is instructed, by July 1, 2010, to carry out actions in reference to FGUPs not included in the mentioned lists for their restructuring, liquidation or inclusion into a forecast plan (program) of privatization and to exercise ownership rights in relation thereto until such actions are completed.

The said Regulation made a number of amendments in and additions to the legislative and normative acts regulating functions of the unitary enterprises in federal ownership, the most significant changes being as follows:

Amendments in Regulation of the RF Government of December 3, 2004 No 739 "On the authorities of the federal executive authorities in exercising the ownership rights to the federal government unitary enterprise" expanded the range of authorities of the federal executive authorities in relation to enterprises in their jurisdiction that are included in the Forecast plan (program) of privatization of the federal property.

Earlier these authorities were exercised only in relation to enterprises to be converted into joint-stock companies with the contribution of shares into the charter capital of other joint-stock companies or keeping them in federal ownership.

Besides, the range of authorities now includes rendering support in preparation of documents by the enterprises required for taking decisions about the terms of privatization and the submission of these documents to the Federal Property Management Agency that has been granted the right to:

- request documents from the enterprises which the enterprises are obliged to keep according to the 2002 Law on Unitary Enterprises; while in relation to enterprises included in the Forecast plan (program) of privatization of federal property – request also documents required for taking decisions on the privatization terms and also to set the dates for their submission;
- launch claims to courts on invalidation of transactions performed by enterprises in violation of the established procedure;
- audit, within the framework of their authorities, the use of federal property being in economic management of the enterprises, decide on and carry out documentary due diligence and other audits, including inspections, and make decisions on auditing enterprises including those in the Forecast plan (program) of privatization of federal property to see whether federal property is used efficiently and kept safe.

The list of grounds to terminate an employment contract with a Leader of a federal unitary enterprise under the RF Government Resolution No 234 of March 16, 2000, was supplemented with such grounds as a failure to present or a failure to present on time, a failure to present valid (correct) and/or complete data (information) as necessary to the Federal Property Management Agency and/or a respective executive federal authority under which jurisdiction the given enterprise falls.

The Federal Property Management Agency was also granted the right to include their representatives with the decisive votes in the commissions in organizing a competition to fill the vacancy of the enterprise director and in certifying director's competences.

The Regulation on the management of federally owned shares of open joint-stock companies and the use of a special right of the Russian Federation ("golden share") to participate in the management of open joint-stock companies approved by the RF Government Resolution of December 3, 2008 No 738 was changed as follows:

Earlier the Federal Property Management Agency exercised the right of the federal government as a shareholder in different ways based on the classification of joint-stock companies with the federal government interest in their capital (three categories):

- joint-stock companies included in a specialized list[1] as agreed with the federal ministry or federal authorities of executive power vested with the authorities of management of

[1] A group of companies of importance in relation to which the position of the federal government as a shareholder on a number of significant issues is defined by resolution of the federal government, Russian Government Chairman or his/her Deputy upon the Chairman's assignment. Initially this List was approved by the RF Government in 2003, however it has been changed since then many times.

state property under the guidance of the President of Russia or the Government of the Russian Federation;

– joint-stock companies included in the list of strategic companies approved by the President of Russia (hereinafter the Strategic List)[1], except joint-stock companies that are included in a specialized list – based on proposals of a federal agency in the jurisdiction of the federal ministry concerned or the respective federal body;
– other joint-stock companies - independently, while where a federal agency or a federal body as a shareholder presents proposals according to the established procedure – with account of those proposals.

RF Government Resolution of December 1, 2009 No 978, cancelled the category of strategic joint-stock companies keeping only the category of joint-stock companies in the specialized list; it was stated that in other joint-stock companies the Federal Property Management Agency exercises the shareholder's rights based on the proposals of the federal agency in jurisdiction of the federal ministry or the relevant federal body.

It was stated additionally that if a joint-stock company not included in the specialized list does not submit any proposals (also on candidates proposed for inclusion in the list of candidates for electing board of directors), the Federal Property Management Agency shall develop independently proposals on the federal government position as a shareholder.

The general change of the legislative and normative framework regulating activities of the unitary enterprises and economic entities where the federal government is involved, may be described as having a growing number of exclusions.

Thus certain government acts established that the above mentioned Regulation on the management of federally owned shares of open joint-stock companies and the use of a special right of the Russian Federation ("golden share") to participate in the management of open joint-stock companies shall not apply to management of federally owned shares of OJSC State Transportation Leasing Company, shares of joint-stock companies to be transferred to GK Rostechnologies as an asset contribution of the Russian Federal Government before such shares are transferred. A number of authorities of the Federal Property Management Agency have been passed over to Administrative Board of the President of the Russian Federation and the Federal Agency of Marine and River Transport in relation to unitary enterprises in their jurisdiction, while late 2008 these authorities were transferred to the RF Ministry of Defense.

5.1.6. Possible impact of the financial crisis on the property relations and prospects of their development

The anti-crisis actions of the RF Federal Government with a domineering trend of limiting direct involvement of the government in capital in principle set the context for this or other privatization scenario.

The development of a future privatization agenda and its possible format, however, meets with certain difficulties.

Firstly, the bulk of the state-owned property was represented by either low-liquidity assets (that required sizable investments or were insufficient in terms of giving control as in case of

As for joint-stock companies included in this specialized list, if a federal ministry has federal agencies under its control, proposals submitted to the Federal Property Management Agency must reflect consolidated positions of the federal ministry and its federal agencies on each issue.

[1]Decree of President of Russia of August 4, 2004 No 1009.

minority shares) or very attractive assets (e.g. control or blocking stakes in national monopolies) which sale was quite possible but at the adequate market price if certain conditions allowed for this. It is quite probable that the list of problematic assets owned by the state will be expanded as the crisis continues.

Secondly, the financial crisis that brought about the collapse of the stock market, devaluation of assets and withdrawal from the market of many potential investors who experienced serious problems in their native countries still acts as a natural limiting factor of privatization.

In such situation prospects of significant growth of budget receipts from privatization are quite low moreover with account of lacking assets in the fuel and power complex. We may hope receiving large amounts of revenues only when the Russian economy begins showing signs of going out of the crisis while in the countries with more developed economies the crisis will be close to its end, and as a result of this a flow of capital and investments would be observed to the emerging markets including Russia.

Therefore no inclusion of major assets such as Sberbank, VTB, RZhD, Airoflot, Sheremetievo airport in the privatization program is planned for the near future. As for VTB, it is enough saying that in the mid-term there is a probability of selling its minority block of shares while presently the government interest in the VTB capital reaches 85.5%.

Thirdly, the orientation on the budget revenues as the only criterion of conducting the privatization policy, specifically in the context of crisis, contradicts the tasks of the so-called structural privatization primarily in attracting investments for production upgrade.

The Ministry for Economic Development jointly with the Federal Property Management Agency is drafting amendments for the Law on privatization that would allow conducting auctions with investment terms. In a number of cases, e.g. where state-owned stakes in infrastructure facilities are sold the auction terms may include the requirement to preserve the business profile[1].

In this connection it would be worth reminding the low efficiency of the investment bids in the 90"es. The volume of investments received from the sales at the investment auctions (with account of delivery of obligations of the previous years) in 1997 made 1.3% only of the total investments in the capital assets (in 1994–1996 less than 1%). Alongside with this quite a large number of investors participating in the investment bids demonstrated obvious examples of unfair behavior disrupting their commitments. As a result, the investment bids were cancelled (Second Law on privatization of 1997) and replaced for commercial bids with investment and/or social terms[2] where the property rights were granted to the auction winner only after certain commitments had been delivered. The current 2001 Law on privatization provides for bids as an independent method of privatization, however the exhaustive list of its possible terms[3] does not contain the terms of attracting investments for restructuring of a company. De-facto an auction with social terms may be deemed.

[1] Interview with the Head of the Federal Property Management Agency E. L. Adashkin, RIA Novosti, www.rosim.ru, 25.11.2009.

[2] The commercial bid as an independent method of privatization was actively applied in 1992-1997 mainly for privatization of small businesses when the buyer of an enterprise undertook certain obligations, preserving the business profile, among them. After Law on privatization was enforced in 1997, the investment and the commercial bids merged actually into one method.

[3] The bid terms may be like follows: (1) keeping a certain number of jobs (2) retraining and raising qualification of the employees; (3) restriction on changes of the business profile of the unitary enterprise or designation of

Speaking about possible return to privatization practices with investment obligations and their future, we can assume that this aspect is similar to the issue of reasonable fine tuning of the tax system towards encouragement of certain types of activity (e.g. innovations). In other words, whether the government administration is sufficiently able to control the use of certain legal norms/provisions for compliance with their target purpose.

Fourthly, the critical condition of many private companies that rushed to get support from the government threw light on the fact that had not been obvious until recently that the private business is not always a synonym of an efficient and responsible owner of the assets. Comparison of efficiency of state-owned and private companies in terms of their resistance to crisis and needs in the government support requires additional examination in the context of present-day realities.

Fifthly, a partial shift of the "gravity center" from the government authorities to various integrated entities with government involvement in making decisions on privatization (one of such examples is Rosneftegaz that secures its indirect control over Rosneft and Gazpromneft) when these entities become owners of a large number of assets due to various reasons (assets are received from the government in the process of establishment and M&A) makes the position of the management of such entities very weighty.

Where such entities initiate sales of their assets, the state is obliged to receive certain reimbursement at least for the assets that had been contributed to those entities earlier for free. It refers primarily to state corporations established in 2007 – 2008 that proved to be outside the scope of true corporatization, and to the recipients of state support programs during the crisis. In some cases the government may put up with ignoring budget-related problems in the course of "big privatization" by integrated entities; but then the obligatory set of behavioral requirements to such business entities must include the absence of outstanding debts, refusal from participation in mergers and acquisitions for the definite period of time, active investments with account of priorities of the federal government anti-crisis program.

Otherwise there may be a return to the earlier privatization stages in Russia with fast and uncontrolled enrichment of the management in cases where a "shell" of a holding head company became a subject of corporate governance or privatization deprived of its valuable subsidiaries with their expensive production or financial assets.

In the sixth place, one should understand that stimulation of the privatization process as such is not a sufficient condition for changing the corporate control market situation. Much depends on the regulation of participation of companies with the government stake in mergers and acquisitions. The focus here should be placed on restricting the acquisition of non-core assets, better selection of decisions that require the agreement of the state both as the owner and the market regulator.

Thus the degree of real submission to the state control of the management of those companies in which the state participates, the degree of manageability, loyalty and the vision of the place and roles of particular assets through the lenses of long-term development of various integrated entities including state corporations moves to the forefront. This makes the task of improving corporate and strategic governance in the companies with the government involvement more urgent and up-to-date.

facilities for cultural, utilities or transportation services, or termination of their use; (4) f rehabilitation, repair and other works on the facilities of cultural heritage and of social, cultural and utilities designation.

In this context rolling out the practice of attracting professional directors[1] to the management bodies of such companies could play a certain role.

The Federal Property Management Agency jointly with the RF Ministry for Economic Development began doing some work in execution of the assignments of the President of Russia set as a follow-up of his meeting with representatives of the Russian Union of Industrialists and Entrepreneurs held in April 2008.

For this purpose general provisions and normative acts regulating both the process of attraction of independent managers to the board of directors of joint-stock companies with the stake of the Russian Federation in their charter capitals and the issues of their activities[2] were developed; changes were made in the RF Government Regulation of December 3, 2004 No 738 "On the management of federally owned shares of open joint-stock companies and the use of a special right of the Russian Federation ("golden share") to participate in the management of open joint-stock companies" regarding election of independent directors to the management bodies of those joint-stock companies which shares are owned by the Russian Federation. Early 2009, the Federal Property Management Agency by its order established a Commission for selection of independent directors, representatives of the interests of the Russian Federation and the auditors for electing them to the management bodies of joint-stock companies and approved the respective Regulation[3].

The RF Government performed certain actions to secure the conclusion of contracts with the members of the board of directors who are professional directors; also joint-stock companies with the state involvement and professional directors on their boards of directors have been monitored with the subsequent evaluation of the implementation efficiency of this institution.

At the first stage of work in this direction, professional directors were selected in nine joint-stock companies that are in the specialized list approved by the RF Government Resolution of January 23, 2003 No 91-r, which 100 % shares belong to the Russian Federation

[1] Following the established tradition of corporate governance of joint-stock companies with the state participation, board of directors members elected by votes according to shares owned by the federal government as a shareholder can be grouped as follows: (1) government officials who represent the interests of the federal government are obliged to vote according to the owner's instructions; (2) representatives of the government interests who are proxies are obliged to vote according to the owner's instructions on the limited range of 5 issues while on other issues – at their own discretion (this mechanism of securing the government interests emerged in 1996 but has not been widely applied since then); (3) independent directors who vote being guided by their personal professional experience and opinion and meet the established selection criteria. According to the Federal Property Management Agency, the persons in the second and third groups may be called professional directors.

[2] Among others, were defined:
- criteria of professionalism and independence of BoD members applied to individuals proposed by the federal government for their selection and further engagement as independent directors in joint0stock companies;
- the list of joint-stock companies which BoDs should have professional directors;
- the number of independent directors and professional proxies determined in relation to the size of the RF government stake;
- the selection procedure of professional directors and the principle of creating a list of candidates for election into open JSC management bodies as independent directors and professional directors-proxies;
- criteria of referring a board director to independent directors and the development of the respective requirements to the candidates.

[3] Does not apply to JSC that are included in the specialized list in relation to which the position of the state as a shareholder on a number of important issues is defined by the decision of the RF Government, the RF Government Chairman or the RF Government Chairman Deputy in the name of the Chairman. Initially approved by the RF Government.

(OJSC Agency for Mortgage and Housing Crediting, OSC Joint-Stock Company for Oil Transportation Transneft, OJSC Zarubezhneft, OJSC Corporation Roskhimzaschita, OJSC International Airport Sheremetievo, OJSC Russian Railways, OJSC Rosselkhozbank, OJSC SG-Trans and OJSC Modern Commercial Fleet).

At the second stage of the implementation of the objective to increase the number of professional directors on the boards (Supervisory councils) of the joint-stock companies which shares are owned by the Russian Federation, extraordinary general meetings of shareholders were held, and new management bodies were elected with participation of professional directors in another seven companies: OJSC Airoflot – Russian Airlines, OJSC Russian Fuel Company Rostoprom, OJSC FSK Unified Energy Network, OJSC Rosagroleasing, OJSC RusHYDRO, OJSC Holding MRSK and OJSC RAO Energy Networks of the East[1].

According to the Federal Property Management Agency, by autumn 2009 the BoDs (Supervisory councils) of 253 joint-stock companies had 563 professional directors while at the end of 2008 their number was about 50)[2]. Thus we can state that early 2009 this institution was implemented in 7.6% of the companies with the federal government stake of their total number. This institution has been most widely applied in the electric energy and communications sectors.

Besides, the Federal Property Management Agency also applied the practice of engaging managing companies that acted as sole executive bodies of the joint-stock companies, but this practice has been even less popular than the institution of professional directors (as of the end of 2009 only six managing companies had been involved in management of the joint-stock companies with the government stake).

A most important area of activities of professional directors to improve performance and efficiency of the joint-stock companies with the government interest should be their work on three specialized Committees at the management bodies of these companies (Strategic Planning Committee, Audit Committee and HR and Remuneration Committee); it is proposed to elect as Chairmen of these Committees those board members who are not government officials (but independent directors or professional proxies).

5.2. Government Support of strategic companies: key instruments, specifics and practical implementation challenges

5.2.1. Specific measures and approaches to the support of backbone enterprises in crisis situation

To correctly evaluate government support of strategic companies it is important to understand specific economic conditions in which government anti-recession instruments and measures were developed and the approaches underlying government support to strategic companies were defined[3].

[1] Federal Agency for Federal Property Management. Progress report for 2008, M., 2009.
[2] T. Zykova.To replace civil servants// Russian Gazette, September 16, 2009. Federal Agency for Federal Property Management. Progress report for 2008, M., 2009.
[3] This section is based on part of the deliverables of the project implemented by the Academy of National Economy under the RF Government focused on evaluation of various instruments of government support to strategic companies. The project was implemented by a group of experts in the end of 2009 in the interests of the Expert Council with the Government Commission for improving sustainable development of Russian economy.

Russian banking system was the first to be hit by global economic crisis. In September 2008 certain efforts on behalf of the monetary authorities were already in demand to support the liquidity of the banking system. In October such support was already provided on a bigger scale allowing for avoiding the financial system collapse, but not capable of improving the credit terms for the real economy entities. By October 2008 the crisis has already affected the manufacturing industry as well, though recession examples at that time were mainly of local character: significant drop of production was evident in metallurgy (milled products reduced by 21% versus October 2007, steel casting – by 19%), in mineral fertilizers production (14% reduction), cement production (20% reduction), in certain mechanic engineering subsectors (materials handling, construction and road engineering, commercial vehicles).

However by mid-end November it became clear 2008 that the crisis might affect a broader range of sectors. Several factors were pointing at that. First of all, drastic decay of external environment: FTSE/S&P indices slump, fall in oil prices, growing challenges for global financial system. Secondly, despite the efforts of the Bank of Russia and of monetary authorities to support the banking system, the credit terms for Russian companies continued to deteriorate –with regards of both loans accessibility, and borrowing prices. Thirdly, a steady trend for unemployment rate growth became obvious: the number of registered unemployed increased by 4% in the end of November 2008 (vs. October). In the fourth place, negative monetary trends accelerated: сокращение forex/gold holding decrease, ruble devaluation.

It is worth noting that recession, unemployment and other indicators were critical per se, but the main problem was in highly uncertain development outlook, in significant concerns of all market players including the government with regards of possible scale and length of crisis.

It was no longer possible to view the crisis as just financial one associated with insufficient liquidity. Moreover, it was not possible to view it as the crisis affecting mostly major financial and industrial groups with high external debt. It became clear: global energy markets fall and decrease of export is going to affect a significant number of major Russian exporters; inevitable disinvestment and lending reduction jeopardizing all sectors of the economy will have a chain effect leading to material deterioration of market situation and of financial positions of companies across all industries and sectors of Russian economy. Collapse and bankruptcies of major companies in any sector were quite possible; and in the environment when the business community was close to panic, any announcement about suspension of production or about insolvency of just one company could have caused significant growth of mutual distrust among market players and provoked knock-off effect along the cross-sector links.

In the situation of vague economic outlook due to the specifics of Russian banking system the possibilities for effective support of real sector businesses solely through monetary policy instruments turned out to be quite limited: support of bank liquidity was not backed by maintaining the credit terms for real economy. In particular, during late 2008 – early 2009 when ruble was devaluated, it much more profitable and less risky to invest into buying currency rather than to issue loans to enterprises. In other words, high uncertainty generated total collapse of confidence between banks, banks and borrowers, suppliers and consumers. Those were credibility gap and high risks that impeded restoring normal credit terms for enterprises.

Concerns about rapid growth of unemployment in case companies start mass layouts were also justified, and that could lead to extremely negative social consequences, especially in mono cities and in certain regions highly dependent on a limited number of major city-forming enterprises.

It became obvious that anti-crisis measures cannot be completed with just support to major banks. Prevention of bankruptcies or shutdowns of major enterprises due to inaccessibility of funding requires other "pinpointed" instruments of government policy focused on resolving the problems of selected, the most valuable businesses. It is worth noting that most of serious concerns had not come true, but they looked quite realistic by the end of 2008.

However, at that point of time the Government did not have any better fine-tuned "pinpointed" support instruments, or more or less adequate action list.

This, Strategic Actions and Strategic Companies List[1], first of all, is focused on other objectives, mainly – on special procedure for privatization and/or incorporation; secondly, it includes only government owned enterprises and joint-stock companies with government holding blocking or controlling interest. Other officially approved lists (e.g., the Register of Business Entities with market share of 35%+) turned out to be not instrumental for defining the priorities for support, – the latter, in particular, contains several thousand organizations, not all of them being real majors.

It is necessary to acknowledge: the *List of systemic companies of strategic importance* (hereinafter – the List) was formed as an "all-hands-job" simultaneously with defining its goals and objectives and with discussing the possible government's measures. This, of course, marked an imprint on the composition of the List. On top of that, the benefits for the future members of the List were still unclear, so different groups of stakeholders were lobbying the process of the List development. It appears that if only the business community had known the scope and format of future government support in advance, the number of willing participants could have turned out not as big.

Government support to strategic companies was stated to have the following objectives:

– First and foremost – assure social stability, prevent massive layouts at major enterprises;
– Second – assure sustainability of critical cooperation value chains by way of supporting their elements;
– Third – assure stable operations of the key infrastructure elements.

Today we have to recognize: forming the List and administering it (which meant, first of all, monitoring its members and providing government support to them) have become the critical element of the anti-crisis policy. With that, support to strategic companies had its own specifics in different sectors – from the standpoint of both the applied mechanisms and the scope of measures.

We have identified the following topics allowing for detailed review of the government anti-crisis policy:

(1) the List of strategic companies – its objectives and formation principles, sector breakdown;

(2) the key areas and mechanisms of government support to strategic companies – specifics and practical implementation challenges;

(3) high-level definition of sector-based specifics within the government support to strategic companies – benchmarking the scale of support and instruments used in priority industries.

[1] Decree of the RF President of August 24, 2004, No. 1009 "On Approving the List of Strategic Enterprises and Strategic Joint-Stock Companies"

The following material limitations applied to the performed analysis need to be highlighted:

Support rendered to defense industries was quite special, so we are going to refrain from its review (except for some very limited examples);

The scope of our analysis covers only the instruments and measures which the RF Government was really using during the crisis period.

5.2.2. List of systemic organizations of strategic importance: formation principles and composition

Objectives, principles and criteria for forming the list of strategic companies

As per public information, the first approaches to forming the List of strategic companies were discussed at the government level as early as early December 2008. At that time the inclination was to select about 150–200 companies with the biggest contribution to Russian GDP. Various government agencies were simultaneously developing their proposals on including companies into the list and on criteria for qualifying the companies as strategic ones. They were mostly focused on such attributes for as size and social value of a company.

However, already at the first stage at least part of the stakeholders was viewing this List formation not only from the standpoint of preventing bankruptcy of major enterprises, but also from the point of view of creating the capability for future development. Thus, according to the representative of the RF Ministry of Commerce, List preparation was approached from the standpoint of "demand configuration, so that in several years when the crisis is over the companies could enter the market being fully competitive"[1]. Respectively, the following criteria were offered: unique technological capabilities, availability of export contracts for 2009, on-going major capital projects, and key positions within the inter-sector business network.

In December 2008 the List of strategic companies was finalized[2], 295 organizations were included. Initially it was declared open for including other companies; however, no significant changes were made even though there were a number of attempts to increase the list.

As per available data, over 300 proposals to increase the List of strategic companies were received during the first year. However, the List was only insignificantly increased[4] *by way of adding several agricultural enterprises, one agricultural engineering enterprise, two jewelry industry plants and Goznak (money-printing enterprise).*

In our opinion, based both on the finalized List as a whole and on comments provided by various government officials, the formation of the List of strategic companies was associated, on one hand, with significant lobbying by certain agencies to include the maximum possible range of their subordinate organizations into this List; and on the other hand – with the tendency for minimizing the List to the extent possible demonstrated by a number of other agencies. The last tendency, in our view, was based not only on the fact of Government resources to support businesses being limited, but also by a *limited "throughput capacity" of the respective decision-making system.* The number of reviewed issues was limited by multistage endorsement practice within the complicated system of sector-based, inter-sector and gov-

[1] Cited as per Article "Putin's List", *Vedomosty*, December 9, 2009

[2] List of systemic organizations of strategic value was approved by the RF Government Commission for improving sustainable development of Russian economy on December 23, 2008

ernment commissions. Besides, those commissions did not have enough resources and staff for developing the solutions – they were relying on the available personnel of the respective government agencies.

For example, the Cross-Sector Work Group for monitoring economic and financial positions of organizations included in the List of strategic companies held 6 meetings between January 17 and 30, 2009. 15 strategic companies were reviewed at those meetings[1]*. And still, with the List comprising more than 300 companies at that point of time, even such facilitated review would not allow for immediate monitoring of all the strategic companies totality.*

In addition to lack of clear understanding of the List objectives and criteria, the situation was complicated because *the package of potential "rights and responsibilities" of strategic companies was not defined at that point of time.* In particular, the format of potential government support to the List members was not clear, which stimulated the companies for lobbying their inclusion into the List. In our opinion, some pretty tough statements by officials declaring that becoming members of the List would mean thorough control on behalf of the government and would not guarantee financial support[2] could be explained by their desire to somehow limit such lobbying activity.

A very meaningful, though ambiguous from the methodology standpoint decision was made to include multidiscipline holdings and business groups into the List. On one hand, they undoubtedly belong to the backbone of Russian economy and provide for its sustainability to a great extent. On the other hand, major groups comprise of multiple enterprises, businesses and organizations, and most of them do not fall under the criteria for "strategic" companies. The transparency of intra-group connections and relations is extremely poor, so selecting such groups for monitoring and support significantly limits both pin-point selective support capabilities and efficiency of situational monitoring by different sectors and activities.

Thus, due to the above listed contradictions the List of strategic companies viewed as a government policy instrument lacked clear overall objective, but was a sort of a compromise between various specific objectives. And given numerous commentaries to the List including those by government officials, none of the available official documents contain a definition of its main objective. All we can do is just to "recover" some of them by analyzing the method of forming the List and its composition. We need to emphasize that it would be an "ideal" set of objectives and that not each and every of them has eventually been achieved.

The List was aimed to:

- provide for *on-line monitoring of key companies* which are indicative for the economic situation and responsible for socially valuable sectors of economy; also for – presumably – preventing opportunistic actions by the companies' owners and management – actions potentially leading to serious negative social consequences and/or damaging economic security of the country (e.g., due to infrastructure deterioration);
- assure immediate review of government support to major companies *to prevent catastrophic scenarios* in unfavorable circumstances;
- *monitor the efficiency of government support rendered to specific companies.*

[1] Press-Release by the RF Ministry of Finance of February 4, 2009.

[2] See, for example, the RF Government Press Service commentary to publishing the List of strategic companies (http://premier.gov.ru/events/messages/2883/).

All those objectives to a certain extent were reflected in the criteria for selecting the future members of the List. The size of the company actually became the dominating criterion, which is quite disputable from the standpoint of reflecting the true role of the company for the national economy, as well as distorting the sector structure by way *shifting the focus to the sectors with high concentration of industries and domination of business super-giants.*

Initially it was planned to perform screening of the companies with revenues no less than Rb 15 mln and headcount no less than 5,000 pers.[1] These numbers were not underpinned by any meaningful analysis of Russian economy profile, and soon it became clear that many de-facto strategic companies turn out to be beyond the set limits. Eventually the quantitative criteria became softer, but they still were not differentiated by sectors (except for special requirements set for agriculture). The finalized criteria were set in the Methodology Guidelines by the RF Ministry of Economic Development[2] as follows:

Qualitative criteria (a company should comply with at least one of them):

- technology capabilities (availability of hi-po / unique technology included into the List of technologies of social and economic importance or valuable from the national security/defense standpoint (critical technology)[3];
- impact on social stability (jobs maintenance and prevention of massive one-time unemployment единовременной безработицы);
- meaningful for maintaining infrastructure and production chains;
- participation in hi-po investment projects;
- participation in international agreements / commitments.

Quantitative criteria (all of them are mandatory):

- annual revenue for 2007 – no less than Rb 10 bn (for agriculture – no less than Rb 4 bn);
- fiscal charges into different level budgets for the last 3 years – no less than Rb 5 bn (for agriculture – no less than Rb 2 bn);
- headcount – no less than 4,000 pers. (for agriculture – no less than 1,500 pers.).

As it is easy to see, the qualitative criteria were rather high-level and could be interpreted were broadly and in a biased manner, because they were based on non-regulated concepts, such as "hi-po investment projects", "production chains", "mass one-time unemployment", etc. We can take the risk and assume that a very big portion of major and mid-sized businesses in Russia could be recognized as compliant with at least one of those qualitative criteria. No wonder, *the qualitative criteria became the ones that really worked.*

Composition of the List of Strategic Companies

Let us see if the List of Strategic Companies was adequately representing Russian economy[4], was in line with the challenges and priorities of both the crisis stage and of the mid-term perspective.

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[1] Lower thresholds were set for agricultural businesses.

[2] Methodology Guidelines for including businesses into the List of Strategic Companies, April 16, 2009 (http://www.economy.gov.ru/minec/activity/sections/macro/politic/doc1239893148108)

[3] Approved by the RF Government Resolution No.1243-p of August 25, 2008

[4] It is worth noting that it is very difficult to fully evaluate the List from the standpoint of sectors and regions representations – due to a number of reasons. Reason number one: the List comprised not just companies per se – stand-alone productive assets with the status of legal entities – but multidiscipline diversified corporations with dozens and even hundreds of subsidiaries. In addition, the List comprised holdings at the level of their headquarters – and it is difficult to define their sectors and even the level of their control over their own enter-

The results of data search for separate enterprises included into the list allow for the following conclusion: the publication of this document was not backed by public information about the key characteristics of the entities of this List. The main sources of data for analytical purposes were SPARK, Expert-400 rating, official corporate sites, media publications.

List of Strategic Companies versus the list of major Russian companies

As it has been noted above, the main numeric criterion for including a company into the List was its size. In this context it is interesting to benchmark the List against the list of 400 Russian majors composed by "Expert" journal. Let us remember that Expert-400 comprises all major companies irrespective of the business area or sector the operate in, while as mainly "real sector" (productive) companies and trading companies were included into the List of Strategic Companies. To assure like-for-like comparison we excluded financial sector players (banks and insurance firms) from Expert-400 list, as well as a number of servicing companies (entertainment, IT).

The finalized "cleared" list of major companies has got 344 instead of 400 (compare with 304 in the List of Strategic Companies). Let us note that the "passing score" – the size of the annual revenue – was Rb 11.3 bn for Expert-400, which is pretty close to Rb 10 bn threshold approved for the List.

However, comparing the two lists proves that only about 50% of major "real sector" and trade companies were included into the List of Strategic Companies. *40% of the List are companies which cannot be called majors of Russian economy.*

prises (the shares of which are owned by the respective holding). However, the biggest challenge is to analyze a number of managing companies included into the List. The best data available about such companies is list of assets they manage, but it is impossible to assess any consolidated reporting. "Solnechniye Produkty" Managing Company may be one example – it controls several major fat-and-oil producers, cereal-handling elevators, etc., but has no consolidated reporting. This company having got material market share in the respective business areas (mayonnaise, vegetable oil, etc.) is not part, for example, of major enterprises rating Expert-400.

Data about major state-owned corporations are not always available for analysis. This mainly pertains to Rosatom Corporation, the business of which may be evaluated only through some of its subsidiaries (such as OJSC "Atomenergoprom"). But neither for Rosatom, nor for Rostekhnologiyi (formed in 2008 and still being in the process of set-up at the point of time the List was created) consolidated performance reports are available. At the same time, it is impossible to evaluate all separate enterprises – members of Rostekhnologiyi, as there are several hundreds of them.

A significant number of state unitary enterprises included into the List are yet another challenge. They do not disclose their production output and financial performance data.

And finally, there is the "double count" issue due to the fact that the List comprised both the corporations' headquarters and separate subsidiaries/affiliations.

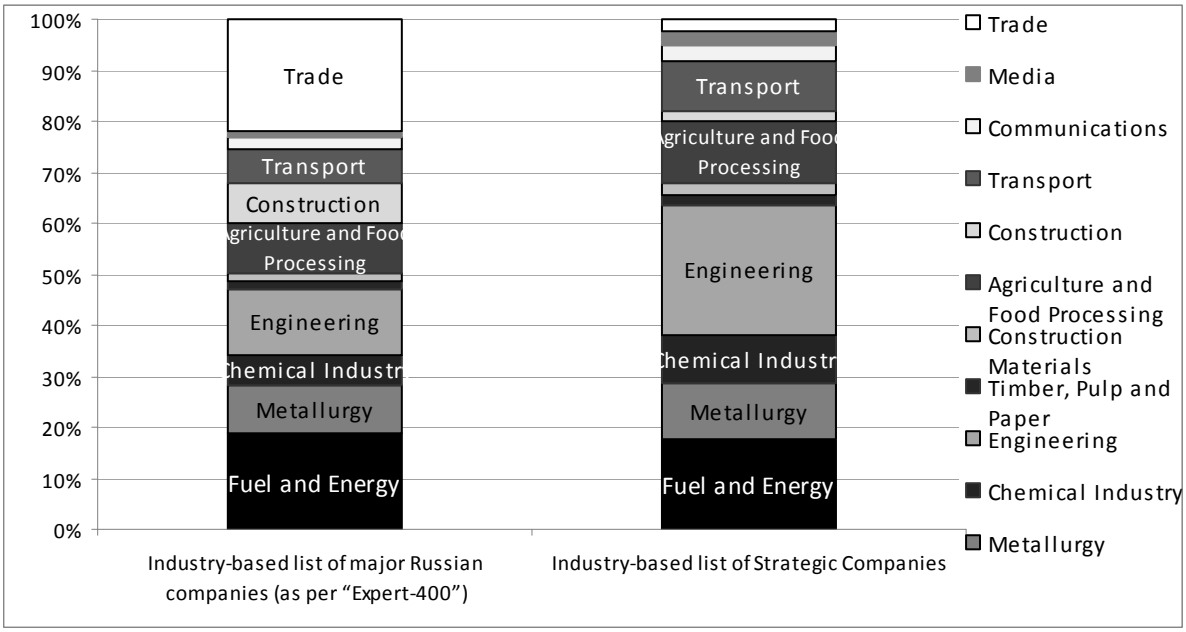


Fig. 1. Sector Profile of Russian Majors According to Expert-400 and the List of Strategic Companies

The biggest discrepancies were noticed in three sectors: engineering, construction and trade. A ten-fold gap in trade share between the two lists proves that *trade companies were included into the List as exceptional cases* and this business area was not recognized as a priority one for identifying the "strategic" component of the economy. If we exclude trade from both lists, then the majority of deviations will be found mainly in two sectors: *construction is strongly underestimated in the List of Strategic Companies*, *and machine engineering companies are, on the contrary, occupy a much bigger place than they are given in the major companies Expert-400 list.*

It is necessary to say that the fact of insufficient presentation of construction companies is caused by the fact that the List comprised only major companies engaged in residential development, while as Expert-400 list comprised mainly companies engaged in industrial (non-residential) construction (like Transstroy, Mosremstroy, Stroytransgas, etc.).

But even coincidence of sector shares in both lists does not always mean that the companies are the same. Thus, in energy (and fuel) sector the lists are 80 similar, while as in agriculture and food processing – only 40% similar.

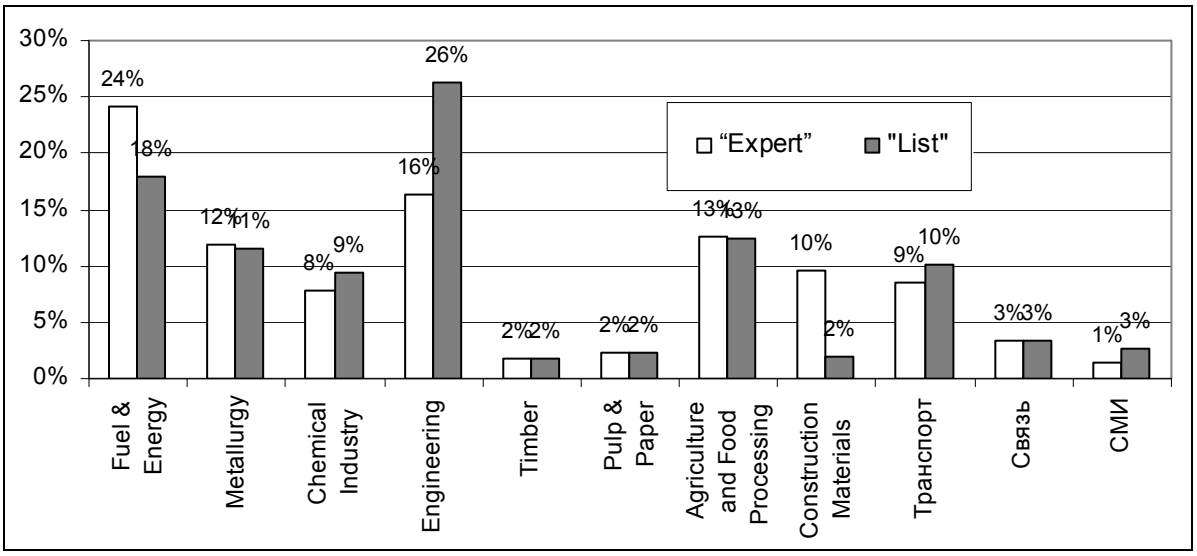


Fig. 2. Sector-based Differences Between Expert-400 and the List of Strategic Companies

If we analyze the lists by sectors in greater detail, it is obvious that *the most critical deviation factor for both lists is the ownership,* though this particular criterion was not specified as important one in the Methodology Guidelines. We need to emphasize that some companies were *discriminated with regards to qualifying them as strategic ones* based not only on the fact of government's interest, but mostly – on *the fact of foreign capital participation.*

Such discretion in including companies with foreign capital into the List may be illustrated by an example in automotive industry: such foreign companies operating in Russia as Ford-Motors, Volks Wagen, GM-Auto and others (all of them – members of Expert-400 list).

The same approach is quite visible in other sectors. Thus, in food processing not only foreign brewing companies were not included into the List, but such major food producers as Nestle-Russia, Krafts-Food and others.

Discrimination based on the fact of foreign capital participation is absolutely obvious, while as preference in favor of companies with government participation versus private capital is not that transparent.

Specific weight of unitary enterprises and government corporations included into the List is ca. 12%, which exceeds significantly their share in the economy (as per Russian Statistics Service, the share of government and combined ownership is less than 8% of the total number of organizations) or their share in the major companies list. This may be explained, first of all, by the fact that many infrastructure companies were included into the List, and most of them are "federal state unitary enterprises (FGUPs)". Also 20 design bureaus and research institutes in the area of shipbuilding, aviation, rocket and missile engineering and in energy sphere were included into the List.

Another 18% of the List covers joint-stock companies with dominating or blocking government stake. Thus, by number of assets the share of the "public sector" in the List is a bit less than 1/3. As for the annual revenue, the share of state-owned companies or companies with material government stake is significantly higher (ca. 50%), but this is explained by the

fact that the List comprises such giants as Gazprom, Rosneft and OJSC RZhD holding the first, the third and the fourth positions in the list of major Russian companies.

Representation of particular sectors was evidently not a criterion for including companies into the List. In other case individual thresholds would need to be established for different sectors – and this was done only for agriculture and food processing. That is why the extent of coverage of different sectors differs materially depending on the sector profile: if majors and super-majors are characteristic of a sector, this sector is broadly represented in the List; for sectors where majors are not typical (e.g., light industry) – the coverage is much smaller. It is difficult to evaluate the "coverage" just by the list of productive sites, because significant number of companies, as we have emphasized earlier, have got those in various areas of business, while as data on revenues distribution between different positions within the All-Russian Classifier of Types of Economic Activity are rarely available.

We can use expert method to evaluate the share of production in individual aggregated areas of business – in terms of its distribution between companies included into the List. Thus, in power generation, there is maximum coverage, up to 90%. For oil and gas industry the coverage is also pretty significant – 80%. Some of relatively "small" industries are also strongly represented in the List, such as pharmaceutical industry (10 producers and 1 distribution chain were included, while as only one producer and three distribution chains from pharmaceuticals were part of Expert-400). Other well-covered sectors are shipbuilding industry, aviation, missile and rocket engineering, defense industry. Chemical industry and metallurgy have over 50% coverage.

Least coverage is found in construction materials (only a few major cement producers were included), construction, food processing and light industry.

Thus, the List of Strategic Companies is not a comprehensive totality of major companies (even though the correlation is pretty close). Neither is it the reflection of the sector-based profile of Russian economy. Nevertheless, it would be wrong to say that the List has no scientific basis at all and is a result of mere lobbying by companies and organizations.

The analysis of this document allows for clear definition of the priorities, which were not explicitly worded, but still underpinned the approach for selecting companies to be included into the List. In our opinion, *such priorities were infrastructure (mainly, energy and transport), export, national security with regards to hi-tech defense enterprises, and agriculture.* In total, two thirds of the List is dedicated to such companies[1].

Such focus on infrastructure companies is to a certain extent justified, because termination or abrupt reduction of their operations at key infrastructure sites could indeed have a very strong negative impact on citizens, on national security and on businesses in other sectors of the economy. Special attention to major exporters may also be explained in the situation when drastic external demand decline and world markets prices slide with regards to Russian exported products became one of the major implications of the global crisis.

[1] Multidiscipline companies were qualified as parts of such priority sectors based on the expert opinion taking into account their core business

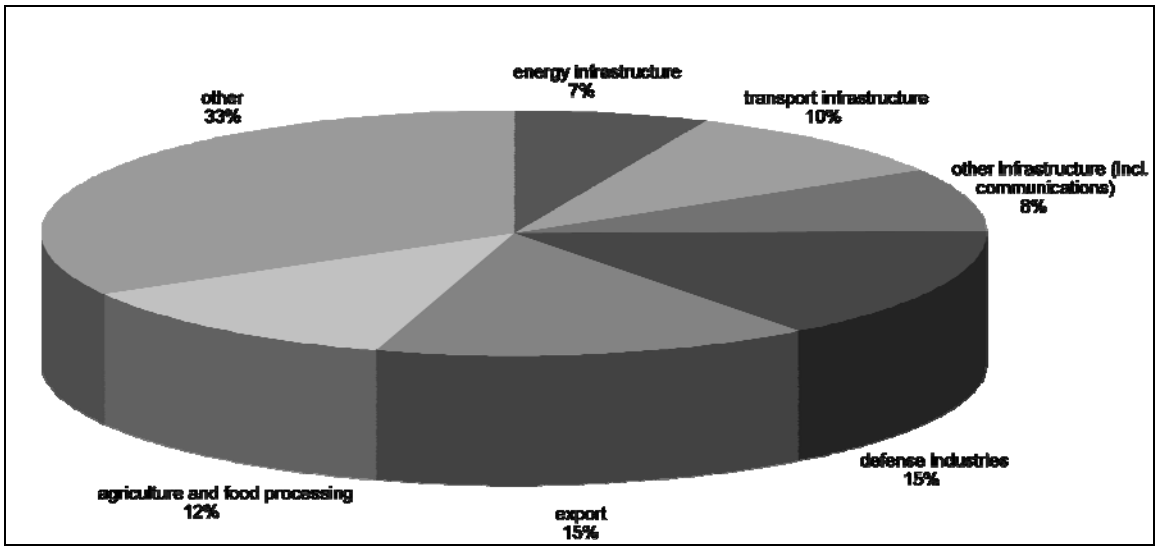


Fig. 3. Distribution of the List of Entities by Priority Business Areas

The following general observations may be made on the structure and purposes of the List of Strategic Companies:

1. In general the List is more than 50% consistent with the Expert-400 major companies list. This is especially true for such sectors, as fuel and energy, metallurgy and chemical industry.

The exceptions are mainly associated with "discriminating" certain companies with foreign capital participation, as well as with underestimating certain sectors of the economy: service sector, trade and construction. The so-called "additions" to the List (meaning companies which are not in the Expert-400 major companies list, but were included into the List of Strategic Companies) pertain mostly to engineering (because many manufacturing and R&D centers of defense industry were included), pharmaceuticals and transport (by way of including major airports and sea ports).

Despite the discrepancies between the List of Strategic Companies and Expert-400 list of major companies, the cumulative dynamics and key financial indicators of the List reflect the totality of major Russian companies.

2. The List of Strategic Companies is mostly focused on infrastructure (primarily energy and transport), export and defense. Due to these industries being more or less "autonomous" (in the sense of their challenges and threats being very different and relating to different spheres) the List appears to be pretty eclectic.

3. If we were to evaluate the instrumentality of the List from the point of view of the objectives declared at the stage of its formation, our opinion would be: it did not provide for fully achieving any of them. In particular, the List has substantial deficiencies from the point of view of "on-line monitoring of key economic entities": first of all, it does not include major manufacturers in quite some sectors and industries; secondly, in many cases it includes both holding companies headquarters and companies being parts of such holdings. At the same time, the List comprises many companies which can be qualified as "strategically important", but have no impact on the overall economic situation (and even on the situation in a particular sector).

The List also raises certain doubts with regards of preventing opportunistic behavior by businesses owners and management and implementation of decisions with seriously negative social implications and/or damage to national economic security, because – on one hand – the List is too extensive to provide for on-line monitoring of management decisions for all the selected companies, and on the other hand – it includes significant number of unitary enterprises and corporations fully owned by the state, in which the owner should control such decision-making within their standard internal governance procedures.

The List is not very instrumental for "reviewing the issues of government support to major companies with the purpose of preventing catastrophic scenarios in unfavorable circumstances", because it does not include quite a few major companies. Besides, it is unclear, what scenarios should be regarded as "catastrophic". The decision-making practices during the time of the crisis build-up, social catastrophes may occur not only at major companies, but at medium-sized ones, if they are city backbones.

4. The key problem with forming the List of Strategic Companies, in our opinion, was not only the "diluted" criteria for selecting companies, but even more – lack of clear understanding of why this List was needed. It is evidently redundant to be viewed as the list of candidates for receiving government support because it comprises too many entities, most of which have such complicated structure that detailed review of the issues associated with one of such entities (e.g., Gazprom or Rostekhnologiyi) is too difficult for Work Groups and industry commissions.

Publication of the List reflected, most likely, the political declaration of the government at the critical stage of the crisis and in the environment of extremely vague outlook for 2009 development, stating that the government would not allow for bankruptcy of the key "strategic" companies. This declaration was aimed at reassurance of creditors and suppliers to avoid panic in case of the risk of major business entities insolvency. This objective was achieved – to a certain extent.

It may be assumed that the very fact of a company being included into the List irrespective of receiving real financial aid provided for decreasing the risk ratings for this particular entity - on behalf of both banks and suppliers. Besides, inclusion into the List could force regional governments to be more attentive to the situations at particular enterprises providing for immediate organization support and other types of assistance.

5.2.3. Key areas and instruments of government support to strategic companies: specifics, challenges and practical implementation progress

A number of official documents[1] declared the following instruments to be used for government support of strategic companies:

– debt financing;
– government guarantees;
– subsidies from the budget;
– additional capitalization;
– tax arrears restructuring;

[1] Ref. RF Government Anti-Crisis Program for 2009 (approved by the RF Government on June 19, 2009), presentation by E. Nabiullina, RF Minister for Economic Development at the ministerial board meeting "2008 Performance of the RF Ministry for Economic Development and Key Objectives for 2009" on March 24, 2009 (http://www.economy.gov.ru/minec/press/news/doc1237883863610), Press Release by the RF Government about publication of the List of Strategic Companies (http://premier.gov.ru/events/messages/2883/)

– government procurement;
– change of import and export duties.

In this sub-section we will review *the instruments actually applied to strategic companies (and having impacted their situations),* their coverage and industry focus. Three comments need to be made for this purpose.

The first one: many measures listed as possible government support instruments were not really focused predominantly on strategic companies (e.g., partial interest rate subsidies).

The second one: one of the key measures to support strategic companies was refinancing of the external debt of major companies by Vnesheconombank, even though this particular mechanism had been in use before the List of Strategic Companies was in place.

And the third one: a significant portion of anti-crisis measures were not de-targeted at strategic companies and was not listed among government support instruments; rather, it was focused on a number of particular industries and sectors (automotive, oil-and-gas); however, due to high plant concentration in such sectors these measures had a focused impact mainly on respective strategic companies. In particular, such measures included partial interest rate subsidies to citizens for purchasing new cars, raising the non-taxable limit for MET assessment.

Direct and indirect anti-crisis measures to support strategic companies may be grouped by key areas of support:

(1) assuring financing resources accessibility:

– loans by Vnesheconombank to major companies to settle their external debt,
– government guarantees for loans,
– partial interest rate subsidies,
– expanding the Lombard List of the Central Bank,
– budget subsidies to prevent bankruptcy (recipients – strategic companies of defense industry), compensation of shortfalls in income (OJSC Russian Railways),
– increase of share capital, additional capitalization;

(2) incentives for domestic demand:

– additional government procurement programs (cars for federal executive authorities, public vehicles fleet renewal at regional and municipal levels),
– partial interest rate subsidies to citizens for purchasing new cars;
– additional capitalization of OJSC RosAgroLeasing to increase procurement of agricultural vehicles, equipment, etc.;
– increasing import customs duties (for used and new cars, buses, grain harvesters, pipes, rolled metal, etc.), decreasing import quotas (poultry)[1];

(3) decreasing burdens for businesses:

– reducing oil-and-gas sector tax burden (raising the non-taxable limit for MET assessment, changing the procedure for accruing the expenses for acquisition subsoil use licenses, introducing tax holidays for developing some of the fields);
– mandatory payments arrears restructuring for some of automotive companies;
– changing the calculation methodology and decreasing export duties (price monitoring period decreased, respectively – period for fixing crude and products export duties de-

[1] Big number of government measures in this sphere does not allow for detailed review within this Section. We can only note that most of them were focused on supporting automotive industry, agricultural engineering, metallurgy and agriculture/food processing.

creased, export duties cancelled for unalloyed nickel and copper cathodes, nitrogen and mixed fertilizers, etc.)[1].

We believe it is necessary to focus on a detailed review of the following three mechanisms and the ways they were implemented:

– loans to companies to refinance their external debt;
– government guarantees to borrowing companies;
– providing budget subsidies to partially compensate interest rates.

The reasons we are especially focused on these three mechanisms are, firstly, their scale (at least, the planned scale), and secondly – the fact of them not being limited to one or two priority sectors.

Assuring financial resources accessibility for strategic companies

Loans by Vnesheconombank to major companies to settle their external debt

The legal framework for this mechanism of Vnesheconombank refinancing the external obligations of the real sector companies was defined in mid-October 2009[2] – approximately two months prior to approving the List of Strategic Companies. The bank was granted the right to issue foreign currency loans to Russian companies for the purposes of redemption and servicing of previously received loans from foreign credit institutions, as well as to purchase receivables from foreign creditors. The minimal interest rate for loans issued was set at the level of 5 points LIBOR spread (in USD for 1 year). The ceiling was set for overall amount of loans issued by Vnesheconombank and of the acquired receivables at the level of not higher than $50 bn.

At the same day Vnesheconombank Supervisory Board approved the Procedure for refinancing the external debt of Russian companies[3], setting the following key criteria for application of this mechanism:

- economic security of the Russian Federation is jeopardized, significant assets of the borrower may be lost leading to its business reduction or bankruptcy;
- refinanced obligations were formed as a result of raising funds for major investment projects or for purchasing assets to significantly expand the borrower's operations in the territory of the Russian Federation.

The refinanced obligations should be no less than $100 mln. The maximum loan to a single company (or to interrelated companies) was also capped – $2.5 bn. Besides, co-financing on behalf of the borrower was stipulated – at the level of at least 25% of the overall refinanced obligations amount (unless otherwise prescribed by Vnesheconombank Supervisory Board). The borrower was also to provide the loan security to Vnesheconombank equal to security provided to foreign creditors (and in case it was insufficient – additional security).

[1] Just like in the case of changing import duties we will refrain from detailed review of such measures, and limit ourselves with the most meaningful ones (in our opinion, those are measures targeted at exporters in oil-and-gas sector, non-ferrous metals, chemical and petrochem industries.

[2] Federal Law No.173-FZ of October 13, 2007 "On Additional Measures to Support the Finance System of the Russian Federation".

[3] The procedure for the State Corporation "Development and Foreign Economic Activity Bank (Vnesheconombank)" to implement measures stipulated by Articles 1 and 2 of the Federal Law No.173-FZ of October 13, 2008, "On Additional Measures to Support the Finance System of the Russian Federation" (approved by Vnesheconombank Supervisory Board on October 13, 2008, Minutes No. 11).

To receive such loan a real sector company had to provide a package of several dozens documents to Vnesheconombank (as a rule, it comprised at least 40). The requests had to be reviewed in sequence by Investment Operations Development Committee, Credit Committee, Management Board, Special Committee for Review of Requests and finally – by Vnesheconombank Supervisory Board. Requests having successfully passed the Investment Operations Development Committee review had to undergo comprehensive expert review.

Just one week after defining the legal framework for external debt refinancing Vnesheconombank Supervisory Board approved the internal regulatory framework for practical implementation of this measure[1]. Prior to the end of October the Supervisory Board made its first decisions about external debt refinancing. y early December Vnesheconombank received requests for external debt refinancing for the total amount of $78 bn, including requests from real sector companies for about $50 bn[2]. At the same time, it is worth noting, that only 32 requests for the total amount of $27.1 bn were able to successfully pass through all the stages and reviews and reach the final one – review by the Supervisory Board. Out of them – only 15 requests from 12 organizations were approved for the total amount of $14.3 bn (without co-financing)[3] comprising less than 30% $50 bn allocated by central Bank for these purposes.

Out of 11 real sector companies[4], the requests of which were approved by Vnesheconombank Supervisory Board, 7 were included into the List of Strategic Companies in December (Rosneft, Rusal, Russian railways, PIK Group, Sitronix, Gazprom, Mechel), and the remaining 4 had direct links to the companies from the List (Evraz Group S.A., Gazpromneft, En+ Group Limited, ECO Telecom Ltd.).

Evraz Group S.A. is the holder of assets operated in Russia by Evraz Holding LLC included into the List of Strategic Companies.

Gazpromneft is a subsidiary of Gazprom (which was included into the List).

En+ Group Limited is the holder of controlling interest of Rusal (in the List) and of the parent company of EvroSibEnergo (in the List).

ECO Telecom Ltd. is part of telecommunications block of Alpha Group headed by Altimo, which owns 44% of OJSC Vympelkom shares and 25.1% of OJSC Megaphone (both in the List)[5].

Two companies, the requests of which were approved by Vnesheconombank Supervisory Board (Mechel and En+ Group Limited) further refused from the loans by Vnesheconombank. According to media publications, the first one did not like the security coverage requested by Vnesheconombank, and the second one was not able to provide a full set of docu-

[1] Vnesheconombank 2008 Performance Report (http://www.veb.ru/common/img/uploaded/files_list/VEB_Annual_2008_rus.pdf)

[2] Briefing by V. Dmitriev, Vnesheconombank President, on the outcomes of the Supervisory Board meeting on December 1, 2009, (http://www.veb.ru/ru/about/press/ns/index.php?from32=3&id32=5446)

[3] From here downwards, unless otherwise specified, ref. data from the RF Government Reports about implementing measures to support capital market, banking system, labor market, Russian economy sectors and social net of citizens, and other social policy measures.

[4] One of the companies that received refinancing represented the finance sector - OJSC VTB Bank.

[5] It is also worth noting that ECO Telecom Ltd. raised 2 bond loans from Deutsche Bank AG in 2007 using 44% of OJSC Vympelkom shares as security. Vnesheconombank issued its loan to refinance this debt.

ments required for closing the loan deal[1]. Other companies received the loans from Vnesheconombank with the total amount of $11.28 bn (less than ¼ of the initially allocated $50 bn). The loans term did not exceed 1 year, the interest rate was 7–10%.

In early February 2009 it was declared that Vnesheconombank suspended accepting the requests for external debt refinancing due to the following reasons:

- Russian commercial banks having got excessive foreign currency liquidity will "help the borrowers to settle with their foreign creditors";
- Companies are finding ways to settle their external debt without loans by Vnesheconombank.

At the same time Vnesheconombank management was not excluding the possibility of resuming this activity in future[2].

In early June Vnesheconombank management declared the possibility of extending the 1-year loans "subject to implicit discharge of the borrowers' obligations under initial loan agreements and under original format for redemption and servicing of the debt"[3].

By mid-October 2009 the borrowers redeemed part of their debt to Vnesheconombank for the total amount of $2.43 bn (the principal). 3 borrowers – Rosneft, Russian railways and VTB Bank – provided for pre-scheduled full redemption. Vnesheconombank Supervisory Board approved extension of the loan period for one year for 6 companies – Rusal, PIK Group, Sitronix, Evraz Group S.A., Gazpromneft and ECO Telecom Ltd. – with the total amount of $8.34 bn.

Finally, in December 2009 the right of Vnesheconombank to extend the loan period was de-jure confirmed[4].

Overall. The following conclusions can be made with regards to specifics of practical implementation of major companies' external debts refinancing mechanism:

- Despite the fact that external corporate debt refinancing was not de-jure an instrument for supporting strategic companies (at least because the List of such companied was finalized 6 weeks after the first requests for such refinancing had been approved), all the companies having received loans from Vnesheconombank were either de-facto included into the List of Strategic Companies, or were directly linked with some companies from the List;
- Different from many other anti-crisis measures, the external debt refinancing mechanism was promptly developed and "launched": the first requests for Vnesheconombank loans were approved two weeks after creating the appropriate legal and regulatory framework (remember that the requests had to be backed by several dozens of documents, and the Procedure of their review comprised 7 stages), and the first loans with the total amount of over $10 bn were issued as early as before the end of 2009;
- Request for external debt refinancing from the companies were subject to pretty strict screening: it is sufficient to say that the amount of loans issued by Vnesheconombank was several times lower the requested amount;

[1] Ref: T.Komarova, V. Kovalenko. Trojan Tranche – Corporate Secret, May 4, 2009; D. Shabashov, E. Godlevskaya. Deripaska qualified as non-payer. – RBC Daily, November 12, 2009.

[2] Briefing by V. Dmitriev, Vnesheconombank President, on the outcomes of the Supervisory Board meeting on February 5, 2009, (http://www.veb.ru/ru/about/press/ns/index.php?from32=2&id32=5449).

[3] Briefing by V. Dmitriev, Vnesheconombank President, on the outcomes of the Supervisory Board meeting on June 1, 2009, (http://www.veb.ru/ru/about/press/ns/index.php?from32=2&id32=5450)

[4] Federal Law No.361-FZ of December 27, 2009 "On Amendments to the Federal Law "On Additional Measures to Support the Finance System of the Russian Federation"".

- After pretty strict initial screening of obligations qualified for refinancing, Vnesheconombank demonstrated a rather "liberal" attitude to the debtors further down the way: it extended the loan period practically for each company undergoing difficulties with redemption of obligations (and those were more than 50%).

Government loan guarantees to strategic companies[1]

The legal grounds for providing government loan guarantees to strategic companies were defined as early as in 2008 – the respective amendments were made into the Federal Law on 2009 Budget[2] one week after the List of Strategic Companies had been approved. It was anticipated that the coverage for this area of government support would make RB 200 bn in 2009. In mid-February the RF Government approved the Rules for Granting Government Guarantees[3].

Let us note here that 6-week delay with enacting the delegated legislation (probably, caused by lengthy inert-departmental coordination) was criticized by the RF President[4]. Further on top Russian leaders repeatedly turned to the topic of government guarantees, which may be viewed as an evidence of high political value of this particular instrument.

Initially the following basic conditions for government guarantees were defined:

(1) Guaranteed loan terms:

- loan shall be used for funding the core business operations of the company and of the related capital projects;
- loan shall be received from Russian banks (including the revolving credit facilities);
- loan period shall be between six months and five years;

(2) Guarantees parameters requirements and limitations:

- guarantee shall be provided to a company to secure its loan pay-back obligations *in the amount up to 50%* of the received loan (the principal);

[1] It is necessary to state that along with the reviewed mechanism of providing guarantees to strategic companies, another similar mechanism was formed in late 2008 – early 2009. It stipulated government guarantees to strategic companies within the defense industry: the above mentioned Federal Law No.324-FZ of December 30, 2008, stipulated government guarantees to such companies for the total amount of RB 100 bn (further on it was decreased down to RB 75 bn). The respective Rules were approved by the RF Government Resolution No.104 of February 14, 2009. At the same time a number of companies included into the List of Strategic Companies complied with the criteria set for strategic defense companies, due to which some of them received government guarantees in 2009 under the second mechanism. However, due to significant specifics of this area of government guarantee support, relatively modest coverage and insufficient data about it in public sources we will refrain from reviewing it here.

[2] Federal Law No.324-FZ of December 30, 2008, "On Amendments to the Federal Law "On 2009 Federal Budget and 2010 - 2011 Plan"".

[3] RF Government Resolution No.103 of February 14, 2009, "On Provision of Government Loan Guarantees for 2009 to Companies Selected as per the Procedure Set by the RF Government Borrowing for Supporting Core Business Operations and capital Projects".
Strictly speaking, neither this document, nor the previously enacted law explicitly stated that the recipients of such guarantees should be qualified as strategic companies – they refer to "companies selected as per the procedure set by the RF Government". However, government officials repeatedly emphasized in their various comments and presentations, that this mechanism was focused on strategic companies – ref., "V. Putin: RB 326.3 bn provisioned for support to the RF economy", Prime-TASS, December 30, 2008.

[4] Ref. Abstracts from the veRbatim records of the extended Presidium session of the Government Council for Improving the Efficiency of Government Support to Real Sector held on February 20, 2009, in Irkutsk (http://www.kremlin.ru/transcripts/3258).

- *guarantee period shall be defined based on the obligation discharge deadline set by t he Loan Agreement extended by 1 year,* and in case the company's obligations are also secured by *real property collateral – by 2 years;*
- guarantee shall be provided for the amount *of no less than RB 150 mln;* the total amount of guarantees provided to one company *shall not exceed RB 10 bn;*

(3) Terms and limitations for providing guarantees:

- guarantee *shall not be used to secure obligations to payout interest on the loan,* other interest, commission, forfeit (fines and penalties), as well as responsibility of a company for failure to fulfill or for unduly fulfillment of its obligations under the Loan Agreement and for infliction of loss;
- guarantee *shall not be provided to a company with outstanding (unsettled) debt* to the Russian Federation (mandatory payments), nor to a company subject to *insolvency law suit and/or bankruptcy procedure;*
- *availability of counter-security for the company's obligations* under Loan Agreement shall be *the mandatory condition for receiving government guarantees*. With that *the total amount of the security for the company's obligations, guarantee inclusive, shall comprise no less than 100% of the loan amount* (the principal);

(4) Conditions for exercising guarantee:

- guarantee shall be exercised in the amount not to exceed 90% of the amount of non-fulfilled company obligations for payback of the principal;
- the Russian Federation shall bear subsidiary liability for the guarantees; guarantee shall be subject for exercise after other security for the company obligations under Loan Agreement is fully exercised;
- Creditor's receivables under Loan Agreement in part equal to the guarantee amount shall be subject to cession in favor of the Russian Federation represented by the RF Ministry of Finance before the guarantee is exercised.

It was also established that the Joint Inter-Departmental Committee set up by the RF Ministry for Economic Development shall select the companies for providing guarantees in the amount not to exceed Rb 5 bn, and that companies for providing guarantees in the amount above Rb 5 bn shall be selected by the RF Government Commission on improving Russian economy sustainability. Provided the decision of the respective Commission is positive, the company shall submit a package of documents to the RF Ministry of Finance no later than December 1, 2009. This package needed to include, among others, the original copy of the Loan Agreement with the bank. The RF Ministry of Finance together with Vnesheconombank shall perform the compliance check of the presented documents against the established requirements and shall within 10 days make a decision about providing or not providing government guarantees.

Simultaneously with developing the legal framework for government guarantees mechanism the required organizational infrastructure was formed in late 2008 – early 2009. The already mentioned RF Government Commission on improving Russian economy sustainability[1] and the Inter-Departmental Work Group for monitoring financial and economic status of

[1] The Commission was established by the RF Government Resolution No.957 of December 15, 2008. The scope of the Commission was not at all limited to reviewing the issues and making decisions on support to strategic companies. By now this Commission has been liquidated due to establishing the Government Commission for Economic Development and Integration (RF Government Resolution No.1166 of December 30, 2009).

organizations included into the List of Strategic Companies[1] (starting from March 2009 it was transformed into a Commission with the same name[2]) became the key elements of such infrastructure.

The first requests for government guarantees from strategic companies had been preliminary approved before the RF Government adopted the above described Rules.

Thus, according to mass media, on February 4, 2009, the Inter-Departmental Work Group approved provision of government guarantees to OJSC KAMAZ in the amount of Rb 4.6 bn[3].

However, after that *during about half a year* the requests for guarantees were reviewed and approved in an extremely slow manner, and government guarantees were not provided to strategic companies at all. The key reason pertained not to bureaucratic delays, but rather to the difficulties of executing Loan Agreements with banks. Banks' disagreement with one of the key conditions for providing guarantees became the main stumbling stone in negotiations. This was the condition according to which *the government was obliged to exercise the guarantee only after all other security for the loan had been exercised in full*. On top of that, the banks were very much dissatisfied with the norm providing for the government guarantee to cover no more than 90% of the outstanding company obligations[4].

By March-April of 2009 lack of any visible progress in provision of government guarantees raised certain concerns in the top echelons of power[5] resulting in declarations of possible modifications to this mechanism in the interests of the banks: it was planned to establish the norm that the banks shall receive money against government guarantees immediately upon guarantee event occurrence – prior to exercising other security[6].

The first amendments were introduced into the legal framework for the mechanism of government guarantees to strategic companies in late April. They, however, did not change the procedure for granting and exercising the government guarantees, but just *expanded the list of possible grounds for provision of guarantees:* in addition to funding the core operations and capital projects it was allowed to use loans issued against government guarantees for *redemption of loans and bonded loans* previously raised by the companies for supporting their core operations and capital projects [7].

In May 2009 the topic of government guarantees for credit facilities to strategic companies again was put into the focus of the top government officials[8]. Soon the RF Ministry of Fi-

[1] Order No. 7 by the RF Ministry for Economic Development of January 17, 2009
[2] Order No. 83 by the RF Ministry for Economic Development of March 16, 2009
[3] G. Stolyarov. Guarantee for KAMAZ – Vedomosti, February 5, 2009
[4] Ref.: Yu. Chaykina, T. Alyoshkina. Guarantees are not profitable for SbeRbank – Kommersant of March 30. 2009
[5] Ref. Materials for the working meeting of the RF President D. Medvedev with the First Vice-Premier I. Shuvalov on March 16, 2009 (http://www.kremlin.ru/transcripts/3454).
[6] Opening remarks by Prime Minister Putin at the economic conference on April 22, 2009 (http://premier.gov.ru/events/news/3936/).
[7] Federal Law No.76-FZ of April 28, 2009, "On Amendments to the Federal Law "On 2009 Federal Budget and 2010-2011 Plan"
[8] Thus, in his Opening Remarks at the conference on banking system development on May 13, 2009, President D. Medvedev acknowledged that the idea of providing government guarantees had failed in its initial format. He proposed to make the government jointly and severally responsible for its guarantees (http://www.kremlin.ru/transcripts/4048).

nance submitted draft amendments to the legal framework for granting government guarantees, and they were adopted at the end of June[1].

The key changes to the norms regulating government guarantees provision were as follows:

- redemption of loans and bonded loans previously raised by the companies for supporting their core operations and capital projects was included into the list of possible borrowing objectives along with funding core business operations and associated capital projects (as has been stated above, the respective changes were prior to that introduced into the Budget Law);
- *additional requirements were set for the companies* seeking government guarantees, including the following:
  - top management bonuses cancellation;
  - transparency of financial and business operations;
  - discharge of employer's obligations during layouts, maintaining jobs for the disabled and other socially disadvantaged categories of employees;
- elimination of the norm about government guarantees covering not more than 90% of the company's outstanding obligations to the bank;
- elimination of the norm about exercising government guarantees only upon other company's securitization is fully exercised. Instead it was set that the bank in case the borrower does not perform against its loan payback obligations issue the respective claim to this company, and in case the latter is not fully settled within 30 days – the bank is qualified for claiming the respective guarantee to be exercised by the Ministry of Finance.

We need to state here that the main objective of modifying government guarantees mechanism was to provide additional incentives to the banks for issuing loans secured by government guarantees. Commenting this measure Prime-Minister V. Putin called for banks leadership to make a counter-move by increasing the issue of loans to priority businesses and to reduce borrowing costs[2].

In August 2009 the process of issuing loans to strategic companies against government guarantees finally got on rolling.

In the end of August 2009 VTB announced issuing the first tranches to OJSC KAMAZ (total loan amount – Rb 2.9 bn, government guarantee amount – Rb 1.45 bn), OJSC Sollers (Rb 1 bn and Rb 500 mln respectively) and OJSC Sollers – Naberezhnye Chelny (Rb 700 mln and Rb 350 mln).

Approximately at the same time the number of approved requests for guarantees started growing fast. However, we believe that amendments to the regulations were not the only fac-

[1] RF Government Resolution No.542 of June 30, 2009. Remarkably, the respective amendments into the Federal Law "On 2009 Federal Budget and 2010-2011 Plan" (except for the norm expanding the list of possible purposes of using the borrowed funds) were introduced later still – in early October (Federal Law No.230-FZ of October 3, 2009).

[2] Opening remarks by Prime-Minister V. Putin at the conference on preliminary key parameters of federal 2009 budget and 2011-2012 plan and on the principles of budget expenditure formation on June 29, 2009 (http://premier.gov.ru/events/news/4529/)

tor underpinning such growth. *The political message to major banks with government stake* on behalf of the Prime-Minister about the need to increase issue of loans was extremely important, as well as *relative economic recovery* (significant retardation of the decline and reduction of uncertainty level).

According to some official statements, by the end of October 2009 requests from strategic companies for government guarantees for the total amount of RB 189 bn were approved making approximately 95% of the amount allocated within 2009 federal budget. The practice of granting government guarantees was also improved: in early October the total amount of government guarantees granted to strategic companies was RB 8.2 bn, and by the end of this month this amount was already RB 41.8 bn[1] – a bit more than 20% of the amount allocated in 2009 budget.

By early December 2009 the overall amount of the approved requests was making Rb 199.4 bn almost achieving the limit set by the federal budget (RB 200 bn). Most likely due to this fact this limit was *increased by Rb 25 bn*[2]. Before the end of the year all the allocated funds were disbursed. The key government guarantees recipients were companies from metallurgy sector, agriculture and food processing, automotive industry, and construction.

At the same time, the process of granting government guarantees was still lagging behind: thus, by mid-December the amount of guarantees effectively provided to strategic companies was only about Rb 70 bn[3]. All the paper work and issuance of the guarantees approved in 2009 was to be continued in the next coming year.

We need to pay attention to certain specifics of the structure of government guarantees mechanism and of its applications:

- guarantees were provided to the companies with significant backlog: first loans against government guarantees were issued only in August 2009 – 6 months after the legal framework and organizational of the planned amount was actually provided. Thus, this mechanism *did not result in the required economic effect with regards to provision of long-term financing to the companies in the most acute phase of the crisis* – early in 2009 (which was especially valuable in the context of delaying other government support measures such as government procurement, budget subsidies, etc). At the same time, the intensive process of coordinating the interests of various stakeholders, settlement of claims and agreeing on the obligations for future borrowing against government guarantees became an important stabilizing factor for the economy suffering from the crisis;
- the key reason for the delay in issuing loans secured by government guarantees was the banks' disagreement with the established procedure for exercising guarantees by the government. Modification of this mechanism in mid-2009 was undertaken mostly in the interests of the banks;

[1] Ref.: E. Pismennaya. Guarantees for modernization. – Vedomosti, October 30, 2009, and also materials for parliamentary hearings of the Council of Federation Commission for interaction with the RF Accounting Chamber on the topic: "Modernization of the Economy as Major Anti-Crisis Measure", December 17, 2009.

[2] Federal Law No.309-FZ of December 2, 2009 "On Amending Federal Law "On Federal 2009 Budget and 2010-2011 Plan"". At the same time the amount of government guarantees to strategic companies of defense industry was decreased by Rb 25 bn

[3] A.Gudkov, O. Sapozhkov. Government Guarantees Are Growing. – Kommersant, December 18, 2009
It is necessary to say that by the end of 2009 the aggregate amount of government guarantees provided to both strategic companies and defense sector companies made Rb 145.9 bn. M.Tovkaylo, V. Kholmogorova. Coming Late report. – Vedomosti, February 4, 2010.

- initially the government guarantees mechanism was focused on loans for funding the core business operations and investment activity of companies. Including restructuring of previous debt into the list of possible borrowing purposes, on one hand, was in line with the companies' needs, but on the other had it converted government guarantees from the mechanism for business development into the method of delaying urgent problem solving;
- the complexity and the duration of procedures to prepare the request and get it approved, in particular – the difficulties of executing Loan Agreements with the banks resulted in the fact that some companies initially looking for government guarantees further rejected the idea after several attempts to get everything right;
- the important feature of the mechanism was approving the requests stipulating for provision of government guarantees to several principal companies simultaneously. One of the reasons for that was the officially established ceiling for government guarantee to an individual company – Rb 10 bn. Distributing the requested amount of government guarantee between several affiliated companies allowed business groups for receiving government support in much bigger amounts than Rb 10 bn.

The new law on the federal budget[1]*, just like the previous one, stipulated provision of government guarantees in 2010* to companies selected in accordance with the procedure established by the RF Government to assure their borrowing for the purposes of *maintaining their core business operations and capital projects, as well as for redemption of previous loans and bonded loans.* In 2010 the total amount of government guarantees is planned to be RB 200 bn, while as this specific type of government support is not planned at all for 2011 and 2012. The legal framework remained the same except for one additional requirement setting that guarantees shall be provided to organizations selected in 2009 in case such guarantees were not actually issued in 2009. It is also worth noting that the rules for providing government guarantees applied in 2009 were extended onto 2010, but solely with regards to the companies, whose requests had been already approved in 2009[2].

In addition to "traditional mechanism of providing government guarantees to strategic companies" the new law of the federal budget stipulated for *another version of providing government guarantees* to the companies selected in accordance with the procedure set by the RF Government – *for loans issued to fund investment projects.* In 2010 the amount of such guarantees is to make Rb 100 bn ($3.3 bn), and they are not planned for 2011 and 2012. With that the legal norms established with regards to this new mechanism of providing government guarantees are visible different from those regulating the "traditional" mechanism described above.

The key specifics of guarantees-based support to the investment projects are the following:

- Guarantees shall cover 100% of the principal of the loan borrowed by strategic company to fund an investment project. At the same time, the amount of guarantee shall not exceed 50% of the investment project budget;
- The minimal amount of government guarantee shall be Rb 1 bn or $30 mln;
- The loan period covered by the guarantee shall be from 4 to 20 years, with that exercise of the guarantee shall not be possible before 2014;

[1] Federal Law No.308-FZ of December 2, 2009, "On Federal 2010 Budget and 2011-2012 Plan"
[2] RF Government Resolution No.1181 of December 31, 2009

- Securing of the government obligations shall not be required with regards to recourse issued to the company is case of exercising the government guarantee.

We need to emphasize that in case the new mechanism for providing government guarantees is also applied mostly to strategic companies, the aggregate amount of guarantee-based support in 2010 may reach Rb 400 bn – more than 50% of the government guarantees stipulated within the law on the federal budget for the current year.

The following comments should be made with regards to the new mechanism for providing government guarantees:

- The "investment focus" and long-term nature of this mechanism are, most likely, defined (at least partially) by the fact that the "traditional" mechanism was excessively focused on solving the current financial challenges of strategic companies;
- The fact that at least 50% of government guarantees for the investment-targeted loans shall be provided in US dollars allows for assuming that implementation of such projects will be to a great extent linked to importing equipment and technology;
- The fact that government guarantees are to cover 100% of the principal is a sign of the government planning within the framework of this mechanism to accept practically all the risks of banks financing such investment projects (and thus assure incentives for them to participate in such projects), however, this may result in less attentive review of investment projects on behalf of banks;
- Limiting the total amount of guarantee to 50% of the overall investment project budget in general allows for counting on the respective risks being shared by the government and the business, however, it may turn out very difficult to access the real contribution of business;
- Lack of the established ceiling for provided government guarantees contributes to significant increase of the interest on behalf of different stakeholders to lobbying very big, lengthy – and respectively very risky investment projects, which requires material improvement of project evaluation infrastructure.

Subsidizing part of interest rates paid by strategic companies on their loans

Eventually the RF Government Anti-Crisis Program for 2009 stipulated the following areas of subsidizing the interest rates of real sector companies' loans (under which strategic companies could be the recipients of borrowed funds)[1]:

- Subsidizing interest rates for the loans issued to manufactured goods exporters (RB 6 bn allocated for such purposes within the budget);
- Subsidizing interest rates for the loans issued to meat-and-dairy companies (Rb 7 bn);
- Subsidizing interest rates for the loans issued to Subsidizing interest rates for the loans issued to other agricultural companies (Rb 10 bn);
- Subsidizing interest rates for the loans issued to forestry enterprises to set-up shoulder-season stock of timber, feedstock and fuel (Rb 0.325 bn);

[1] In addition to the listed areas the RF Government Anti-Crisis Program also stipulated subsidies of interest rates on the loans received by fisheries in the amount of Rb 1.07 bn, however, such companies are not represented in the List of Strategic Companies. On top of that, 3 measures were stipulating subsidizing of the shortfall in revenues associated with carrying out government assignments, and 1 measure – providing subsidies to strategic defense companies to prevent their bankruptcy

- Subsidizing interest rates for the loans issued to automotive and transport engineering companies for their technical refurbishment (Rb 2.5 bn);
- Subsidizing interest rates for the loans issued to defense industry companies being the prime contractors (contractors) for the government defense procurement (Rb 15 bn);
- Subsidizing interest rates for the loans issued to defense industry companies for implementing innovations and investment projects targeted at hi-tech products (Rb 1 bn).

We will briefly review here those of the above listed measures that were practically implemented in 2009.

Subsidizing manufactured goods exporters

The mechanism for partial reimbursement out of the Federal Budget of the interest rates on the loans received by Russian exporters of manufactured goods was formed back in 2005[1] and has remained practically unchanged. The norms set the following key conditions for receiving such budget subsidies:

– A company should be exporting manufactured goods for at least 3 years;
– The loans received by a company should be used for exporting goods with high degree of processing[2].

Two thirds of the interest rate of such loans is subject to reimbursement- not to exceed two thirds of the Central Bank refinancing rate.

Early in 2009 the RF Government[3] allocated Rb 6 bn to subsidize interest rates on the loans issued to Russian exporters[4]. This amount was used during the first 9 months of the year. Moreover, the exporters eventually received a slightly bigger amount of Rb 6.135 bn, and 90% of it (Rb 5.709 bn) was distributed among them during H1 2009[5].

In December 2009 the amount of budget allocations for implementing this measure of government support was increased up to Rb 9 bn[6].

Over 100 Russian exporters received interest rate subsidies during 2009 for the overall amount of RB 9.135 bn. It is worth noting that only 1/3 of them belonged to the List of Strategic Companies or were subsidiaries of strategic companies, however, in terms of the amount of budget subsidies they received about ¾ of it. With that the major bulk of the subsidies were granted to various strategic companies from the defense sector (primarily to space rocket engineering and aviation), as well as nuclear sector and automotive industry.

The key areas of the RF Government anti-crisis measures for 2010[1] stipulate budget subsidizing of exporters to reimburse part of their interest rate on the loans they received from Russian credit institution in 2005–2012 in the amount of Rb 7 bn.

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[1] Rules for providing budget subsidies to Russian exporters of manufactured goods to partially reimburse their interest rates on the loans received from Russian credit institutions, as approved by the RF Government Resolution No.357 of June 6, 2005

[2] The procedure for qualifying the goods as those with high degree of processing is currently defined by Order No.31 of the RF Ministry of Industries and Trade issued on February 2, 2009

[3] Federal Law No.204-FZ of November 24, 2008, "On Federal 2009 Budget and 2010-2011 Plan" granted the RF Government the right to allocate up to Rb 175 bn (as effectively amended – up to Rb 450 bn) within the Federal Budget to support capital market (as effectively amended – to support capital and labor markets, and sectors of Russian economy, social net for Russian citizens and other social policy measures)

[4] RF Government Resolution No.24 of January 14, 2009 (Rb 3 bn were allocated for the same purpose in 2008)

[5] Order No.144 of the RF Ministry of Industries and Trade, Order No.144 of the RF Ministry of Finance issued on March 27 2009; Order No.250 of the RF Ministry of Industries and Trade, Order No.175 of the RF Ministry of Finance issued on April 20, 2009.

[6] RF Government Resolution No.996 of December 2009

Subsidizing the RF constituent entities (regional governments) to reimburse interest rates on the loans received by agricultural and food processing companies

This measure practically combines 2 areas stipulated by the RF Government Anti-Crisis Program: subsidizing interest rates on the loans issued to meat and dairy products manufacturers (Rb 7 bn) and other sub-sectors of agriculture and food processing (Rb 10 bn). The legal framework of this particular measure[2] is different from the others and sets a two-stage procedure for allocating such subsidies: first the funds are allocated within the Federal Budget to regional government, and only then they are distributed between agriculture and food processing companies. Payments of interest on short-term loans (up to 1 year) used to procure Russian-make agricultural feedstock and for some other needs, as well as payments of capital loans used to procure certain types of equipment, transport vehicles and machinery (the list defined by the RF Ministry of Agriculture), as well to fund upgrading of farms, storage facilities, greenhouses, etc. may be subject to reimbursement. For certain types of loans issued to meat and dairy companies the amount of subsidies was set at 100% of the refinancing rate, while as in other cases it makes 80%[3].

In February 2009 the RF Government allocated Rb 17 bn to implement this measure, out of which Rb 12.1 bn were meant to reimburse the interest on capital loans, and Rb 4.9 bn – interest on short-term loans[4]. During the first 3 quarters of 2009 Rb 16.9 bn were remitted to the RF regions: Rb 12.1 bn – to reimburse the interest on capital loans, and Rb 4.8 bn – interest on short-term loans. Let us note that over 90% of the funds were disbursed in H1 2009. Most likely, members of the List of Strategic Companies were among the end beneficiaries of funds; however, we do not have reliable data on the amount of subsidies granted to those particular entities under this measure.

Subsidizing companies of the forestry sector

The legal framework for this particular mechanism was the last one to be developed – in late June of 2009[5]. In particular, it stipulated the following:

- Loans subject to partial interest rate subsidies should be received from Russian credit institutions in 2008–2009 and used for setting up the shoulder-season stock of timber, feedstock and fuel;
- Subsidies should cover 2/3 of the interest rate not to exceed 2/3 of the Central Bank refinancing rate.

In September 2009 the RF Ministry of Industries and Trade decided to subsidize 11 companies from the forestry sector for the total amount of Rb 59 mln[6]. In early October these funds were effectively disbursed to the recipients. The names of such recipients were not officially published, however, as per mass media, at least one of them belonged to the List of Strategic Companies – OJSC Arkhangelsk pulp-and-paper plant (received Rb 15 mln).

Subsidizing defense industry companies engaged in government procurement

[1] As approved at the RF Government session on December 30, 2009
[2] Federal Law No.318-FZ of December 30, 2008, "On Amendments to Articles 11 and 18 of the Federal Law "On Development of Agriculture""; RF Government Resolution No.90 of February 4, 2009
[3] In addition, regional budgets are used for additional reimbursement in the amount exceeding the Central Bank refinancing rate by 3% – for meat and dairy manufacturers, and in the amount of 20% of the refinancing rate – for other companies.
[4] RF Government Resolution No.140 of February 24, 2009
[5] RF Government Resolution No.528 of June 25, 2009
[6] Order No. 866 by the RF Ministry of Industries and Trade issued on September 28, 2009

This mechanism stipulates subsidies to defense industry companies performing as contractors (including – as prime contractors) of the government procurement to cover a part of their interest rate payments on the loans received from Russian credit institutions to sustain their core business operations. The respective legal framework was developed in late March 2009[1], but the actual disbursement of funds started only in H2 2009. According to the RF Government Anti-Crisis Program, the aggregate amount of this type of subsidies for 2009 should be making Rb 15 bn; however, according to the available data, the companies effectively received only about Rb 5.5 bn. Over 50 companies became the recipients for these funds, and 2/3 of them either belonged to the List of Strategic companies themselves, or comprised subsidiaries of strategic companies. About ¾ of the effectively disbursed subsidies (Rb 4 bn) covered this 2/3 of the companies.

Subsidizing automotive and transport engineering companies

In January 2009 the RF Government allocated Rb 2.5 bn as subsidies to Russian automotive and transport engineering companies to reimburse part of their interest rate payments on the loans used for technical upgrade and refurbishment[2]. However, the legal framework for this mechanism was developed only by the end of March[3], while as the criteria for selecting the refurbishment projects – only by the end of May 2009[4]. It was defined that 2/3 of the interest rate is subject for subsidizing, not to exceed 2/3 of the Central Bank refinancing rate.

In August 2009 additional opportunity aroused for receiving subsidies for partial reimbursement of funds paid by Russian automotive manufacturers as coupon yields on the bonds issued in 2009 to finance their own or subsidiaries' refurbishment projects[5]. Subsidies were to cover 2/3 of coupon yields payments, not to exceed 2/3 of the Central Bank refinancing rate.

In December 2009 the RF Government reduced budget allocations for such subsidies from Rb 2.5 bn down to 1.5 bn[6]. By this time the RF Ministry of Industries and Trade had reviewed 15 requests for subsidies (9 of them submitted by automotive businesses and 6 – by transport engineering companies). In October 2009 the RF Ministry of Industries and Trade drafted the first Resolution on granting the subsidies for the total amount of RB 59 mln[7]. Nevertheless, no effective disbursement of funds had been initiated by mid-December.

The key areas of the RF Government anti-crisis measures for 2010 stipulate subsidies to automotive and transport engineering companies to reimburse part of their interest rate payments on the loans received in 2008-2009 and used for technical upgrade and refurbishment for the total amount of Rb 2.5 bn.

The following overall conclusion may be made with regards of planned and actually effected interest rates subsidizing:

– The total budget allocations covering 7 areas of subsidizing in accordance with the RF Government Anti-Crisis Program were to make Rb 42 bn. Defense industries together

[1] RF Government Resolution No.255 of March 26, 2009
[2] RF Government Resolution No.24 of January 14, 2009
[3] RF Government Resolution No.262 of March 30, 2009
[4] Order No.453 of the RF Ministry of Industries and Trade issued on May 28, 2009
[5] RF Government Resolution No.675 of August 19, 2009
[6] RF Government Resolution No.996 of December 10, 2009
[7] Materials for parliamentary hearings of the RF Council of Federations Commission for Interaction with he Accounting Chamber of the Russian Federation on the topic: "Modernization of economy as the Main Anti-Crisis Measure", December 17, 2009

with agricultural and food processing companies were to become the main recipients of these funds;

- In the majority of cases interest rate subsidies were to cover no more than 2/3 of the refinancing rate, while as for meat and dairy products manufacturers the subsidies were set at 100% of the Central Bank discount rate;
- These measures covered loans issued not only in 2009, but in earlier periods as well (in 2008, and in some cases – in preceding years). Thus, subsidies were targeted (at least partially) at servicing the debt accumulated by the respective companies and improving financial stability of these companies;
- The measures implemented rather quickly – subsidies to exporters of manufactured goods and to agricultural and food processing companies – represented continuation of programs implemented over the preceding years, while as in other cases actual disbursement of funds either was initiated after a significant delay, or was not effected at all;
- During 10 months of 2009, according to the available data, the funds were disbursed only within 5 measures (*Table 1*). The actual federal budget spent in these areas amounted to circa Rb 32 bn, 80% of which were received by defense industries together with agricultural and food processing companies;
- The overall amount of interest rate subsidies to strategic companies and their subsidiaries (without accounting for the funds provided to agricultural and food processing companies out of the regional budgets) made about Rb 7 bn. The defense industries were the dominating recipients of these funds. Among civil industries the most meaningful amounts of subsidies were granted to strategic companies in nuclear and automotive industries.

Table 1

Interest Rate Subsidizing Mechanisms

	Allocations, Rb bn[1]	**Disbursed funds, Rb bn[2]**	**Execution, %**	**Funds disbursed to strategic companies[3] Rb bn[2]**	**Purposes of borrowing**	**Time of borrowing**
Interest rate subsidies to exporters	6 / 9[4]	9.1	102	6.7	Export of goods with high degree of processing	2005–2010
Interest rate subsidies to agricultural manufacturers and food processing companies	17	16.9[5]	99	NA		
-for capital loans	12.1	12.1[5]	100	NA	Procurement of equipment, specialized vehicles and machinery, pedigree stock (materials; establishment of perennial plantings and vineyards; construction and upgrading of grafting facilities for perennial plants, of livestock units (farms), breeding and forage production facilities, storage facilities for potatoes, vegetables and fruit, greenhouses, etc.	Beginning of 2008
-for short-term loans	4.9	4.8[5]	99	NA	Procurement of lubricants, spare parts and materials for repairing agricultural machinery, mineral fertilizers, crop-protective agents, forage, veterinary preparations and other material resources for seasonal operations; procurement of young stock, of Russian-make agricultural feedstock for primary processing and industrial food processing, etc.	Beginning of 2004, 2005, 2007, 2008 or 2009 – depending on the recipient and pur-

	Allocations, Rb bn[1]	Disbursed funds, Rb bn[2]	Execution, %	Funds disbursed to strategic companies[3] Rb bn[2]	Purposes of borrowing	Time of borrowing
						poses of borrowing
Interest rate subsidies to forestry companies	0.325	0.06	18	No less than 0.015	Set-up of shoulder-season timber, feedstock and fuel stock	2008–2009
Interest rate subsidies and bond loans interest payments reimbursement to automotive and transport engineering companies	2.5 / 1.5[3]	0	0	0	Implementation of technical refurbishment projects	2008–2009
Interest rate subsidies to defense industry companies performing in the capacity of prime contractors (contractors) for government military procurement	15 / 5,3	5,5	104	4	Core business operations	2008–2009
Interest rate subsidies to defense industry companies to implement innovations and investment projects	1	0	0	0	Implementation of innovations and investment projects to assure hi-tech production	

[1] in accordance with the RF Government Anti-Crisis Program for 2009
[2] during 10 months of 2009
[3] accounting for the subsidiaries
[4] after adjustments
[5] during 9 months of 2009

Additional capitalization for strategic companies

The following measures were implemented within this area of support:

(1) using budget monies to fund issue of new private companies shares (to increase of collective capital funds of unitary enterprises);

(2) additional asset contributions to state-owned corporation "Rostekhnologiyi"

Increasing charter capitals of private companies

In the end of 2008 and throughout 2009 the RF Government adopted several resolutions about additional capitalization of 13 organizations – either members of the List of Strategic Companies, or directly linked to companies from the List. Rb 118 bn were allocated within the Federal Budget for this purpose. 10 organizations represented the defense industry, however (Rb 57 bn). As a rule, additional capitalization for such companies was aimed at stabilizing their financial positions, redemption of debt and working capital replenishment.

The major bulk of the allocations were granted to OJSC Russian railways. With that, the RF Government issued to separate resolutions about increase of the company's charter capital: the first one in December 2008[1] – by Rb 41.5 bn, and the second one – in July 2009[2] – by

[1] RF Government Directive No.1877-p of December 16, 2008
[2] RF Government Directive No.918-p of July 7, 2009

Rb 11.3 bn, 3 bn out of which were to be spent on purchasing products from Tverskoy coach-building works, and 8.3 bn – on construction of track between Yayva and Solikamsk.

In addition, in 2009 the RF Government adopted resolutions on additional capitalization of 2 other strategic companies: Research and Production Center "Urals wagon Works" – by Rb 4.4 bn to redeem the debt[1], and OJSC Rus Hydro – by Rb 4.3 bn to fund the construction of discharge sluice at Sayano-Shushenskaya hydroelectric plant[2].

The Law on the Federal 2010 Budget allocated funds for additional capitalization of several dozens of companies, some of which are part of the List of Strategic Companies.

Asset contributions to state-owned corporation "Rostekhnologiyi"

During 2009 the RF Government adopted 3 resolutions about disbursement of the federal budget funds to state-owned corporation "Rostekhnologiyi" for their further disbursement to OJSC AVTOVAZ as interest-free loans:

- in early June the respective asset contribution made Rb 25 bn[3];
- in mid-December it made Rb 12 bn. The following limitations were set: the funds should be used only to assure discharge of AVTOVAZ obligations to suppliers, intermediaries, credit institutions and other counterparties with further increase of Rostekhnologiyi share in the charter capital of the company[4];
- in late December – RB 28 bn allocated for discharge of AVTOVAZ obligations to credit institutions with further increase of Rostekhnologiyi share in the charter capital of the company[5].

It should be noted that in the last case 2 pre-conditions were set for the automotive manufacturer to qualify for receiving the funds:

- prepare and agree with the RF Ministries of Industries and Trade, of Economic Development and of Finance the mid-term Program of ABTOVAZ development including high potential investment projects;
- sign MOU between Rostekhnologiyi, OJSC AVTOVAZ and group of banks including Sberbank and VTB about restructuring the company's debt and banks' commitment to issue loans to fund its core business operations under mutually accepted terms.

In addition, late in 2008 and early in 2009 5 more decisions were made to disburse budget funds to Rostekhnologiyi as asset contributions:

- 2008: Rb 1.5 bn without indicating specific objectives[6];
- 2009:
  - Rb 7.48 bn to finish the construction and commissioning of federal hi-tech medical centers[7];
  - Rb 2.97 bn to settle debt servicing obligations on loans used for consolidation of VSMPO-AVISMA Corporation[8];

[1] RF Government Directive No.346-p of September 15, 2009
[2] RF Government Directive No.1604-p of November 2, 2009
[3] RF Government Directive No.745-p of June 1, 2009
[4] RF Government Directive No.1895-p of December 10, 2009
[5] RF Government Directive No.2080-p of December 25, 2009
[6] RF Government Directive No.1847-p of December 8, 2008 – respective amendments were introduced into 2009 budget by Federal Law No.837-FZ of November 8, 2008
[7] RF Government Directive No.837-p of June 2,2 2009
[8] RF Government Directive No.1466-p of October 8, 2009 – respective amendments were introduced into 2009 budget by Federal Law No.76-FZ of April 28, 2009

- Rb 1.44 bn to fund especially important and special flights of aircrafts[1];
- Rb 900 mln without indicating specific objectives [2].

Providing incentives to increase domestic demand for strategic companies products

Additional government procurement

The RF Government Anti-Crisis Program identified two large-scale measures stipulating government and municipal procurement of products manufactured by the companies included into the List of Strategic Companies:

(1) automotive vehicles for federal executive agencies, their territorial branches and subordinate institutions (Rb 12.5 bn from the Federal Budget);

(2) renewal of the automotive vehicles fleet used by regional and municipal authorities for passenger transfer, medical purposes, of specialized vehicles used by militia, by utility companies and for road construction purposes (Rb 20 bn from the Federal Budget, Rb 10 bn as co-financing from regional budgets).

Procuring automotive vehicles for federal executive agencies

Funds to procure automotive vehicles for federal executive agencies in the amount of Rb 12.5 bn were allocated by the RF Government in February были 2009[3]. In the same month the RF Ministry of Industries and Trade approved the list of automotive vehicles for such procurement[4], comprising over 1 thousand of various types and names (cars and trucks, buses, tow cars), with practically all of them (99.9%) being manufactured by plants either included into the List of Strategic Companies, or by their subsidiaries.

By early October 2009 automotive vehicles were procured for the amount of Rb 11.8 bn (94% of allocated funds), including Rb 2.2 bn spent on purchasing VAZ cars ("Ladas"), Rb 2.1 bn – on KAMAZ trucks (in the amount of 2.1 thousand trucks), Rb 2.0 bn – on UAZ (2 thousand cars), Rb 1.6 bn – on GAZ (1.7 thousand cars), Rb 1.4 bn – on FIAT (1.4 thousand cars)[5].

In early November budget allocations were this purpose were increased up to Rb 15.5 bn.

Renewal of the automotive and specialized vehicles fleet used by regional and municipal authorities

In late March of 2009 the RF Government allocated total amount of Rb 20 bn to purchase automotive and specialized vehicles; at the same time the main rules for disbursement of such funds were approved[6]. In mid-April the RF Ministry of Industries and Trade approved the list of Russian manufacturers of the respective vehicles comprising all automotive manufacturers from the List of Strategic Companies, as well as number of their subsidiaries.

By early October the RF Government allocated the total subsidies of Rb 12.6 bn, and then a month later they amounted to Rb 14.4 bn. The procurement of vehicles was significantly lagging behind due to the need to organize tender procedures, review the bids, award and exe-

[1] RF Government Directive No.1717-p of November 13, 2009 – respective amendments were introduced into 2009 budget by Federal Law No.230-FZ of October 3, 2009
[2] RF Government Directive No.2065-p of December 24, 2009
[3] RF Government Directive No.139-p of February 9, 2009
[4] Order No.78 by the RF Ministry of Industries and Trade issued on February 20, 2009
[5] UAZ and Fiat cars are manufactured by subsidiaries of OJSC Sollers
[6] RF Government Resolution No.253 of March 24, 2009

cute contracts, etc. Thus, by October 2009 the total amount of executed contracts was only RB 4.3 bn. The majority of vehicles were procured from GAZ and KAMAZ.

Creating incentives for demand

The RF Government Anti-Crisis Program for 2009 stipulated a series of measures and steps to create incentives for demand for the product manufactured by the plants included into the List of Strategic Companies. We need to focus on two measures, implementation of which allowed for achieving visible results in 2009:

(1) subsidizing 2/3 of the refinancing rate for 3-year consumer loans for purchasing cars manufactured in the territory of Russia (overall amount making Rb 2 bn);

(2) increasing the charter capital of OJSC RosAgroLeasing to procure domestically made agricultural machinery and equipment subject to further leasing (Rb 25 bn).

Partial interest rate subsidies for loans to consumers

The Federal Budget allocations for subsidizing 2/3 of the refinancing rate for 3-year consumer loans for purchasing cars manufactured in the territory of Russia for the total amount of Rb 2 bn were agreed by the RF Government in February 2009[1]. This measure was applied only to cars with the price not to exceed Rb 350 K included into a special list created by the RF Ministry of Industries and Trade. The initial version of this list[2] contained names of 29 car types, 25 of which were manufactured by strategic companies and their affiliates: 23 – by AVTOVAZ; 1 – by its joint venture with General Motors; 1 – by Sollers Group enterprises.

In March 2009 the RF Government adopted the rules for providing subsidies to Russian credit institutions to compensate for the shortfall in income from consumer loans for purchasing cars[3]. However, disbursement of such funds did not start until the end of the first six months.

In July 2009 the coverage of this measure was significantly expanded: now it could be applied not only to passenger cars but to commercial vehicles with mass not to exceed 3.5 tons, and the maximum price of a car/vehicle was increased up to Rb 600 K[4]. The list of cars/vehicles subject to such measure was also significantly expanded – up to 50 names, 37 of which were manufactured by strategic companies and their affiliates[5]. With the representation of VAZ cars (together with VAZ / General Motors JV) was decreased down to 18 names, and Sollers cars representation was increased up to 12; moreover, 7 other cars were added to the list (manufactured by GAZ).

In Q3 2009 the process of disbursing the subsidies started rolling out, however, the scale of this measure was far from the originally expected: by early October about 39 thousand of soft auto loans were issued (32 thousand – for VAZ cars), and the amount of interest rate subsidies was Rb 33 mln; and one month after the number of loans reached 48 thousand, and the amount of subsidies – about Rb 40 mln. In December 2009 the amount of budget allocations for this purpose was decreased more than 2 times – down to Rb 950 mln[6]. However, the actual total amount of granted subsidies during 2009 made less than 20% of the budget limit – Rb 187.7 mln[7].

[1] RF Government Directive No.139-p of February 9, 2009
[2] Order No.77 by the RF Ministry of Industries and Trade issued on February 20, 2009
[3] RF Government Resolution No.244 of March 19, 2009
[4] RF Government Directive No.905-p of July 7, 2009
[5] Order No.650 by the RF Ministry of Industries and Trade issued on July 15, 2009
[6] RF Government Resolution No.996 of December 1o, 2009
[7] M. Tovkaylo, V. Kholmogorova. Coming Late report. – Vedomosti, February 4, 2010.

The key areas for the RF Government anti-crisis activities in 2010 stipulate subsidies to Russian credit institutions to compensate the shortfalls in income on loans issued in 2009–2010 to individuals for purchasing cars – for the total amount of Rb 1 bn.

Increasing OJSC RosAgroLeasing charter capital

RF Government agreed for additional capitalization of OJSC RosAgroLeasing in the overall amount of Rb 25 bn in early February 2009[1]. By early March the respective funds were disbursed to OJSC RosAgroLeasing. By October 2009 the company used these funds to procure products to be leased to agricultural manufacturers for the overall amount of Rb 28.4 bn, including:

- Agricultural machinery – for Rb 22.8 bn;
- Equipment for cattle breeding and agricultural products processing – for Rb 3.6 bn;
- Pedigree livestock – for Rb 2 bn.

During 9 months of 2009 RosAgroLeasing supplied the agricultural manufacturers with 2,882 tractors, 1,600 harvesters, 4,196 automotive vehicles, 1,719 machinery and equipment pieces for setting-up grain processing facilities, and 18.9 thousand of high-yield pedigree cattle stock.

Decreasing the burden on business

Decreasing tax burden in oil-and-gas sector

The majority of tax measures applied from the time the crisis started were of "general systemic" character. We can identify some measures, however, focused at strategic companies, in particular – measures to decrease the tax burden on oil-and-gas sector:

- increasing the tax-exempt minimum from 9 to 15 $/bbl when calculating MET rates;
- improving the procedure for recognizing (deducting) the expenses for subsoil licenses acquisition when calculating the Profit Tax by providing the taxpayers with the possibility to write-off such expenses during the period of 2 years
- introducing tax holidays for developing off-shore fields, fields in Nenetsky Autonomous District, Yamal Peninsula, East Siberia, Azov and Caspian seas[2].

As per the available estimates, the aggregate benefit for oil-and-gas companies amounted to over RB 100 bn.

We also need to emphasize here, that starting from January 1, 2010, a number of changes were introduced to classification of fixed assets included into amortization groups[3]. These changes are about shifting certain types of equipment (primarily those used in exploration and production) into amortization groups with shorter useful life.

Tax arrears restructuring

The RF Government Anti-Crisis Program for 2009 stipulated adjustments to the effective schedules for *redemption of restructured tax arrears of the automotive companies* to the federal budget, as well as to extra-budgetary funds (in terms of insurance payments arrears). In March 2009 the RF Government adopted respective resolutions with regards to OJSC AV-

[1] RF Government Directive No.122-p of February 4, 2009

[2] Federal Law No.158-FZ of July 22, 2008, "On Amendments to Chapters 21, 23, 24, 25 and 26 of Part II of the Tax Code of the Russian Federation and to some other legislation of the Russian Federation pertaining to taxation"

[3] RF Government Resolution No.165 of February 24, 2009

TOVAZ and AMO ZIL[1]. According to the RF Ministry for Industries and Trade, simultaneous restructuring of tax arrears was performed for the amount of Rb 7.24 bn[2].

Let us also note that in December 2009 the RF Government defined the procedure and conditions for *restructuring the arrears for defense industry companies* engaged in government procurement and included into the List of Strategic Companies – this covered all the arrears to the Federal Budget (taxes, fees, accrued penalties and fines)[3].

5.2.4. Overall evaluation of coverage and sector-based specifics of measures supporting strategic companies

The aggregate amount of government support to strategic companies (taking into account the shortfall in budget revenues and potential budget expenditure) starting from October 2008 until the beginning of 2010 made, according to our estimate, about Rb 1.1 trillion[4]. Oil-and-gas sector, metallurgy, automotive and defense industries received the biggest amounts of such support.

In 2008 the amount of government support was only slightly below Rb 500 bn, the major bulk of it falling under 2 measures: external corporate debt refinancing (approximately Rb 270 bn) and amending the procedure for calculating export duties for crude (about Rb 150 bn, as per available estimates).

The amount of anti-crisis support in 2009 is estimated as exceeding Rb 500 bn; the major portion of budget resources was spent on additional capitalization of companies (direct budget expenditure of about Rb 150 bn), provision of government guarantees (amounting to Rb 150 bn), and tax incentives to oil-and-gas sector (the amount of shortfall in budget revenues exceeds Rb 100 bn, as per some estimates).

Overall, as per our estimates, the amount of direct Federal Budget expenditure and shortfall in budget revenues associated with support to strategic companies exceeded in 2009 г. the amount of Rb 300 bn.

As per the timeline of their implementation, the government support measures reviewed in this material may be clearly split into 2 groups:

- *immediate measures* – their practical implementation started in the end of 2008 or in Q1 of 2009 – such as external debt refinancing, additional capitalization, customs tariffs policy, decreasing tax burden on oil-and-gas sector, interest rate subsidies to exporters, subsidies to the RF regions to reimburse the interest rate on loans issued to agricultural and food processing enterprises, and some others;
- *"delayed" measures* – their practical implementation started only in H2 2009 – partial interest rate subsidies to defense industry and forestry industry companies, provision of government guarantees, interest rate subsidies on consumer auto loans.

A number of comments need to be provided in relation with that:

– practically all the measures having turned out as "immediate" did nit require establishment of any new mechanism for their implementation. Only external debt refinancing was

[1] RF Government Resolution No.260 of March 30, 2009

[2] Ref. Report by V. Khristenko, Minister of Industries and Trade at the Government Briefing in the state Duma on October 19, 2009
(http://www.minprom.gov.ru/press/release/showNewsIssue?url=press/release/818)

[3] RF Government Resolution No.995 of December 10, 2009

[4] Here and onwards – without accounting for "general systemic" measures covering a very broad range of business entities (change of Corporate Profit Tax rate, etc.)

exceptional – this instrument was created "from scratch" and applied very quickly (during about one month);

- the measures falling into the "delayed" group are fully financial measures initiated in 2009. The delay in their practical implementation (provision of government guaranties, interest rate subsidies on consumer auto loans) had some pretty straightforward reasons: imbedded shortcomings of the established norms and regulations, and other cases – the multiplicity of anti-crisis measures and their insufficient administration effected by lack of institutional capabilities;
- due to misalignment and mistiming of a number of anti-crisis measures, their potential synergy effect turned out to be limited.

Table 2

Evaluating the timing for launching government support to strategic companies, and the scope of their application (coverage)

Instrument	Start of practical implementation	Number of strategic companies having received support*	Sector coverage**
External corporate debt refinancing	2008	small	medium
Additional capitalization	2008	medium	medium
Amendments to procedure for export customs duties calculation and decrease of export customs duties	2008	big	medium
Increase of import customs duties, reduced quotas	2008	big	medium
Decreasing tax burden on oil-and-gas sector	Q1 2009	medium	narrow
Partial interest rate subsidies to exporters	Q1 2009***	big****	broad
Subsidies to the RF regions to reimburse the interest rate on loans to agricultural and food processing companies	Q1 2009***	NA	narrow
Additional capitalization of OJSC RosAgroLeasing	Q1 2009	small	narrow
Tax arrears restructuring	Q1 2009	small	narrow
Renewal of automotive and specialized vehicles fleet of the RF regions and municipalities	Q2 2009	small	narrow
Procuring automotive vehicles for federal executive authorities	Q3 2009	small	narrow
Partial interest rate subsidies to defense industry companies performing as contractors for government military procurement	Q3 2009	big****	narrow
Provision of government guarantees	Q3 2009	big****	broad
Partial interest rate subsidies on consumer auto loans	Q3 2009	small	narrow
Partial interest rate subsidies to forestry industry enterprises	Q4 2009	small	narrow

* categories: small – <10 companies; medium – 10-30 companies; big – 30+ companies;
** categories: narrow – 1-2 sectors, medium – 3-5 sectors, broad – 5+ sectors;
*** implementation started in 2009 (instrument was used before);
**** taking into account strategic companies subsidiaries

The majority of government support measures and instruments subject to our review here provided for support of a relatively small number of strategic companies (up to 10). *Measures effecting the most strategic companies were such financial measures as partial interest rate subsidies to exporters; partial interest rate subsidies to defense industry companies, as well as provision of government guarantees.* Two of these measures (government guarantees and *interest* rate subsidies to exporters) are also characterized by broad sector coverage, while as the majority of measures of government support to strategic companies covered only 1 or 2 sectors.

Table 3

Evaluation of importance of the key measures of government support to strategic companies by main sectors

	Assuring access to financial resources				Creating incentives for demand			Decreasing burden on business		
	Debt refinancing	Government guarantees on loans	Interest rate subsidies	Additional capitalization	New regional/municipal government procurement programs	Creating incentives for demand	Increasing import customs duties and reducing quotas	Decreasing tax burden on certain sectors	Decreasing export customs duties	Tax arrears restructuring
Oil-and-gas sector	++							+++	+++	
Energy (power generation)				+						
Coal mining										
Metallurgy	+++	++					++		+	
Chemistry and petrochem		+					+		+	
Construction materials manufacturing										
Automotive industry		+		++	++	+	+++			++
Agricultural machine engineering						++	++			
Transport machine engineering				+						
Defense industry		++	+	++						
Electronics, telecom	++									
Agriculture and food processing		+	+				++			
Construction	+	+								
Transport	+			++						

\+ moderately important;
++ important;
+++ very important.

The biggest number of various government support measures was applied to strategic automotive companies, and some instruments were purposefully developed specifically for this sector. Government support to oil-and-gas sector, metallurgy, defense industry, agriculture was also pretty diversified.

In general, *support to strategic companies was primarily focused on assuring access to financial resources.* At the same time, for certain sectors *incentives for creating domestic demand (automotive industry) and decreasing the tax burden (oil-and-gas sector) were especially important.*

* * *

The following conclusions may be made to summarize the analysis of government support:

1. With all its drawbacks and shortcomings, the List of Strategic Companies has performed a pretty important stabilizing function during the most acute phase of the crisis. The very fact of being included into the List irrespective or receiving actual support provided for decreasing the level of risk assessment for the respective company in the view of both banks and suppliers.

2. During the crisis period the RF Government exercised a pretty broad variety of diversified measures targeted at supporting strategic companies in that or another way. At the same time, the only support measures targeted and designed specifically for strategic companies

were provision of government guarantees and expanding the Lombard List of the Central Bank.

In addition, strategic companies were the key recipients of government support in such areas as external debt refinancing by Vnesheconombank, contributing additional assets into charter capital, interest rate subsidies to exporters. However, in such cases just like in many others strategic companies were becoming the recipients of this support "on common terms" (at least, there were no normative regulations on supporting strategic companies only).

3. The government support to strategic companies was mainly focused on assuring their access to financial resources. At the same time, measures targeted at creating incentives to promote domestic demand were especially important for some sectors (automotive), as well as measures targeted at decreasing the tax burden (oil-and-gas).

From the point of view of real funds disbursed among strategic companies, the most valuable measures were refinancing external debt, provision of government guarantees and changing the customs duties and quotas.

4. Practically all measures of government support to strategic companies were targeted (fully or to a great extent) at improving their financial stability and settling their debt problems. The government guarantees instrument was slightly different from all others in this regards, because certain limitations were set for using the borrowed funds only for certain purposes (core business operations or capital projects). However, settling earlier loans was included into the possible areas for using the newly raised money before even starting to grant the first guarantees.

5. Most of the financial support measures were exercised with significant backlog, sometimes – up to 6 months. The mechanisms which were applied almost immediately were the ones created and used before the crisis. Actually, the only new support mechanism which was created and used within the shortest possible time, was the mechanism for refinancing external debt of strategic companies.

6. Taking into account the scope of some anti-crisis measures and their "extension" into 2010, the task of evaluating their efficiency becomes extremely important. It requires setting the philosophy for such evaluation and creating the relevant infrastructure for monitoring and analyzing changes and progress of companies subject to applying support mechanisms, as well as for controlling their performance against obligations of their owners.

The task of defining the "pro-active" monitoring approach also becomes relevant, because it will allow for short-term forecast any serious aggravations of companies' positions and for timely defining the respective preventive measures.

7. In our opinion, the transparency of the whole system for monitoring the strategic companies and the mechanisms for providing support need to be improved drastically. The principles and criteria of feasibility of support need to be clearly set and defined, they would need to be provided to monitoring commissions and work groups established within the ministries.

5.3. Historical and future trends and legal issues related to 2003–2009 bankruptcies

The global economic crisis coupled with significant growth in foreign borrowings by Russian companies in recent years, shrinking market and industrial stagnation in several economic sectors in 2008-2009, as well as an increase in the number of inefficient investment projects and widespread breaches of contractual obligations starting from 2008, together raised the importance of both effective corporate management in general and of monitoring

the financial condition of companies in particular. In equal measure this applies to companies undergoing bankruptcy[1].

According to the Supreme Arbitration Court of Russia, the number of claims related to civil economic disputes filed in the second half of 2008 increased nearly by half compared to the respective number for the first half of the year, while the number of claims related to administrative disputes increased nearly twofold. The total number of civil claims filed with Russian arbitration courts in 2008 stood at 543,000, or 25% more than the respective number for 2007.

The 51% growth in the overall number of claims filed with arbitration courts in the first half of 2009 compared to the same period in the previous year[2], to a point when this number reached nearly 660,000, as well as an increase by nearly 90% of claims related to complete or partial breach of obligations by the contract parties[3], are indicative of the greater incidence of problems related to the breach of contractual obligations linked to payment for goods and services.

Late 2008 – early 2009 saw an increase of civil claim court filings related to creditor claims that, in the instance of executive writs remaining unpaid, are transformed into bankruptcy cases.

5.3.1. Bankruptcy trends under the third Law on Insolvency (2003–2009)

The third Law on Insolvency (Bankruptcy) adopted in October 2002 is best known for considerably curtailing the opportunities for the misuse of insolvency proceedings as a corporate asset takeover tool. In addition to this, the Law granted equal rights to the state and to general creditors, stipulated special bankruptcy procedures for certain debtor classes, and implemented a number of further changes related to insolvency[4].

The legal practice of applying the third Law on Bankruptcy in 2003-2009 has pointed to an excessive focus on certain issues that arose in the preceding period and to the persistence of the principal shortcomings both of the legislative framework that was in effect previously and of its practical application[5].

Generally speaking, recent years have seen significant growth in the scope of application of insolvency procedures: whereas in 2003-2004 the courts received approximately 12,000-13,000 bankruptcy filings for "substantive" debtors[6], similarly to 1998-2000 levels of 11,000-

[1] See also *Bankruptcies in the 2000s: from a raider's tool to a "double standard" policy*, by E.A Apevalova, A.D: Radigin, published by Economic Policy magazine, issue No. 4 for 2009, pages 91-124.

[2] The increase in the overall number of complaints filed with arbitration courts in 2008 amounted to 13% compared to the respective number for 2007. – Speech by A.A: Ivanov, Chairman of the Supreme Arbitration Court of Russia, at the Federation Council on September 21, 2009 - www.arbitr.ru

[3] Meanwhile, the increase in the number of complaints related to breached obligations under certain specific types of contracts is considerably higher, amounting to 300% for insurance contracts, 131% for supply contracts, and 97% for rental/lease contracts. - Speech by A.A: Ivanov, Chairman of the Supreme Arbitration Court of Russia, at the Federation Council on September 21, 2009 - www.arbitr.ru

[4] See also *Bankruptcies in the 2000s: from a raider's tool to a "double standard" policy*, by E.A Apevalova, A.D: Radigin, published by Economic Policy magazine, issue No. 4 for 2009, pages 91-124.

[5] For a detailed analysis of bankruptcy statistics in 1994-2004, see A.D: Radigin. Yu.V. Simachev, R.M. Entov et al., *The institution of bankruptcy: its establishment, shortcomings, and reform priorities*, Moscow, IEPP, 2005.

[6] Substantive debtors are all debtors except absentee ones.

15,500 filings per year, in 2005-2009 this number doubled to reach approximately 23,000-26,000 filings annually[1]. (see Chart 1 for the trends in the number of debtor insolvency (bankruptcy) filings from 1998 to the first half of 2009).

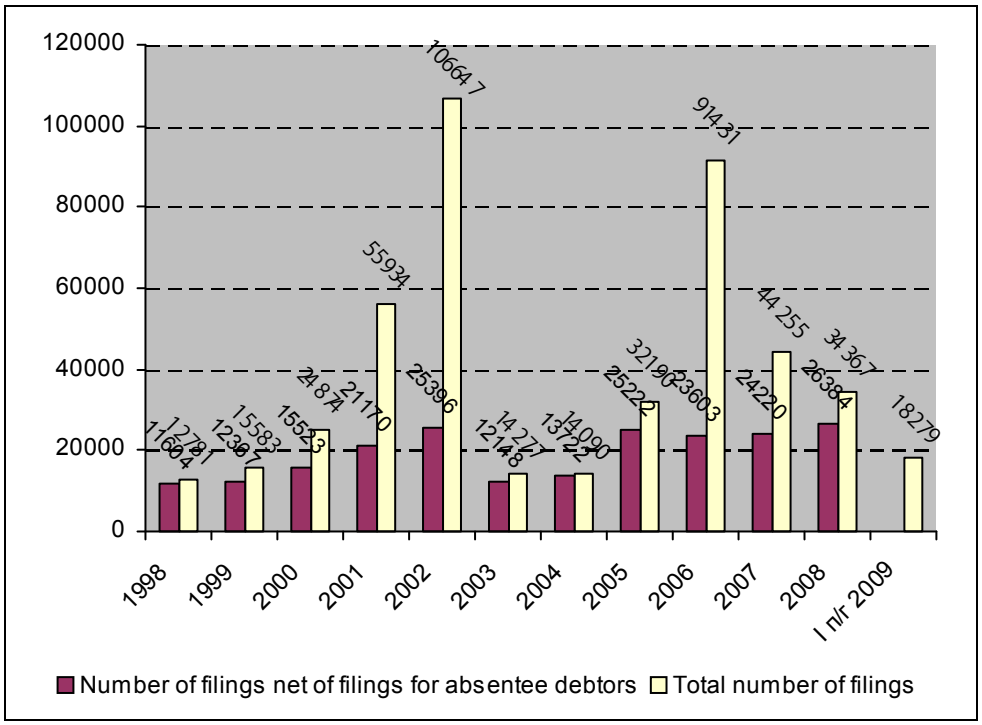


Fig. 1. The number of filings for debtor bankruptcies

As shown in Chart 1, 2002 and 2006 were each characterised by significant growth in the total number of bankruptcy filings, which was caused by an increase in tax authority corporate liquidation operations, including those concerning enterprises that had ceased economic activity (absentee debtors). Thus in 2002-2003, companies that had failed to re-register in accordance with the new Law on Joint Stock Companies were liquidated. By early 2004, the senior experts at the Russian Supreme Arbitration Court estimated the total number of enterprises subject to liquidation due to the cessation of economic activity at approximately 1.5 million. The procedure and terms of financing of bankruptcy procedures for absentee debtors were stipulated in October 2004[2], however, the required financing was only made available by 2006.

Thus in 2006, almost 87% of bankruptcy filings, or approximately 79,500 in absolute numbers, were made by the competent authorities. These included more than 70,000 (76.8%) bankruptcy claims made with respect to absentee debtors or debtors in the process of liquidation. In 2007, the number of bankruptcy filings for absentee debtors decreased 3.5 times compared to the previous year to reach 20,035. The decrease continued in 2008, with the respective number reaching 7,983 filings, or 23.2% of the total number of insolvency claims.

[1] Preliminary estimates show that the bankruptcy filings for "substantive" debtors in 2009 will be no fewer than the respective numbers in 2005-2008.

[2] Russian Government Decree No. 573 dated October 21, 2004, On the Procedure and Terms of Financing of Bankruptcy Procedures for Absentee Debtors

The principal reason for this decreasing trend has been the legislative stipulation in July 2005[1] and the increasing practical application starting from 2007[2] of the liquidation procedure for absentee and/or inactive legal entities by way of their elimination from the register by the tax authorities.

However, even given the tenfold decrease in the number of absentee debtor liquidation filings in 2006-2008, the share of bankruptcy filings made by the competent authorities, predominantly tax authorities, exceeded 67% in 2008. The proportion of debtor-filed claims increased from 13.1% in 2007 to 19.6% in 2008, or from 5,779 filings to 6,734 filings. General creditors filed 4,560 claims, or 13.3% of total claims, in 2008, compared to 4,738 claims, or 10.7% of the total, in 2007. *Thus tax authorities play the leading role in initiating bankruptcy proceedings, including those against "substantive" debtors, while government regulation of the operations of such authorities can have a significant impact both on the scope of application of bankruptcy procedures nationwide and on the general practices of such bankruptcy proceedings.*

As regards bankruptcy claims for specific debtor classes, the following observations must be made:

– Significant growth of individual entrepreneur bankruptcy claims in 2007-2008 (approximately 6.8 times in 2008 relative to 2006). Whereas the number of such claims was in the range of 200-700 in 2004-2006, it reached 2,478 in 2007 and 4,751 in 2008.
– A 2.5-times decrease in the number of agricultural enterprise bankruptcy claims in 2007-2008, from approximately 4,000 in 2006 to 2,465 in 2007 and 1,614 in 2008, and a twofold decrease in the number of bankruptcy claims for farms, from 550 claims in 2006 to 361 claims in 2007 and 273 claims in 2008. This is largely due to government measures aimed at supporting the agricultural sector, such as increased lending, restructuring tax obligations, dating of fuel and lubricant purchases, etc.

The trends in bankruptcy rulings in 1998-2009 were also largely influenced by the activities of government agencies in the area of legal entity liquidation (see Chart 2).

In the first half of 2009, the number of debtor bankruptcy rulings exceeded the respective number for the previous year by more than 16% for the first time since 2006, with approximately 7,500 rulings taken in the first half of 2009 compared to approximately 6,400 rulings in the first half of 2008. Our estimates show this growth continuing in the first half of 2010 unless the state adopts measures aimed at broader use of financial rehabilitation procedures, signing restructuring agreements, etc.

[1] Paragraph 3 of Article 1 of the Federal Law No. 83-ФЗ dated July 2, 2005, On Amendments to the Federal Law on State Registration of Legal Entities and Individual Entrepreneurs and to Article 49 of the Russian Civil Code.

[2] Following the adoption of the Plenary Decree of the Russian Supreme Arbitration Court No. 67, dated December 20, 2006, On the Practical Implementation of Legislative Provisions for the Bankruptcy of Absentee Debtors and the Liquidation of Inactive Legal Entities, that clarified the application procedure in courts of the regulatory provision adopted in July 2005 for the liquidation of inactive legal entities following a resolution by the registration authority.

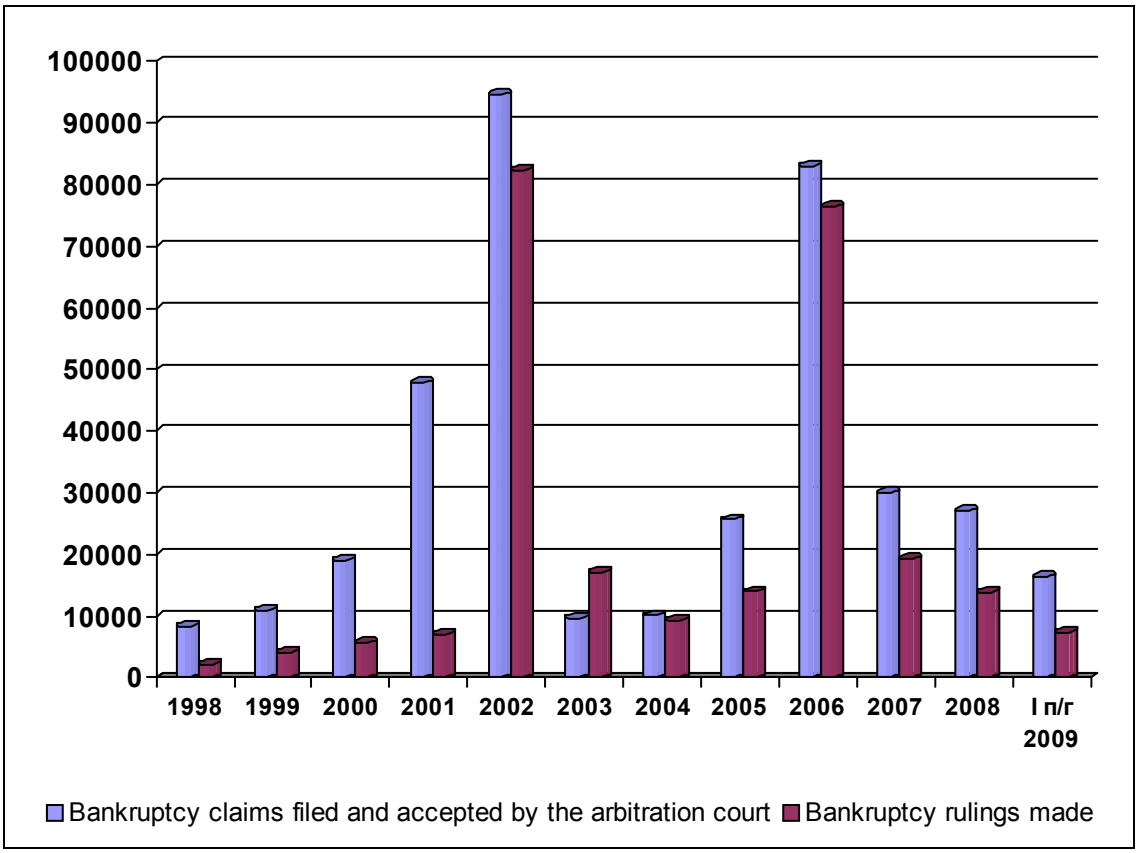


Fig. 2. Bankruptcy claim filing and bankruptcy ruling trends in 1998-2009[1]

The trends vary depending on the specifics of the different bankruptcy procedures envisaged by the Law on Insolvency. Thus the use of observation procedures increased more than twofold, from 4,893 in 1998 to 10,739 in 2002. In 2003-2004 the respective number dropped approximately by half, while in 2006-2008 it came back to 2002 levels, close to the maximum number at more than 10,000.

Throughout the validity period of the third Law on Bankruptcy, *instances of regaining solvency while under external administration* that led to the cessation of bankruptcy proceedings *were isolated*, numbering from 14 to 41 annually. Financial rehabilitation of debtors was likewise seldom used, from 10 to 48 instances annually. Restructuring agreements were signed more frequently, numbering 403 in 2002 and ranging from 84 to 170 in 2003-2008, but their use has amounted to less than 1% of the total number of bankruptcy cases completed annually. The use of external administration by debtors decreased steadily in the 2002-2008 period, dropping more than five times from 2002 to 2008. The trends in the use of external administration, financial rehabilitation, and restructuring agreement procedures in 2002-2008 are shown in *Fig.* 3.

[1] A different reporting system was used for bankruptcy cases in 1998-2001, which may have resulted in data inaccuracies concerning bankruptcy rulings taken in this period.

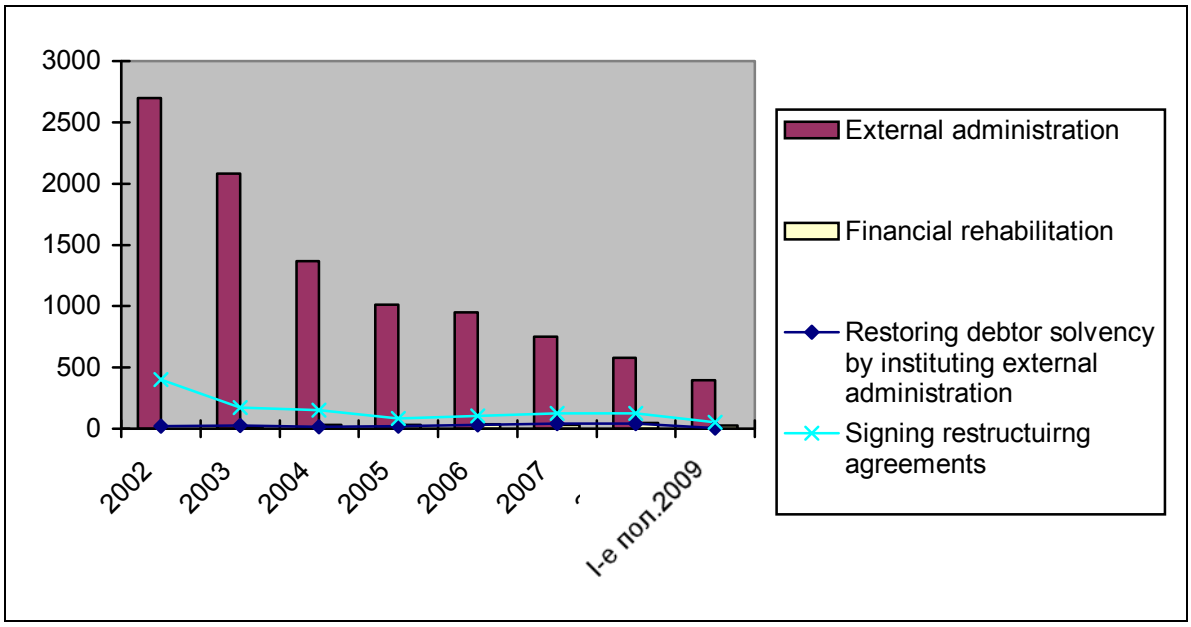


Fig. 3. Trends in the use of external administration, financial rehabilitation, and restructuring agreement procedures from 2002 to the first half of 2009

2008-2009 saw an emerging trend towards an annual decrease in applications for the removal of arbitration managers by approximately a quarter with respect to each preceding year, from 2,491 in 2007 to 1,783 in 2008 to 698 in the first half of 2009 (a 25.3% decrease relative to the respective period in 2008). This trend may be due both to more stringent requirements with regards to the responsibility of arbitration managers and their organizations and to changes in the arbitration manager appointment procedure that at present practically excludes any influence on behalf of the debtor, as well as the greater influence of government representatives and largest creditors upon all stages of the bankruptcy procedure.

The number of bankruptcies among municipal unitary enterprises has significantly decreased from 2007 throughout the first half of 2009, from 1,947 in 2006 to 1,009 in 2007, 676 in 2008 and 273 in the first half of 2009. Conversely, the number of bankruptcies among state unitary enterprises practically doubled in the first half of 2009 compared to the respective period in 2008, growing for the first time since 2007 to reach 163. The trends in bankruptcy rulings regarding state and municipal unitary enterprises are shown in Chart 4.

It should be noted that the 2005-2009 period has been generally characterised by wider application of bankruptcy procedures against "substantive" debtors. However, to a lesser extent the institution of bankruptcy continues to carry out the function of government regulation of the number of inactive legal entities that should be outside its scope. Tax authorities play a leading role in initiating bankruptcy proceedings, including those against "substantive" debtors, while government regulation of their activities can largely determine both the scope of application of bankruptcy procedures nationwide and have a significant impact on the general practices of insolvency proceedings.

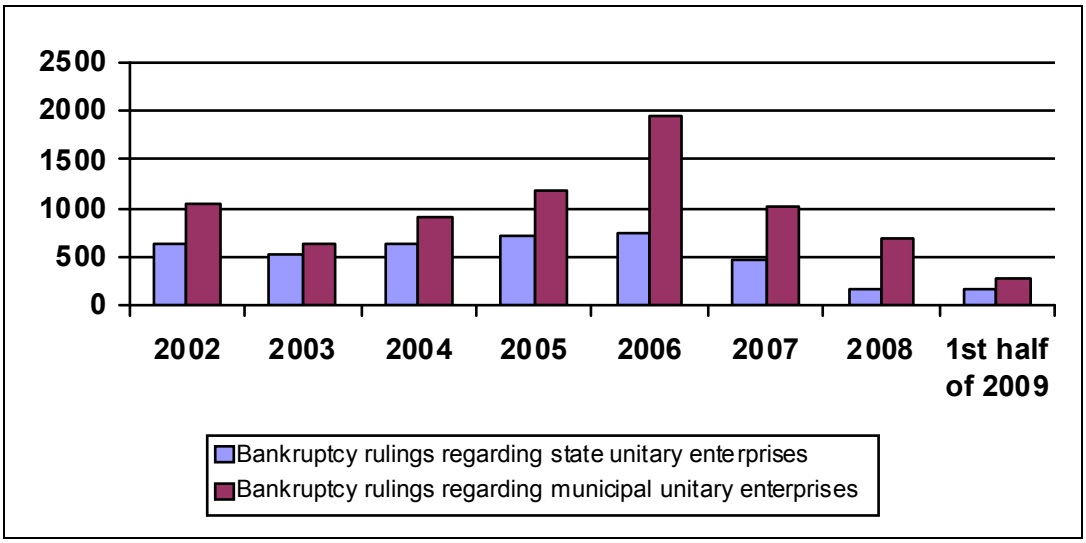


Fig. 4. Trends in state and municipal unitary enterprise bankruptcy rulings

The increase in bankruptcy rulings taken in the first half of 2009 amounted to 16.7% compared to the respective period in the previous year. A 24.1% increase in the number of bankruptcy filings, as well as Supreme Arbitration Court data that show evidence of significant (88%) growth in the number of claims related to breach of obligations, predominantly of contractual obligations, point to the high probability of further growth in the number of bankruptcies in 2010.

Restoring debtor solvency within the framework of bankruptcy procedures and settling creditor claims by signing restructuring agreements, as well as financial rehabilitation, are still confined to isolated instances and leave debtors who have become the subjects of bankruptcy proceedings no practical chances of retaining control over the enterprise. Given the low threshold for an insolvency ruling (RUR 100,000), as well as the large-scale payment defaults, shrinking industrial production volumes, lending volumes, and market demand starting from late 2008, this results in decreasing numbers of economic agents, above all of private entrepreneurs, regardless of their competitive strengths.

5.3.2. 2003-2009 bankruptcy legislation: "identity crisis"

The development of bankruptcy legislation from 2003 through the end of 2008 was largely influenced by the overall policy of direct government expansion in the economy. The creation of seven state corporations and a substantial increase in government-controlled corporate assets led to *the adoption of legislative provisions that lower the risks of loss or decrease of control over assets that are deemed important by the government and by state-controlled companies*.

First, the application of the Bankruptcy Law no longer extends to state corporations (practically all except Rosavtodor that was created later, between May and December of 2007), as well as Vnesheconombank.

The state that actively used the institution of bankruptcy to redistribute the assets of the Yukos oil company has now created preconditions enabling the state corporations, regardless of the economic efficiency of their operations, to unconditionally avoid a similar fate. The narrowed scope of application of the law and the exclusion of specific entities from the appli-

cation of general regulatory provisions is widely used at present to create favourable conditions for such select entities or economic sectors. However, such legal regulation substantially lowers government incentives for the creation of market institutions – in this case bankruptcy – in the interests of all market participants and preserves the persistent lacunae and contradictions in the legislation until such time as they may impact the interests of the key "players".

Second, government control was strengthened with respect to bankruptcy proceedings for enterprises whose activities involved state secrets, together with an increase in the number of companies eligible for a strategic entity designation enabling them to undergo bankruptcy on special terms geared more toward the preservation of the business.

Whereas prior to February 2007 the special provisions regulating the bankruptcy of strategic entities and organisations could only apply to federal state unitary enterprises and joint stock companies that had a government stake and produced goods or rendered services of strategic importance to state defence and security matters, fulfilled government defence contracts, and were involved in a limited number of other activities, at present such provisions apply to an open list of subjects that is being extended with new exceptions concurrent with the adoption of a new federal law.

Entities classified into this category have a higher indebtedness threshold for initiating bankruptcy proceedings (RUR 500,000 versus RUR 100,000 for the rest), higher requirements for arbitration manager qualifications, require mandatory participation by government representatives in the bankruptcy proceedings, and are subject to special treatment with regards to financial rehabilitation procedures, external administration and receivership proceedings.

In essence, the bankruptcy of such entities is subject to more stringent government controls. There can be no doubt that the operations of enterprises that ensure state security and are otherwise strategically important cannot and should not be regulated based solely on market principles. However, the creation of legal preconditions for making an exception for practically any enterprise is unproductive, creating "an illusion of the law for others' sake" and promoting misuse of the law.

Within the overall framework of strengthening government control over bankruptcy proceedings for enterprises whose activities involve state secrets, the requirements for arbitration managers working at such enterprises have been increased, and provisions have been made to allow the participation of regional FSB representatives in bankruptcy proceedings.

A logical extension of the policy of government expansion has been made by the introduction of a *simplified procedure for the reappointment of an arbitration manager that narrows debtor rights*. Effectively, the legislators proposed a mechanism for appointing an administrative (external, receivership) manager bypassing the general procedure for his approval that envisages the debtor's right to veto one of the candidates. The adoption of such norms simplifies the procedure of approving a candidate for arbitration manager in situations when the majority of creditors vote for the same candidate. The adoption of this mechanism in July 2006, its retroactive application and its use in the Yukos bankruptcy proceedings does not appear to be a coincidence[1].

[1] During the court hearing at the Moscow arbitration court regarding the bankruptcy of the Yukos oil company (case № А40-11836/06-88-35«Б» dated August 4, 2006; the Law was adopted on July 18, 2006), a stipulation was made for the approval of a temporary administrator in the capacity of bankruptcy administrator based on the resolution by the creditors' meeting adopted in accordance with Article 45 of the Federal Law on Insolvency (Bankruptcy). By then the indebtedness of Yukos amounting to US$482 million had been assigned by the consortium of foreign banks to the state-controlled Rosneft joint stock company that, jointly with the tax authority

Finally, note should be taken of the prorogation in December 2004of the validity of the Federal Law on the Insolvency (Bankruptcy) of Natural Monopolies dated June 24, 1999, until July 1, 2009, which signified the continued application of a different principle of determining insolvency criteria for natural monopolies in the fuel and energy sector, the so-called payment unfeasibility principle[1]. For such companies, special rules have remained in force for all stages of bankruptcy proceedings that are aimed at ensuring the preservation and integrity of all property of fuel and energy sector natural monopolies and envisage the mandatory participation of fuel and energy sector management agencies in the proceedings (article 7), as well as more stringent requirements for the arbitration manager (article 15).

Other innovations in bankruptcy legislation for the period had more limited reach and were aimed at protecting the interests of specific legal subjects within the bankruptcy process, such as granting preferential treatment to local government agencies facilitating the transfer to such agencies of social sphere assets following bankruptcy and the introduction of legal mechanisms for enhanced protection of the interests of mortgage-backed securities holders.

Thus between 2003 and 2008, legal regulation of bankruptcy evolved to ensure, at the legislative level, the integrity of significant state-controlled assets, while at the same time the development of necessary changes in the interests of other market participants and the development of the institution of bankruptcy as a whole were both stagnating.

The global economic crisis put a stop to government inertia in solving the outstanding issues related to bankruptcy and became an external stimulus for long-overdue changes. The increased legislative activity in this area was particularly spurred by the growth of debt portfolios of the largest Russian banks, as well as by the practice of asset-backed lending to the largest industrial enterprises, many of which experienced a deterioration in their financial condition, and by the expected increase in the number of corporate bankruptcies in 2009-2010.

The government decision to support the banking sector, which is de facto more than 50% state-controlled, and the emphasis on ensuring its stability, including doing so by creating the conditions for ensuring low levels of bad debt in bank loan portfolios, as well as widespread payment defaults on loan agreements have defined the focus going forward of developing bankruptcy legislation that is centered around the notion of *creating real conditions for satisfying creditor interests and increasing the protection of creditor rights*.

The implementation of this concept translated into the following changes instituted by state laws No. 296-ФЗ dated December 30, 2008, On Amendments to the Federal Law on Insolvency (Bankruptcy) and No. 73-ФЗ dated April 28, 2009 On Amendments to certain legislative acts of the Russian Federation:

1. *The exclusive right of the creditor assembly to elect the arbitration manager* has been instituted, along with the previously envisaged possibility of electing a self-governing body of arbitration managers. At the same time, the procedure of appointing the arbitration manager now allows for a single candidate to be proposed by the creditors (three candidates knee were required previously, and earlier still the debtor had the right to veto one of those).

representatives, held the majority vote at the creditors' meeting. The company assets were subsequently sold by the Yukos arbitration manager at an estimated substantial discount to market price, and more than 80% of these assets were transferred under direct or indirect government control.

[1] See V. Vitrianski, Insolvency (bankruptcy) specifics for natural monopolies in the fuel and energy sector (http://www.juristlib.ru/book_1091.html)

2. The liability of the arbitration manager has been increased. Failure to carry out his duties, in full or in part, including the duties envisaged by federal standards, can be the basis for removing the arbitration manager by the arbitration court based on a claim by the bankruptcy case participants. Furthermore, the procedure of disqualifying an arbitration manager has been stipulated in detail.

3. The system of remuneration for the arbitration manager and specialists that he may involve in the bankruptcy proceedings has been changed.

The proposed mechanism of remuneration payments for the arbitration manager is aimed at incentivising the arbitration manager to act in the interests of creditors. It envisages fixed compensation for the arbitration manager of between RUR 15,000 and RUR 45,000 monthly[1] depending on the stage of the bankruptcy process, and the payment of additional remuneration decided by the creditors. Such additional remuneration amounts to:

– Compensation ranging from 4% (for total assets valued at less than RUR 250,000) to RUR 301.500 plus 0.001% of the total value of debtor assets in excess of RUR 1 billion (for total assets valued at more than RUR 1 billion) at the supervision and financial rehabilitation stages;
– 8% of the amounts designated for satisfying the claims or registered creditors in case the bankruptcy proceedings are terminated, or 3% of the increase in value of the debtor's net assets during the external administration period in case the debtor is ruled bankrupt and receivership proceedings are initiated at the external administration stage;
– compensation ranging from 3% to 7% of the total amount of the satisfied claims of registered creditors.

The amount that the bankruptcy administrator can designate as payment for specialist services is also stipulated in detail and, depending on the total book value of debtor assets, can range from 10% for total assets valued below RUR 200,000 to RUR 2,995,000 plus 0.01% of the total value of debtor assets in excess of RUR 1 billion for total assets valued at more than RUR 1 billion. Furthermore, the legally stipulated remuneration for such services, as well as the amounts paid for the services of specialists involved by the arbitration manager can be deemed unjustified based on an appeal by bankruptcy case participants if such services are not linked to the specific object of bankruptcy proceedings or to the responsibilities of such agents, or if the amount of remuneration for such services is "clearly disproportionate relative to the expected results".

4. The responsibilities of arbitration managers with regard to informing the participants of bankruptcy proceedings have been increased: creditors must be informed about transactions and actions that lead or may lead to third party legal liability, as well as about any evidence uncovered of a deliberate or fictitious bankruptcy, while government bodies must be informed about any administrative or criminal breaches identified.

5. The responsibilities and liability of the self-regulating bodies of arbitration managers have been increased.

Thus starting from 2009, self-regulating organisations have been granted accreditation rights with regards to insurance agencies, valuation specialists, professional securities market participants that carry out registration activities, as well as with regards to other entities involved by the arbitration manager when carrying out his duties in the bankruptcy process.

[1] This amount can be increased based on a court decision following an application by the bankruptcy case participants.

Furthermore, such agencies are put in charge of developing standards and regulations governing the professional activities of arbitration managers and monitor compliance with such standards and regulations. These agencies are also entrusted with monitoring the compliance of arbitration managers with the mandatory liability insurance requirements.

Mandatory disclosure by arbitration manager self-regulating bodies has been instituted concerning their activities, including the use of compensation funds; their managing companies; any instances of disciplinary measures applied to arbitration managers (for more details on the issues of arbitration manager self-regulation, see Section 3.2);

6. The Law has stipulated procedures for the use by arbitration manager self-regulating bodies of compensation funds that are utilised to make payments to debtors, including the procedure of making claims for compensation payments, timing deadlines for compensation payments; investment terms for compensation fund assets; responsibilities of the managing company; the transfer of compensation fund moneys to a national association in case of elimination of the self-regulating organization from the register.

7. State control over the activities of arbitration manager self-regulating bodies has been increased.

Control functions that were previously carried out by the Federal State Registration, Land Register, and Cartography Service (formerly called Rosrtegistratsii), were strengthened by granting it additional powers:

– the right to start legal proceedings for administrative breaches against arbitration managers, arbitration manager self-regulating bodies and/or their representatives, and the right to review such cases or remit them for review by arbitration courts;
– the right to include non-commercial organization records into the general state register of arbitration manager self-regulating bodies and the right to keep such a register;
– the right to establish the status of an association of arbitration manager self-regulating bodies as that of a national association, etc.

In case of non-compliance by arbitration manager self-regulating bodies with the directives of monitoring and controlling agencies aimed at correcting deficiencies related to setting standards and developing regulations or related to reviewing complaints about the actions of their members, the representatives of the government agency must file an application at an arbitration court for the elimination of such an organisation from the general state register.

8. Strict requirements have been established with regards to the mandatory liability insurance contracts signed by arbitration managers. The objects of mandatory insurance, insurance events and insurance risks for such contracts have been stipulated along with the insurance payment procedures.

9. Measures have been taken to counteract the transfer of assets.

The focus on maximizing the satisfaction of creditor claims has led to the implementation of mechanisms for contesting transactions aimed at transferring debtor assets, the so-called "suspicious transactions" and "transactions leading to preferential treatment of one of the creditors". *In essence, the state has taken legislative measures to eliminating bankruptcy "grey areas" for the first time in five years*.

10. The concept of liability for debtor owners has been established.

For the first time, in addition to the above entities, subsidiary liability has been established for the real owners, "entities controlling the debtor", understood as persons or entities that have or have had, within the two years prior to the acceptance of a bankruptcy claim by an

arbitration court, the right to issue instructions that are subject to mandatory execution by the debtor or can otherwise determine actions by the debtor[1].

The practical possibility of establishing liability and pursuing legal action against such persons or entities is doubtful due to the impossibility of establishing the real owners and beneficiary owners of many substantial Russian assets even in the context of criminal proceedings.

The duties of the managers and owners of financial institutions in situations approaching bankruptcy have been significantly broadened, and new types of liability have been established including a ten-year prohibition on the purchase of financial institution shares amounting to 5% or more of total stock and a three-year ban on taking top management positions in financial institutions.

11. The possibility of a closed sale of debtor assets has been narrowed. The enterprise sell-off procedure has been given detailed legal treatment, with its rules applying also to the full or partial sale of debtor property (articles 110, 11 and 139 of the Federal Law on Insolvency (Bankruptcy). While the possibility of a closed sale of debtor assets has remained and is now called an "auction featuring closed price offers", numerous necessary technical innovations have been introduced such as the application procedure and application requirements when applying for participation in the auction, as well as requirements concerning the company sale contract, while the information transparency of the sale process has been enhanced. The practice of formally open auctions has been announced; however, the practice of selling assets to "earmarked" buyers will remain (albeit to a limited extent), especially considering the growing influence of the state upon the arbitration manager who acts either as auction organiser or as the person contracting a specialised agency for this purpose.

Furthermore, enterprise sale can now be carried out both by auction and by competitive sale so long as the buyer complies with specific conditions set by a creditor assembly or creditors' committee with respect to the company being sold. The introduction of an electronic format for enterprise sale is a progressive measure, however, its implementation has been postponed indefinitely[2].

Further changes were made to the key provisions of the bankruptcy legislation.

A. Whereas previously the right to make a bankruptcy claim at the arbitration court came into effect 30 days after the date of remittance of the executive order to the court bailiff service, at present such a right comes into effect from the date of the legally binding court decision concerning a monetary claim upon the debtor.

[1] Debtor actions can be determined by a controlling entity, including determination by coercion of the representatives of the debtor manager or of the members of debtor management bodies, or by otherwise exerting influence on the debtor manager or of the members of debtor management bodies (thus, debtor controlling entities can include members of the receivership committee, persons or entities that had the power by way of power of attorney or regulatory act, or by way of special power to enter into transactions on behalf of the debtor, persons or entities that had disposal rights with respect to more than 50% of the voting shares of a joint stock company or more than half of the statutory capital of a limited (subsidiary) liability company). Federal Law No. 73-ФЗ dated APril 28, 2009, On Amendments to certain legislative acts of the Russian Federation.

[2] Electronic auctions for the sale of enterprises shall be held 120 days following the day of approval by the regulatory body of the requirements regarding electronic trading sites, requirements regarding the operators of electronic trading sites when holding open auctions in electronic format, the procedure of verifying compliance of the electronic trading site and its operator with the established requirements, the procedure of holding open auctions and electronic format (Federal Law No. 296-ФЗ dated December 30, 2008, edited July 19, 2009). By November 2009, the relevant provisions have been developed by the Ministry for Economic Development, but they are yet to be adopted.

Thus it becomes possible to start insolvency procedures prior to ascertaining the impossibility of carrying out the court decision and prior to actual insolvency. This allows for the application of bankruptcy procedures to companies that are neither bankrupt nor even in a state approaching bankruptcy.

Such a situation is once again advantageous for creditors who at present compete among themselves. From a legal point of view such stipulation of a creditor's right to file a bankruptcy claim prior to the expiration of the deadline for voluntary execution of a court order by the debtor and prior to the start and end of executive proceedings is illegal as it infringes upon the debtor's rights and the subjects the debtor to bankruptcy proceedings that are the last resort measure of protecting creditor rights, without sufficient legal grounds and unjustifiably bypassing the customary process is of protecting creditor rights. Doubts also arise regarding the stipulation of the right of the competent authorities, primarily tax authorities, to file a bankruptcy claim. The legal grounds for the stipulation of such rights must undergo a fundamental test of substance, and the procedure must be changed if sufficient grounds exist.

B. The list of bankruptcy procedure participants has been expanded with the inclusion of authorised representatives of the Russian Federation and local government bodies. Furthermore, the right to participate in bankruptcy procedures has been granted to the self-regulating body where the arbitration manager is a member, to bankruptcy supervision and monitoring agencies (the Ministry for Economic Development and the Federal State Registration Service), as well as to creditors for current payments.

Overall systemic measures for the development of bankruptcy legislation are accompanied by strengthening direct and indirect government influence upon the execution of bankruptcy proceedings and by the further narrowing of debtor rights that underlines the pro-creditor focus of the insolvency legislation[1]. Apart from direct participation by representatives of the Federal State registration service and other government representatives in bankruptcy procedures, there is growing informal influence of government officials upon arbitration managers (also by way of influencing the self-regulating bodies), and growing influence of the tax authorities by way of arbitration manager selection and establishing his remuneration. The same purpose is served by changing the status of "mandatory payments" that become due after the instigation of the bankruptcy procedure, resulting in ensuring the growing influence of government representatives at the creditors' assembly.

The area of enterprise rehabilitation that is in great need of development has undergone changes linked to its potential application at any stage of bankruptcy proceedings and to stipulating the right of founders (partners) and owners of unitary enterprises and third parties to settle company indebtedness for mandatory payments at any stage of the bankruptcy process. Considering the increasing state control over bankruptcy proceedings and the increase in

[1] The pro-creditor focus of the bankruptcy legislation uses the presumption of the debtor being an ineffective owner. Unlike countries with more advanced economies, Russia has low levels of competition and corporate governance, an underdeveloped financial system, and a high level of criminal involvement in corporate activities. Furthermore, breaches of contract roll obligations, including monetary obligations, were pervasive in Russia even at the time of economic growth due to insufficient asset levels, difficulties in attracting debt financing and in using financial instruments that would ensure the fulfillment of such obligations. On top of that, the methods of financing chosen by the government at the time of crisis have led to the deterioration of the competitive environment. In this situation the practically unchecked right of large creditors with regards to determining debtor activities while depriving the latter of any possibility of preserving their business and restoring company solvency goes against market interests as in such cases efficient owners are likewise in danger of losing their assets.

the methods of directly and indirectly influencing the arbitration manager, this innovation provides a "loophole" for those willing to preserve their business. The measures adopted are insufficient and incapable of radically changing the unsatisfactory situation with regards to preventing bankruptcies.

The increase of bankruptcy participant rights as regards demanding an expertise at any stage of the bankruptcy proceedings to determine instances of deliberate or fictitious bankruptcy is a positive development albeit a clearly belated one.

A number of procedural innovations have also been made:

a) *A general federal register of bankruptcy information* is being created that will contain a broad range of information regarding the procedures used in bankruptcy cases such as asset sale auctions and their results, their removal of arbitration managers, etc.;
b) *Debtor employees have been included among the interested persons who cannot be appointed as temporary, administrative, external, or receivership managers*, while the statute of limitations within which debtor managers, members of its board of directors and executive body, as well as its chief accountant are considered interested persons has been extended from one year to three years;
c) *The arbitration court has been granted the right of independently ordering an expertise* to investigate issues that require specialized knowledge in the preparation of the bankruptcy case.

Important *social innovations* include changing the ranking of payroll indebtedness within the order of creditors for current indebtedness arising after a court bankruptcy ruling. It will now be settled immediately following the payment of legal expenses and remuneration to the arbitration manager and persons contracted by him for the purpose of conducting the bankruptcy proceedings. Previously payroll indebtedness ranked below current utilities and maintenance payments and below creditor claims arising after the bankruptcy filing.

In general, the development of bankruptcy legislation in 2003-2009 can be conditionally divided into two periods. The first was the *pre-crisis* period focusing on the preservation of the overall corporate bankruptcy framework whose functioning had limited impact upon the interests of key players who had significant lobbying potential. The protection of their interests necessitated the strengthening of government control and broadening the scope of application of special bankruptcy procedures for strategic enterprises that were subjectively designated as such, while the most influential economic subjects (Vnesheconombank and government corporations) were exempted from the application of the bankruptcy law.

With the onset of the crisis, the priority changed from ensuring the integrity of state controlled assets to ensuring low levels of bad debts in the loan portfolios of the largest banks, which was meant to contribute to the preservation and support of the banking system. In this situation the banking sector is significantly aided by the state twice, once by way of direct finanscial aid and once again by substantial protection of bank interests in the area of bankruptcy, thus promoting the idea of banks as efficient owners while inefficient owners have been penalised not only by the financial crisis but also by the impossibility of protecting their legal interests given the strengthening pro-creditor focus of the bankruptcy system that practically rules out the preservation of business and at present has little to do with the efficiency for market participants or lack of such.

At the same time, the significant number of expected bankruptcies and the dispersal of state interests in this regard has resulted in *the adoption in December 2008 and later in April*

2009, for the first time since 2004, of general legislative provisions concerned with the interests of all market participants.

A number of proposed measures, such as more detailed stipulation of procedures, more stringent controls over the activities of arbitration managers and their self regulating bodies, stipulation of auction procedures for debtor assets, the introduction of greater information transparency in bankruptcy proceedings are *long overdue and can improve the protection of both creditor and debtor rights*. The efficiency or inefficiency of the new measures will be largely determined by the extent to which the state will continue to use its growing influence to further strengthen its position and protect quasi-government interests in the corporate market by controlling the redistribution of corporate assets, or by whether the economic downturn will cause the state to be guided by the interests of society in general, however contradictory.

The practice of developing both corporate legislation and bankruptcy legislation in the 2000s shows a growing trend toward a merger or government interests with those of the largest state-owned (pro-government) companies and banks, along with amending economic legislation predominantly in the interests of such agents and to the detriment of the interests of society in general. The only exception is provided by the reaction to acute social phenomena.

At present there is no planned systematic development of either corporate law or bankruptcy law in the interests of all market participants. In this respect the pre-crisis and post-crisis developments in bankruptcy law are similar, with legislation serving as *an instrument of upholding the interests of a specific group of subjects that the state identifies itself with at various points in time*. Until such time as this identity crisis is resolved by the state, the development of economic institutions we'll be chaotic and destructive to the development of the economy as a whole.

5.3.3. The judicial system and issues of self-regulation

Judicial system

Arbitration courts play a crucial role in bankruptcy rulings with respect to debtor enterprises and individual entrepreneurs. All the key decisions starting from the acceptance of the bankruptcy filing and up to the ruling on the termination of receivership proceedings that serves as the basis for a liquidation entry with respect to the debtor in the state register of legal entities are taken by the arbitration court that reviews the bankruptcy case. Within the framework of this judicial process, the court takes decisions that have a significant impact on the economic status of the participants of bankruptcy proceedings. In some cases, significant shortcomings and mistakes in the court rulings cannot be rectified. It is therefore of supreme importance that the numerous decisions taken within the bankruptcy process, such as the appointment and removal of arbitration managers, settling disputes among creditors and between creditors, the arbitration manager, and the debtor, including creditor claims in the register, removal of debtor management, the adoption of safeguard measures, the invalidation of debtor transactions and other such decisions should be taken by an independent court, be legally enforceable, be well grounded, and be implemented.

Otherwise the institution of bankruptcy cannot function effectively within the economy. The above applies in equal measure to settling other disputes arising from economic and administrative legal relations where the rulings, in cases of noncompliance with the same, form the basis for initiating bankruptcy cases.

In practice the Russian judicial system, having inherited many of the traditions of the Soviet judicial system, *continues to be significantly influenced by the executive power*. It would be unfair to claim that all or most judges lack independence; however, rulings for legal cases "of special importance" are entrusted to those whose decisions follow the recommendations of the presiding judge who assigns the cases. According to the determination of the president of the Russian constitutional court V.D: Zorkin[1], ensuring the independence of such presiding judges is a key issue.

Recent assessments of the judiciary system range from "a mockery of justice" and "a tool serving the executive branch" [2] to "a comprehensive judiciary system albeit riddled with numerous shortcomings" [3]. These shortcomings arise from inadequacies in the legal mentality, including that of professional practitioners, in professional personnel training, in organizing the functioning of courts, including workload issues, in the selection criteria, selection mechanisms, and appointment mechanisms for judges, in receiving and improving professional qualifications, and in the degree of transparency in the system.

A widely known shortcoming of the Russian judiciary is the *lack of enforcement of Russian court rulings*. Statistically, half of the rulings by both general courts and arbitration courts in Russia are not enforced. [4]. The most urgent issues related to the enforcement of court decisions are to do with the inefficient and illegal sale of arrested assets, as well as with staffing issues. The possibility of selling corporate assets to "designated" buyers at discount prices is a significant component of corporate takeovers. An analysis carried out by the Federal Court Bailiff service has revealed the following shortcomings of the present property sale mechanism[5]:

– lack of access to "closed" debtor property sale auctions
– lack of information on property sales, which information in the majority of cases is published in low circulation periodicals dealing with unrelated subjects
– the auctioning off of property at discounted prices.

Thus corporate takeovers still use the well established old practice involving the sale of arrested and confiscated property.

In order to deal with the above shortcomings, the Federal Court Bailiff service supports the development of the system of selling arrested property based on mixed auctions using global auction practices (Dutch and English auctions).

Such a system must combine various features aimed at attaining the full of sale of arrest and property at a maximum price. This will allow to minimise the issues related to the current system of valuing arrested property.

If the new property sale system is implemented, property valuation by the court bailiff or by a professional assessor will be mostly indicative, as necessary for determining commensu-

[1] Speech by V.D. Zorkin, president of the Russian constitutional court, at the seventh Nationwide Congress of judges.- Russian Judiciary, No. 1 (2009), p.12
[2] A. Pushkarskaia, The Constitutional Court loses its dissenting opinions – Kommersant, No. 225 (December 2, 2009)
[3] Here and further below, Yu. Kolesov, "Valeri Zorkin: each component of the judiciary system has its shortcomings"- Vremia Novostei, No. 105, June 16, 2005
[4] Speech by the President of Russia D.A: Medvedev at the seventh Nationwide Congress of judges.- Russian Judiciary, No. 1 (2009), p.4
[5] Here and further below, "The Federal Court Bailiff service on the liquidation of assets arrested, confiscated, and otherwise converted to state property" - http://www.fssprus.ru, June 28, 2007

rate penalties. Such indicative values for arrested property will serve merely as initial auction prices that can then change during the auction (either grow under the English system or decrease under the Dutch system) to reach an equitable price. Some of the proposed innovations limiting the closed sales of debtor assets have been adopted, however, these have not yet been implemented in practice.

As regards *staffing*, the inefficiency and abuses of power by court bailiffs are widespread and have long been an urgent issue. In 2008, 522 criminal cases were initiated for the 780 crimes committed by officials of the Federal Court Bailiff service. It must be noted, however, that the court bailiff service works diligently to uncover such breaches and crimes committed by its employees. 87.4% of the overall number of criminal cases was initiated based on the information provided by the Federal Court Bailiff service itself[1].

The high level of abuse instances by representatives of the Federal Court Bailiff service is coupled with the very low proportion of court decisions to satisfy claims contesting the action or inaction of and rulings by the officials of the Federal Court Bailiff service, at 0.0063% (6.6%)[2] and with the very low proportion of satisfied claims against the Federal Court Bailiff service itself, at 2.3%[3]. Such indicators, together with the practice of contesting the rulings and actions of Federal Court Bailiff service officials, are evidence that the creditors lack an effective mechanism of influencing the enforcement of court rulings and of receiving adequate compensation for losses incurred due to inefficient functioning of the Federal Court Bailiff service.

One of the contributing factors for the low quality of court case review and the long review duration is the *unprecedentedly high workload of judges*. The relatively reasonable workload per judge at an arbitration court in Russia is an average of 15.6 cases reviewed monthly. Meanwhile, in the first half of 2009, the average workload in the arbitration courts had increased by 22% relative to the respective period of the previous year to reach 45 cases per judge monthly[4].

Due to the above, the *level of public confidence in the judicial system* remains low. The number of complaints by Russian citizens filed with the European Court of Human Rights has been steadily growing: 2002 saw the first two rulings on complaints lodged against Russia, with five rulings in 2003, 15 in 2004, 83 in 2005, 102 in 2006, and 192 in 2007. Russia currently has the highest number of complaints lodged against it and the second highest number after Turkey in terms of court rulings that deem state authorities to be responsible for the infringement of at least one provision of the Human Rights Convention. By the beginning of 2008 there were 20,300 complaints against Russia waiting to be reviewed by the European Court, which amounts to 26% of the total number of such complaints (compared to 15,000 complaints at the beginning of 2007). Half of the total number of complaints to the European Court contested the non-enforcement of judicial decisions[5].

[1] On the results of measures aimed at identifying, stopping, and preventing illegal activities by the employees of the Federal Court Bailiff Service regional agencies in 2008 - www.fssprus.ru

[2] The "Key Indicators of Federal Court Bailiff service activities" contain both of the above percentages- www.fssprus.ru

[3] "Key Indicators of Federal Court Bailiff service activities"- www.fssprus.ru

[4] Speech by A.A: Ivanov, Chairman of the Supreme Arbitration Court of Russia, at the Federation Council on September 21, 2009 - www.arbitr.ru

[5] Speech by V.D. Zorkin, president of the Russian constitutional court, at the seventh Nationwide Congress of judges.- Russian Judiciary, No. 1 (2009), p.12

A number of laws were adopted in December 2008 that were aimed at combating corruption, including corruption among judges[1].

Innovations made to the Law on the Status of Judges envisage a new procedure for submitting information on the income, property and property-related obligations of the candidates for the positions of judges, as well as the spouses and underage children of such candidates. The law changed the appointment procedure and requirements for judges. Obvious shortcomings of the proposed edition include:

– The small number of persons whose property records can be verified in connection with the judge's activities (spouse and children). In such situations, the bulk of abuse instances related to illegal payments (bribes) remains beyond the scope of application of the law.
– the impossibility of establishing legal liability for corruption for the judge so long as the illegal or unjustifiably high income is received by the judge's relatives, spouse, or other related persons.
– the impossibility of establishing legal liability for corruption for the judge so long as the illegal income is received by a legal entity owned by the judge, his/her spouse, relatives, or other related persons.
– The provision for legal liability by judges for the failure to provide income and property information or for the provision of false or incomplete data is made using the wording "legal liability may arise", which in practice leads to the routine practice widespread in Russia of the selective application of liability.

At the same time, the provision for the initial appointment of a federal court judge for a duration of three years was eliminated in July 2009[2], while the judge's overall term of office was amended to be limited only by reaching the "maximum age of holding office", i.e. 70 years. Both amendments are aimed at raising the status of judges and increasing their independence.

The above issues are directly related to the issue of *the judges' accountability and setting the standards for judiciary ethics*. This issue is being discussed throughout Europe as part of seeking to balance the judges' independence and accountability. However, there is still a lack of unified standards for judiciary ethics and judges' behavior. In December 2009, the Judges' Council of Russia was presented with a new draft Code of Judiciary Ethics. The Chairman of the Supreme Arbitration Court A. Ivanov characterised the Code presently in force as a "statement of intent" that is of little help to judges in dealing with ethically complex situations. The new draft Code is considerably more detailed, dealing with the judges' relations with court proceeding participants, court senior officials, administrative employees, family members and relatives, as well as extra-judiciary activities. For the first time in Russia, the Code prohibits court presidents from exerting influence on the adoption of rulings by judges for specific cases.

[1] Federal Law On Amendments to certain legislative acts of the Russian Federation due to the adoption of the Federal Law on Combating Corruption, No 274-ФЗ dated December 19, 2008 and On Amendments to certain legislative acts of the Russian Federation due to the ratification of the UN Convention against corruption dated October 30, 2003, and the Convention on criminal liability for corruption dated January 27, 1999, and the adoption of the Federal Law on Combating Corruption, No. 280-ФЗ dated December 25, 2008.

[2] Federal Law No 157-ФЗ, dated July 17, 2009 On Amendments to Articles 6 and 11 of the Law of the Russian Federation Law on the Status of Judges and to Articles 17 and 19 of the Federal Law on Judiciary Bodies in the Russian Federation

The draft devotes considerable attention to the cases of conflict of interest where the judge is prompted to withdraw his candidacy or to inform the proceeding participants about such conflict of interest and obtain their written consent for the case being reviewed by the judge in question. The judges and their family members are prohibited from using their office for the acquisition of any material benefits. Limitations are also proposed that investment activities by judges, whereby such activities must not give rise to doubts concerning the independence and neutrality of judges. Furthermore, judges are cautioned against maintaining "lasting business relationships" with lawyers and other potential court case participants[1].

The issue of ensuring true independence of judges as the necessary precondition for court rulings based solely on considerations of law and justice continu7es to command urgency.

Among the measures discussed recently and aimed at increasing the independence of courts are the introduction of elected office for court presidents who are currently appointed by the President, the strict legislative stipulation of the amount of financial support for the judiciary system, such as a fixed percentage of the GDP automatically assigned for such purposes within the state budget, and the creation of an autonomous logistical division within the judiciary system. This would absolve the courts of the need to seek help in locating buildings, apartments, etc. from the regional authorities, which gives the regional governors an opportunity to control regional courts.

The focus on increasing the independence of judges represents an attempt to restructure the existing system of relationships in the power triangle between supreme executive power, security services, and courts, by minimizing the informal and extralegal elements in favor of formal and legal ones. It is obvious that these measures will not give us an ideal judiciary system fully immune to any involvement by the executive power. However, they offer the possibility of substantially limiting the nature and scope of such interventions that would be confined to the top tier of the political system[2].

The implementation of such measures is only possible upon condition of changing the existing legal policies in the economy where the interests of specific groups and clans concerning the management and use of major Russian assets are currently seen as socially significant, which in turn results in the adoption of laws conflicting with the goals of national economic development and aimed solely at the preservation and redistribution of assets under immediate state control in favour of entities affiliated with "the powers that be" and of individual businessmen loyal to the authorities.

Issues related to self-regulation of arbitration manager organisations and assessors

Starting from the moment when an arbitration manager is appointed for bankruptcy proceedings, he becomes the crucial touch and as an agent carrying out crisis management within the company that has become the subject of an insolvency claim. The competence, independence, and integrity of this manager largely determine the outcome of bankruptcy proceedings.

The number of arbitration managers decreased more than threefold from 2000 to 2007, from 20,000 to 6000[3]. In 2008 there existed 41 self-regulating bodies of arbitration manag-

[1] O. Pleshanina, A. Zanova. Rules for all judicial occasions. – Kommersant, No. 225, December 2. 2009

[2] See Property, oil, and bread – Expert magazine, No. 20 (609), 19 May 2008 (www.expert.ru/printissues/ expert/2008/20/sobstvennost_neft_i_hleb/)

[3] E. Bychkova, "Alexander Georgievich Komarov: to me, the company is sacred"

ers[1], three of which are large, with more than 200 managers in each. However then need to reduce the number of arbitration managers are still being discussed.

The activities of arbitration managers have undergone other significant changes, related to the introduction at the end of 2002 of the institution of self regulation stipulated by the current (third) Federal Law on Insolvency (Bankruptcy). The law defined the structural concept of the market for arbitration manager services. Based on previously existing arbitration manager associations, more than 30 self-regulating arbitration manager organizations were created in a fairly short time.

The new law completely changed the procedure for appointing arbitration managers in bankruptcy cases. Previously, the arbitration manager obtained registration at an arbitration court, and the court used its judgment to select an arbitration manager in a specific case. The new law on bankruptcy determined that each self-regulating organization should have an arbitration manager selection committee. This committee would select three arbitration managers based on applications received from arbitration managers interested in being appointed for a specific procedure and ranks managers in order of decreasing qualifications, will the court only approves the candidates. If all three arbitration managers meet the requirements of the Bankruptcy Law, the court cannot influence the choice of candidate. By adopting this law, the state effectively precluded arbitration courts from exerting influence on the selection of arbitration managers.

Implementing the idea of transferring the supervision and monitoring of arbitration manager activities from the state to self-regulating organizations that started in 2002 received new impetus in 2008 when these organizations were made responsible for the accreditation of assessors and other specialists involved by the arbitration manager in bankruptcy proceedings and gained the right to participate in bankruptcy proceedings directly.

However, according to the data by the State Registration Committee that has been supervising such organizations since 2005, the transfer of broad powers to these bodies has not yet translated into the effective monitoring by them of the observance by arbitration managers of legal requirements relevant to insolvency. Thus, in 2007 the number of complaints to the state registration committee about the unjustified actions of arbitration managers grew approximately threefold compared to 2005 and reached more than 9200 complaints. The number of court rulings imposing administrative liability on arbitration managers increased accordingly, from a total of 425 sanctions including 378 administrative fines and 47 instances of disqualification in 2005 to a total of 1938 sanctions including 1897 administrative fines and 41 disqualifications in 2007, an increase of more than 4.5 times[2].

The state registration committee believes that the self-regulating bodies of arbitration managers have *failed to establish themselves as efficient professional regulators* of their members' activities.

A number of self-regulating organizations of arbitration managers failed to take timely measures even in cases of breaches of law by their members that were evidenced by courts. A few examples are below.

[1] Speech by S.D: Denisenko, Deputy Director of the Federal registration service, at the Russian State Duma parliament hearings on the legal aspects of the emerging self regulation in various sectors - http://www.rosregistr.ru/to_print.php?id=4854

[2] Speech by S.D: Denisenko, Deputy Director of the Federal registration service, at the Russian State Duma parliament hearings on the legal aspects of the emerging self regulation in various sectors - http://www.rosregistr.ru/to_print.php?id=4854

S. V. Bychkovski was dismissed from the self regulating arbitration manager organization of the Central federal region only following 13 court rulings regarding his administrative liability. M.R. Enukashvili was dismissed from the "Inter-Regional Investment Centre" self regulating arbitration manager organization following 17 court rulings, Sh.A. Fazailov was likewise dismissed from the Inter-Regional Centre of Experts and professional managers following 17 court rulings, while I:R: Mullabaev was dismissed from the "Crisis manager association", a self-regulating inter-regional public organization, following eight court rulings. Furthermore, all the decisions concerning the dismissal of the above arbitration managers from self-regulating organizations were taken only following court rulings regarding their disqualification, and in the cases of Mr. Bychkovski, Mr. Enukashvili, and Mr. Fazailov such decisions were initiated by the Federal registration service. V.D: Nesterov, who incurred administrative liability fines 15 times according to documents held by the Russian Registration Committee as of April 9, 2008, continues his membership in the Siberian Inter-Regional self regulating arbitration manager organization.

According to the Russian Registration Committee, such cases are due to the absence in most self regulating bodies of the systemic approach to monitoring the professional activities of their members that should be based on an analysis of the activities of member arbitration managers and of their efficiency and should investigate the causes of any legal breaches committed[1].

The most typical breaches committed by arbitration managers in their activities include:

- Failure to hold creditor assemblies
- Failure to furnish information to creditors
- Failure to pay payroll arrears[2;]
- Failure to take measures to ensure the integrity of debtor property
- Sale of debtor property without a prior inventory taking and valuation and without seeking the prior consent of the creditor assembly[3].

The greatest current challenges in the activities of arbitration manager self regulating bodies are the following:

- Creating effective member activity monitoring mechanisms and other compliance monitoring mechanisms;
- The lack of effective mechanisms for removing disreputable arbitration managers from the professional community
- Liability insurance for arbitration managers
- Interactions with arbitration management infrastructure (insurance companies, valuation specialists, auditors, auction organizers)
- Selective access granted to arbitration managers in bankruptcy proceedings due to the stance of the tax authorities that "blacklist" arbitration managers and veto their candidacies in arbitration courts using criteria are that are unclear for the professional community[4].

[1] Speech by S.D: Denisenko, Deputy Director of the Federal registration service, at the Russian State Duma parliament hearings on the legal aspects of the emerging self regulation in various sectors - http://www.rosregistr.ru/to_print.php?id=4854

[2] Data by the Federal Registration Service Vologda regional department, www.rosregistr.ru

[3] Data by the Federal Registration Service Ryazan regional department. www.rosregistr.ru.

[4] Summary of the speech by V.A. Varvarin, Director of the corporate relations department of the Russian Industrialist and Entrepreneur Association and Deputy Chairman of the Board of the Russian association of arbitration

The low effectiveness of state control over the activities of arbitration manager self regulating bodies is due to the lack of self regulating traditions in Russia given that it is a recent institution and thus relations in this area are not yet established and the legislative basis for dealing with the issues of state supervision and monitoring is still insufficient.

Necessary prerequisites for developing government monitoring in this area include:

– Establishing an official list of documents and information that government agencies are entitled to receive from self regulating organisations and the self regulating organisations are required to furnish
– Making amendments to the Administrative Code of the Russian Federation with regards to the substance of specific breaches that can result in administrative liability of self regulating organisations and giving government monitoring agency is the right to initiate administrative proceedings for such breaches. [1]

At present they only sanction used in cases of noncompliance by self-regulating with the legal requirements is the elimination from the government register of self-regulating organisations.

Meanwhile, in terms of legal implications, such elimination from the register should be a last resort measure as it prohibits the performance of activities that constitute the purpose of the self-regulating organisation. Based on general penal principles, this measure should only be applied after other government sanctions failed to deliver positive results.

The law envisages no other types of liability, including administrative liability.

At present the only other instrument of influencing self-regulating organisations is a document prescribing the elimination of breaches identified during revisions. This measure has proven to be ineffective in practice. Starting from 2003, 79 revisions of self-regulating arbitration manager organisations were performed, including 60 such revisions performed by the State Registration Committee. The activities of more than 30 self-regulating organizations were subject to revision more than once. These revisions formed the basis of prescriptions for the elimination of breaches identified. Statistics show that following reports to the state monitoring agency about the elimination of breaches identified during the revision, self-regulating organizations have continued to breach the legal requirements, and thus that prescriptions are an inefficient government sanction in response to legal breaches. The above statements regarding the inefficiency of government monitoring of the activities of self-regulating organisations apply in equal measure to the activities of assessors that play a crucial role in the bankruptcy process by virtue of valuing debtor assets. Apart from methodological issues that the process entails, especially given the uncertainties imposed by the crisis, the Russian valuation market continues to be plagued by instances of *issuing unjustified valuation reports and process abuses committed during valuation*. Valuation activities in Russia are likewise self-regulated, however, the self-regulation started somewhat later, in 2006. In August 2007 the Russian Ministry for Economic Development adopted the first three Federal Valuation standards that were developed using international best practices. These standards were implemented starting from January 1, 2008. By then, seven self-regulating organizations of assessors had been registered, whose function, formerly per-

manager self regulating bodies, at the Inter-regional conference on bankruptcy and financial rehabilitation on March 28, 2008 - http://www.rspp.ru/Default.aspx?CatalogId=234&d_no=3347

[1] Speech by S.D: Denisenko, Deputy Director of the Federal registration service, at the Russian State Duma parliament hearings on the legal aspects of the emerging self regulation in various sectors - http://www.rosregistr.ru/to_print.php?id=4854

formed by the state, was to regulate the axis of participants to the valuation market. In 2008 these organizations founded the National Council of valuation practitioners.

At present the role of the state in the area of valuation has considerably narrowed, with the state responsible only for registering entities and setting minimal standards. All other tasks have been taken over by the self regulating organizations of assessors.

The key current challenges in the area of valuation are as follows:

– The lack of necessary standards for valuation activities including the standards for monitoring and supervision functions of the self regulating organisations being developed by the National Council of valuation practitioners;
– The lack of an effective system of ensuring accountability of the self regulating organizations and individual assessors for valuation results;
– The lack of methods for large scale real estate valuation;
– The need to ensure high professional qualifications of valuation practitioners the;
– The lack of an effective mechanism for contesting valuation results, including court claims.

The implementation of measures to address the above should considerably limit the market scope for manipulating the valuation process, which would be the greatest feasible achievement given current conditions.

5.3.4. 2009 draft legislation: the crisis as an impetus for addressing deficiencies

Financial rehabilitation, bankruptcy of related entities, and cross-border bankruptcy

The increase in corporate bankruptcy filings, in corporate and individual indebtedness, coupled with falling incomes, inefficiencies in the institution of bankruptcy given the increased workload, as well as within need to defuse social tension, jointly provided a strong impetus for legislative activity that has taken on a new aspect.

The most significant development has been draft legislation by the Ministry for Economic Development aimed at significantly expanding the scope of application of debtor financial rehabilitation procedures. Its submission for debate in October 2009 was accompanied by a statement by presidential aide A. Dvorkovich that financial rehabilitation of enterprises shall now become a state policy priority[1]. The final edition of the draft law was supposed to be agreed upon and submitted to the State Duma for review before the end of 2009. However, the preliminary schedule of State Duma legislative activities during the 2010 spring session does not envisage the review of this draft law.

This may be due to the fact that the draft law affects the contradictory interests of large banks and companies and thus came under heavy criticism by the Trade And Industry Chamber, bankers, tax authorities, etc. It is obvious that the heaviest criticism levelled against the draft law is based on the premise of undermining the financial condition of the banking system and creditors and is due to its pro-debtor bias.

Regardless of the need to remove the pro-creditor bias in developing bankruptcy legislation, the proposed innovations are seen as excessively radical due to the lack of a mechanism for protecting creditor rights that in turn creates conditions for abuse of rights and for responsibility avoidance by debtors.

[1] Here and further below, E. Kukol, The debtor is sent for treatment – Rossiiskaya Gazeta, No. 5024, October 22, 2009

In essence the draft law removes financial rehabilitation from the bankruptcy framework and envisages:

1. The possibility of the financial rehabilitation procedure being initiated by the debtor bypassing the supervision stage (up to seven months) and lasting up to five years regardless of creditor consent. In this case to arbitration court approves the arbitration manager candidate proposed by the debtor.

Despite the need to remove the pro-creditor bias in developing bankruptcy legislation, the proposed measure is deemed unacceptable due to the absence of a mechanism for protecting creditor rights that leaves ample room for the abuse of rights and for responsibility avoidance by debtors.

It appears that the interests of creditors and debtors can be balanced by (a) instituting a mechanism enabling administrative manager candidacies proposed by creditors, (b) instituting mandatory annual debt repayments throughout the duration of the financial rehabilitation stage, the amount of which repayments shall be stipulated in the financial rehabilitation plan and shall be no less than that stipulated by law.

It is also necessary to legally stipulate the possibility for creditors will to contest asset valuations for debtors who applied for financial rehabilitation, since the inadequacy of property valuation and the ease of manipulating value in the Russian context may result in the creditors later being deprived of the possibility of recovering outstanding debts.

2. The right granted to the debtor to submit to the arbitration court a financial rehabilitation plan agreed upon with the creditors that would envisage the full repayment of all creditor claims, including fines, penalties, and compensation for losses, during the financial rehabilitation stage.
3. The introduction of a special procedure for conducting transactions during the financial rehabilitation stage
4. The introduction of a special bankruptcy procedure for groups of related debtors
5. The introduction of a special procedure for cross border bankruptcies, etc

Besides the traditional majority creditor vote mechanism (with certain qualifications regarding different classes of creditors), the approval process for the debtor financial rehabilitation plan envisages the possibility of its approval upon the debtor's request in cases when fewer than 50% but more than 25% of votes by creditors and competent authorities at the creditors' assembly have been cast in favour of approving the plan.

A necessary precondition for the adoption of such a decision is the opinion issued by the self-regulating organization of arbitration managers where the administrative manager is a member regarding the financial rehabilitation plan being in compliance with the law on insolvency. Such an opinion needs to be based on the analysis of the debtors financial condition, on its financial reporting, on data from the register of creditor claims, and other available information. It should be noted that such broadening of debtor rights, as well as the new mechanism of interacting with the self-regulating organization of arbitration managers, is being proposed for the first time. At the initial stage this may permit abuse of the situation by the latter, however, in the medium term, as the practice of claiming material liability for arbitration managers and their organizations becomes more widespread, this risk should diminish.

Furthermore, a simplified procedure has been envisaged for approving the financial rehabilitation plan in cases when the financial rehabilitation plan proposed by the debtor has been approved by the creditors and competent authorities by the moment of application.

It is also proposed that regulatory provisions be introduced for out-of-court settlement procedures for indebtedness claims if agreed upon between the creditors and debtors. Such settlement agreements may define and regulate the mutual concessions that may help prevent company bankruptcies. Such agreements would also envisage the creditors' rights to grant time to the debtor for solving financial problems, within which time creditors would refrain from filing indebtedness claims, while the debtor would voluntarily furnish information regarding its financial condition and would refrain from attempting asset transfers.

A positive feature of the proposed innovations within the bankruptcy framework is represented by the attempt at greater flexibility in settling debt repayment issues related to mandatory payments as part of the financial rehabilitation process that have long hindered the wider application of the practice of restoring company solvency. However, such mechanisms will only function efficiently following the development and adoption of the relevant regulations by competent government agencies (tax, customs, etc)

The debate on the key provisions of this draft legislation inevitably touches upon the issue of the extent of protecting creditor vs. debtor interests in the bankruptcy process. Global practice shows evidence of both pro-debtor and pro-creditor bias in bankruptcy systems, and a choice of system or its development while taking into account both options is largely a politically motivated one. The degree of appropriateness of such choice in each specific case is evidenced by the extent of effective functioning of the bankruptcy institution in the economy, consisting of the liquidation of inefficient companies and the redistribution of assets in favor of efficient owners as well as the preservation of competitive enterprises.

In Russia, the transition to a market economy failed to bring about the creation of a competitive environment in the bulk of economic sectors. Furthermore, government expansion and the increasing direct participation of the state in the economy in the 2000s were accompanied by measures aimed at ensuring the concentration of large assets under government control that further distorted the legal environment. Such measures were adopted in the areas of bankruptcy law, legislation related to competition, and corporate law[1]. Financial support measures for companies during the crisis were also largely geared towards a limited number of companies with state or quasi-state interests and large state controlled banks.

At the same time, amendments were made to bankruptcy law that were once again meant to protect creditors. As a result, these economic entities received dual production, financial and legal, while debtors that received no financial support have also seen their legal protection diminish. The former are now considered efficient owners regardless of the fact that they received government support, while the latter are considered to be inefficient owners. *In this situation, the relations between economic entities at the moment of bankruptcy are not governed by market principles and are not indicative of the efficiency of corporate management, but merely reflect the extent of access to state funding or other funding sources to cover outstanding indebtedness*.

In this case, measures aimed at protecting debtor rights are the only means of redressing the balance to adjust for the state economic policy bias with regards to creating and sustaining

[1] See also Applied issues of internal corporate governance mechanisms by A. Radigin, R.Entov, E. Apevalova et al., – Moscow, IEPP, 2009.; Bankruptcies in the 2000s: from a raider's tool to a "double standard" policy, by E.A Apevalova, A.D: Radigin, published by Economic Policy magazine, issue No. 4 for 2009, pages 91-124; Modern trends in mergers and acquisitions, by A.D. Radigin, R.M. Entov, E.A. Apevalova et al., – Moscow, 2010.

a competitive environment, instituting a culture of corporate governance, and providing financial support to companies.

As a possible measure, limitations may be imposed in a timely manner upon banks and companies that are the recipients of state financial support with regards to initiating the quick sale of debtor assets in the bankruptcy process so long as the debtor retains the prospect of restoring solvency. It is also possible to impose limitations on the initiation of debtor bankruptcy procedures whereby threshold indebtedness amounts would be linked to the amounts of state financial support received.

The development of criteria for assessing debtor prospects is a complex but necessary task in this context. As regards the Russian bankruptcy model per se, its pro-creditor bias is evidenced less by the focus on accumulating funds for their further redistribution among creditors than by its ensuring significant creditor influence upon the arbitration manager and his decisions. Given the practices of inadequate valuation of debtor assets and the closed sales of such assets, this is the only available means of ensuring some degree of protecting creditor interests.

The draft law under discussion also *proposes changes to the ranking of creditor claims*. It is proposed that the current payments that are made prior to payments to ranking creditors include insurance premiums paid to the Russian Pension Fund, the Russian Social Security fund, and the Federal and regional mandatory medical insurance funds. These claims would rank second following the payment of the legal expenses for bankruptcy proceedings.

A significant innovation is represented by the proposed division of creditors into classes based on either the nature of their claims or on the cause of their claims. The terms of the financial restructuring plan should be equal for all ranking creditors and/or competent authorities whose claims have been grouped together in the same class. This innovation is most advantageous for banks.

The proposed draft law devotes significant attention to bankruptcy procedures for groups of related debtors and to cross-border bankruptcies.

The demand for special bankruptcy procedures for groups of entities and the increase in the number bankruptcy filings submitted by debtors, as well as large-scale payment defaults, point to the need to discuss possible changes to insolvency criteria that would supplement the current criterion of outstanding indebtedness amounting to more than RUR 100,000 for over three months by the criterion of outstanding indebtedness in excess of company assets. This proposed amendment is due to the fact that the liquidity gap arising in the course of day-to-day business operations may not reflect the true financial condition of the business, especially given the diminished access to financing, shrinking production and sales volumes of late. The issue of managing the liquidity gap may be addressed by way of out-of-court debt settlement or financial rehabilitation but does not necessarily constitute insolvency as such. Furthermore, the potential for abuse of bankruptcy procedures by a group of related debtors is sufficiently high to merit special consideration.

It should be noted with respect to the issue of bankruptcies for groups of related debtors that the attempt to give proper treatment to this complicated issue, as well as to the issue of cross border bankruptcies, is noteworthy in itself. However, the task of giving maximum formal treatment to all the relevant terms and procedures is highly complicated, especially considering the Russian legal tradition. Complications arise from the very start of the regulatory process of the legal eligibility ruling with regards to initiating bankruptcy procedures for a debtor group. It is expected up and that the proposed five stage system of determining eligi-

bility is too complicated to use in practice and will give rise to "competing" legal eligibility due, among other factors, to the difficulty of determining the "principal location" of entrepreneurial activity, the "principal location" of group member property, and the "principal location" of the majority of group creditors.

It is expected to rule that bankruptcy filings for groups of related debtors shall be reviewed as one legal case, by the same judge a group of judges. A unified set of supervision, financial rehabilitation, external administration, and receivership procedures shall be implemented with respect to groups of debtors.

The concept of "controlling member of the group of the entities" has been introduced to designate the entity that effectively controls the activities of a debtor within the group[1].

The controlling member of the group of entities may incur civil legal liability with respect to settling creditor claims for current payments.

The lack of information transparency regarding the true owners of many Russian assets poses the question of determining beneficiary ownership within the framework of corporate bankruptcy procedures given that such determination is often impossible even in the context of criminal cases. It is quite probable that the application of this legal provision will be limited to a select number of demonstration cases.

The mechanism for filing a single creditor claim with respect to a group of debtors that has been proposed by the authors of the draft law (as per the proposed new edition of Article 201.3 of the Federal Law on Insolvency (Bankruptcy)) leaves unclear the fate of group companies whose rights and interests may be significantly impacted, for example, by carving out specific assets within the debtor group in cases when all group assets are concentrated in one of several companies.

For the first time, the draft law proposed by the Ministry for Economic Development encompasses treatment of *cross border bankruptcy issues*, i.e. the bankruptcies of Russian and foreign legal entities involving different national domiciles of various parties, including cases when debtor property is located abroad, the creditor is a foreign person or legal entity, or legal proceedings against the debtor have been started in a foreign court.

For the purposes of determining the competence of Russian arbitration courts in the crossbow the bankruptcy procedures and determining the governing law in such cases, the notion of "center of principal debtor interests" is introduced to signify the place of its registration as a legal entity unless otherwise provided by law or determined by the nature of debtor operations or by other considerations. The law provides a non-exhaustive list of such considera-

[1] Effective control is deemed to comprise the following rights:

- The right to directly or indirectly control 50% or more of the voting stock of a joint stock company, or a share greater than half in the statutory capital of a limited (subsidiary) liability company forming part of a group of entities;
- The right to give instructions that are mandatory for execution by the debtor forming part of a group of entities based on contractual agreements or statutory documents and the right to otherwise determine the activities of a debtor forming part of a group of entities;
- The right to determine the decisions and/or actions by a debtor forming part of a group of entities, including the terms on which such debtor entity carries out business activities;
- The right to appoint an executive person and/or more than 50% of the executive body of the debtor forming part of the group of entities and/or the possibility to elect more than 50% were of the board of directors (supervisory council) or other collegiate management body of the debtor forming part of a group of entities;
- The right to act in the capacity of managing company for the debtor forming part of a group of entities.

tions including the location of principal debtor assets, the location of the majority of the creditors, of the debtor's production facilities, of its controlling shareholders (beneficiary owners), as well as the location of its principal business activities, the geographical source of the bulk of its revenues, etc.

It is expected that Russian arbitration courts shall review cross-border bankruptcy cases in situations when Russia is:

– The center of principal debtor interests
– The center of principal interests of an entity (Russian or foreign) controlled by the debtor
– The center of principal interests of an entity controlling the debtor
– A permanent representative office and/or property of the debtor (Russian or foreign) when the center of principal debtor interests is located abroad.

Bankruptcy procedures for debtors whose center of principal interests is located in Russia are within the exclusive competence of Russian arbitration courts. Such court proceedings apply to the entirety of debtor property regardless of the country of its location. The competence of Russian arbitration courts in these cases also extends to reviewing bankruptcy cases with regards to entities controlled by the debtor and controlling the debtor.

In case of bankruptcy proceedings for an enterprise that does not constitute the principal production entity, the competence of Russian courts extends to:

1. Initiating bankruptcy proceedings in cases when the debtor has a permanent representative office in Russia

– In case the bankruptcy filing against the debtor is made by a creditor that is permanently domiciled in Russia
– In case the bankruptcy filing against the debtor is based on a claim that is related to the activities of the permanent representative office.

2. Reviewing bankruptcy cases for cross-border bankruptcies in cases when debtor property is located in Russia if debtor and or creditor rights with regards to bankruptcy cannot be realised otherwise (bankruptcy proceedings cannot be initiated against the debtor in the country representing the centre of its principal interests; the bankruptcy process in a foreign country extends only to debtor property located within its territory, etc)[1].

In cases when bankruptcy proceedings are initiated in Russia, such proceedings, as well as their outcomes (with few exceptions), are governed by Russian law.

The proposed mechanism for the regulation of cross-border bankruptcies raises doubts as to the adequate application in Russia of the provisions for determining the centre of principal debtor interests. Apart from the objective difficulty of estimating the size of debtor assets in different countries, determining the location of the majority of creditors, and weighing other factors, other obstacles exist to the determination of legal eligibility using this method by courts that, in the case of the Russian legal system, frequently use formal criteria. These obstacles include:

1. The high level of dependency of the judiciary system upon executive power governing bodies and the practice of selective application of legal responsibility provisions;
2. The significant extent of manipulation with respect to property valuation, coupled with inefficient mechanisms for contesting valuation results;

[1] See also paragraph 3 of Article 223.5 of the Draft Law On Financial Rehabilitation and Bankruptcy (Insolvency) by the Ministry for Economic Development

3. The high level of formality in making court rulings resulting from established historical practice.

Given the above, the adoption or legal provisions envisaging significant discretion on the part of judges may only become acceptable at a time when the extent of influence of the above factors will be significantly decreased. Until such time, the regulation of such issues shall be more in line with the Russian legal and regulatory traditions, i.e. more formal. The practice of implementing regulatory provisions envisaging significant judiciary discretion should be gradual and should be carefully monitored in order to minimise any negative trends.

Bankruptcies of individuals outside the scope of entrepreneurial activity

In November 2009, a new edition of the law on the bankruptcy of individuals outside the scope of entrepreneurial activities was submitted to the Russian government.

According to the Central Bank of Russia, the volume of past due indebtedness for individual loans amounted to RUR 231 billion, or 6.8% of all loans granted, as of the 1 October 2009. Other estimates place these figures at significantly higher levels due to the fact that the Central Bank includes only the past due portion of loans in its estimate of past due indebtedness without considering the principal loan amounts which total another 12%. Experts estimate that the shortening of repayment terms shall start no sooner than 2011[1].

The draft law on individual bankruptcies that was developed in 2007-2009 and has been submitted to the government by the Russian Ministry for Economic Development will create stimuli for individual debtors and their creditors for using civilized methods of restructuring consumer loans[2]. In particular it envisages the possibilities:

– Of granting the possibility to a debtor in financial difficulty to write off its debts against the assignment of its property and a proportion of its income to creditors (the so called fresh start doctrine)
– Of lowering creditor risks and expenses related to bad debt recovery
– Of lowering the administration costs for individual bankruptcies.

The duties of arbitration manager may be placed upon the debtor itself except for cases where the total amount of claims against the debtor is in excess of RUR 500,000 and except for cases when the creditor enters a plea for the appointment of an arbitration manager.

Under the draft law, failure to repay debt exceeding RUR 50,000 (RUR 100,000 in the first draft) for a period of six months constituents individual bankruptcy. Following an eligibility check upon the bankruptcy claim, the court institutes monitoring of the individual debtor for a period of three months. Within the monitoring period, the debtor has a right to submit a debt restructuring plan to the arbitration court that must be prepared in accordance with the provisions of the draft law and should be agreed with the majority of creditors. The draft law also envisages the possibility of approving a debt restructuring plan without the creditors' consent. If the plan is adhered to, the individual is freed from indebtedness and retains his social standing. Conversely, if the individual fails to repay the creditors within the debt restructuring framework, the arbitration court makes a ruling for the bankruptcy of the individual in question and for the initiation of asset receivership proceedings whereby the assets of the debtor

[1] The past due portion of individual loans has reached unprecedented proportions

[2] Thus, in Europe, bad debt levels for consumer loans of 5-6% are considered critical, while the latest Central Bank data show such levels in Russia exceeding 4%. It therefore appears that the state wishes to create the legal basis for reviewing individual insolvency (bankruptcy) cases. See also *Russians will undergo mandatory bankruptcy* by T. Koshkin (www.utro.ru/articles/2007/02/21/626934.shtml).

that are included in the receivership fund are distributed among creditors in proportion to the amounts of their claims[1].

It is further proposed that the provisions for administrative and criminal liability for performing prohibited actions during bankruptcy and for a deliberate bankruptcy, punishable by fines of up to RUR 5,000 for administrative misdemeanors and by fines of up to RUR 500,000 and/or other punitive measures including incarceration for a term of up to six years for criminal breaches the extended to apply to individuals outside of the scope of entrepreneurial activities.

According to a statement by A. Ivanov, Chairman of the Russian Supreme Arbitration Court, the adoption of this law will result in an increased workload for judges which will in turn raise the issue of creating judiciary representative offices[2] dealing with individual bankruptcy cases[3]. At the same time, according to V. Vitrianski, Deputy Chairman of the Russian Supreme Arbitration Court, there will be no significant increase of debtor bankruptcy filings at arbitration courts[4]. Meanwhile, G. Tosunian, President of the Russian Banking Association, believes that the institution of individual bankruptcies in Russia is at present doomed to fail[5].

Bankruptcies of housing construction companies

In November 2009, a *draft law envisaging special bankruptcy procedures for housing construction companies*[6] ("legal entities carrying obligations to provide housing or subject to monetary claims by mutual construction financing participants") with a view to protecting the financing participants was prepared for a second reading. The defining characteristic of housing construction company bankruptcies is the preferential right of federal subjects to acquire incomplete apartment housing construction projects prior to auction.

Federal subjects are entitled to buy incomplete apartment housing construction projects or land parcels at a fair market price as determined by an independent valuation specialist. A necessary condition of any such sale and purchase agreement is the undertaking to complete construction and to transfer the housing to construction financing participants upon completion. The deadline for completing construction is set at three years following the signing of the purchase and sale agreement[7].

Given that construction companies have recently increasingly disregarded the requirements for signing housing construction investment agreements, the fact that individual citizens who signed agreements with the construction company will nonetheless be entitled to receiving the housing they financed regardless of the compliance of the investment agreement with the provisions of the Law on Housing Investments is a positive development.

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[1] The law on individual bankruptcy was expected to come into effect at the beginning of 2009 (www.prime-tass.ru/news/show.asp?id=779274&ct=news).

[2] The permanent representative office of the arbitration court of appeals and the permanent representative office of the arbitration court of a federal subject are detached administrative units of the respective courts outside of their permanent seat and are vested with the powers of such courts.

[3] Supreme Arbitration Court Chairman: arbitration courts expect an increase in individual bankruptcy filings (http://www.dp.ru/a/2008/04/17/Predsedatel_VAS_arbitra).

[4] *The judicial workload issue has been dealt with*, by V. Vitrianski (www.kp.ru/daily/24091.3/321906)

[5] See also *Russians will undergo mandatory bankruptcy* by T. Koshkin (www.utro.ru/articles/2007/02/21/626934.shtml).

[6] Draft Law On Amendments to specific legal acts of the Russian Federation aimed at the protection of instalment-financed construction participant rights.

[7] Mutual financing by Yu. Vasilieva Russian Business Daily, No. 726, November 3, 2009

In summary, a review of government legislative initiatives in the area of bankruptcy or shows both a desire for significant legal innovations in the area of bankruptcy regulation and the focus of such innovations on social aspects. However, recent years in Russia have traditionally seen legal regulation lagging behind the demands of the economy. Given the recent unfavorable economic conditions, this can become a decisive factor in adversely impacting the effectiveness of the measures proposed.

5.3.5. Concluding remarks

In conclusion, it must be noted that the 2005-2009 period was characterised by broadening the scope of application of bankruptcy procedures to "substantive" debtors. However, the institution of bankruptcy continues to carry out, albeit to a lesser extent, the function of government regulation of the number of inactive legal entities that should be outside its scope. Tax authorities play a leading role in initiating bankruptcy proceedings, including those against "substantive" debtors, while government regulation of their activities can largely determine both the scope of application of bankruptcy procedures nationwide and have a significant impact on the general practices of insolvency proceedings.

The increase in bankruptcy rulings taken in the first half of 2009 amounted to 16.7% compared to the respective period in the previous year. A 24.1% increase in the number of bankruptcy filings, as well as Supreme Arbitration Court data that show evidence of significant (88%) growth in the number of claims related to breach of obligations, predominantly of contractual obligations, point to the high probability of further growth in the number of bankruptcies in 2010.

Restoring debtor solvency within the framework of bankruptcy procedures and settling creditor claims by signing restructuring agreements, as well as financial rehabilitation, are still confined to isolated instances and leave debtors who have become the subjects of bankruptcy proceedings no practical chances of retaining control over the enterprise. Given the low threshold for an insolvency ruling (RUR 100,000), as well as the large-scale payment defaults, shrinking industrial production volumes, lending volumes, and market demand starting from late 2008, this results in decreasing numbers of economic agents, above all of private entrepreneurs, regardless of their competitive strengths.

In general, the development of bankruptcy legislation in 2003-2009 can be conditionally divided into two periods. The first was the *pre-crisis* period focusing on the preservation of the overall corporate bankruptcy framework whose functioning had limited impact upon the interests of key players who had significant lobbying potential. The protection of their interests necessitated the strengthening of government control and broadening the scope of application of special bankruptcy procedures for strategic enterprises that were subjectively designated as such, while the most influential economic subjects (Vnesheconombank and government corporations) were exempted from the application of the bankruptcy law.

During the crisis, the priority changed from ensuring the integrity of state-controlled assets to ensuring low levels of bad debts in the loan portfolios of the largest banks, which was meant to contribute to the preservation and support of the banking system. In this situation the banking sector is significantly aided by the state twice, once by way of direct financial aid and once again by substantial protection of bank interests in the area of bankruptcy, thus promoting the idea of banks as efficient owners while inefficient owners have been penalised not only by the financial crisis but also by the impossibility of protecting their legal interests given the strengthening pro-creditor focus of the bankruptcy system that practically rules out

the preservation of business and at present has little to do with the efficiency for market participants or lack of such.

At the same time, the significant number of expected bankruptcies and the dispersal of state interests in this regard has resulted in *the adoption in December 2008 and later in April 2009, for the first time since 2004, of general legislative provisions concerned with the interests of all market participants*.

A number of proposed measures, such as more detailed stipulation of procedures, more stringent controls over the activities of arbitration managers and their self regulating bodies, stipulation of auction procedures for debtor assets, the introduction of greater information transparency in bankruptcy proceedings are *long overdue and can improve the protection of both creditor and debtor rights*. The efficiency or inefficiency of the new measures will be largely determined by the extent to which the state will continue to use its growing influence to further strengthen its position and protect quasi-government interests in the corporate market by controlling the redistribution of corporate assets, or by whether the economic downturn will cause the state to be guided by the interests of society in general, however contradictory.

The practice of developing both corporate legislation and bankruptcy legislation in the 2000s shows a growing trend toward a merger or government interests with those of the largest state-owned (pro-government) companies and banks, along with amending economic legislation predominantly in the interests of such agents and to the detriment of the interests of society in general. The only exception is provided by the reaction to acute social phenomena.

At present there is no planned systematic development of either corporate law or bankruptcy law in the interests of all market participants. In this respect the pre-crisis and post-crisis developments in bankruptcy law are similar, with legislation serving as *an instrument of upholding the interests of a specific group of subjects that the state identifies itself with at various points in time*. Until such time as this identity crisis is resolved by the state, the development of economic institutions will be chaotic and destructive to the development of the economy as a whole.

In terms of the peculiarities of the institutional environment that impacts bankruptcy proceedings, it must be noted that the Russian judicial system, having inherited many of the traditions of the Soviet judicial system, *continues to be significantly influenced by the executive power*. Ensuring the independence of presiding judges is therefore a key issue.

Recent assessments of the judiciary system range from “a mockery of justice” and “a tool serving the executive branch” to “a comprehensive judiciary system albeit riddled with numerous shortcomings”. These shortcomings arise from inadequacies in the legal mentality, including that of professional practitioners, in professional personnel training, in organizing the functioning of courts, including workload issues, in the selection criteria, selection mechanisms, and appointment mechanisms for judges, in receiving and improving professional qualifications, and in the degree of transparency in the system. One of the factors contributing to the low quality and long duration of case reviews is inadequate staffing that results in *unprecedented high workloads for judges*.

Another widely known shortcoming of the Russian judiciary is the *lack of enforcement of Russian court rulings* that contributes to the increasing number of bankruptcy cases. Statistically, half of the rulings by both general courts and arbitration courts in Russia are not enforced. The most urgent issues related to the enforcement of court decisions are to do with the inefficient and illegal sale of arrested assets, as well as with staffing issues.

The development of a system of selling arrested property based on mixed auctions using global auction practices (Dutch and English auctions) is advisable in order to deal with the above shortcomings. Such a system must combine various features aimed at attaining the full of sale of arrest and property at a maximum price. This will allow to minimize the issues related to the current system of valuing arrested property.

As regards *staffing*, the inefficiency and abuses of power by court bailiffs are widespread and have long been an urgent issue. The high level of abuse instances is coupled with the very low proportion of court decisions to satisfy claims contesting the action or inaction of and rulings by the officials of the Federal Court Bailiff service.

Problems likewise exist with respect to the self-regulating bodies of arbitration managers and valuation practitioners that have so far failed to establish themselves as efficient professional regulators of their members' activities. A number of self-regulating organizations of arbitration managers failed to take timely measures even in cases of breaches of law by their members that were evidenced by courts. Such cases are due to the absence in most self regulating bodies of the systemic approach to monitoring the professional activities of their members that should be based on an analysis of the activities of member arbitration managers and of their efficiency and should investigate the causes of any legal breaches committed

The limited effectiveness of state control over the activities of arbitration manager self-regulating bodies is due to the lack of self-regulating traditions in Russia given that it is a recent institution and thus relations in this area are not yet established and the legislative basis for dealing with the issues of state supervision and monitoring is still insufficient. The Russian market is still plagued by instances of issuing unjustified valuation reports and process abuses committed during valuation.

Promoting the effective functioning of the institution of bankruptcy in the economy necessitates the following measures:

1. Continued implementation of legal reform to ensure the independence of judges, including arbitration court presidents, from the executive power, minimising corruption in the judiciary system, etc., along with decreasing the workload of arbitration court judges in the interests of more thorough review of court cases.

2. Substantial changes to the objectives and scope of activities of the tax authorities with respect to insolvency and elimination of inactive legal entities from the register

a. the existing conflict of interest driven by the need to ensure the fulfillment of targets for remittances to the state budget by the tax authorities and the resulting inflexibility of such authorities in initiating and reviewing bankruptcy cases. Ideally, government interests in such proceedings, including those related to taxation issues, should be represented by different government body (such as the Ministry for Economic Development).
b. Legal measures must be taken to create effective mechanisms for rescheduling and restructuring mandatory payments that are to be used within the framework of insolvency cases and whose lack at present hinders the practical implementation of creditor agreements and financial rehabilitation procedures. Given the average level of satisfying registered creditor claims of 10%, such measures are unlikely to have a significant impact upon tax remittances to the state budget.
c. In the medium term, the issue of setting an adequate corporate tax burden, especially in the first three years of the company's existence, shall continue to be of paramount importance.

d. The activities of tax authorities in the liquidation of inactive legal entities must be adequately financed and must be separated from their role in bankruptcy procedures. Ideally, such functions should also be transferred to a different government body. (It has not been possible to analyse the expediency of entrusting tax authorities with the functions of registering legal entities within the context of this paper)

3. Further improvements must be made to the functioning of the court bailiff service with respect to staffing policies, increasing liability for inaction and illegal or inappropriate action, including the obligation to compensate the plaintiffs whose rights have been infringed upon for related losses. This shall be made possible by the improvement of the mechanisms of contesting the actions and rulings of Federal Court bailiff service officials with a view to creating real and effective as opposed to formal mechanisms of legal protection.

4. A crucial task that will result in greater efficiency of the institution of bankruptcy is the creation of preconditions for further development of self-regulatory organizations of arbitration managers and valuation practitioners.

Necessary prerequisites for developing government monitoring (supervision) in this area include:

– Establishing an official list of documents and information that government agencies are entitled to receive from self regulating organisations and the self regulating organisations are required to furnish
– Making amendments to the Administrative Code of the Russian Federation with regards to the substance of specific breaches that can result in administrative liability of self regulating organisations and giving government monitoring agency is the right to initiate administrative proceedings for such breaches.

It is also necessary to create a framework of measures aimed at incentivising the self regulatory organizations toward improving the professional qualifications of their members both by developing and implementing operating standards and by evaluating their effectiveness, as well as by increasing the accountability of their members and active efforts to remove the causes of legal breaches.

Further development of valuation activities requires:

– The development and implementation of necessary standards for valuation activities including the standards for monitoring and supervision functions of the self regulating organisations developed by the National Council of valuation practitioners
– The development and improvement of the mechanism for discharging the monitoring and supervision functions by self-regulating organizations
– The implementation of an effective system of ensuring accountability of the self regulating organizations and individual assessors for valuation results
– The development of methods for large scale real estate valuation
– Creating the conditions ensuring the high professional qualifications of valuation practitioners
– The implementation of an effective mechanism for contesting valuation results, including court claims

5. Of equal importance to redressing the pro-creditor bias in the development of bankruptcy legislation is the approval, subject to certain criticisms being addressed, of the *draft legislation proposed by the Ministry for Economic Development and aimed at significantly expanding the scope of application of debtor financial rehabilitation procedures* in the Russian market. However, provisions regarding the possibility of the financial rehabilitation pro-

cedure being initiated by the debtor bypassing the supervision stage (up to seven months) and lasting up to five years regardless of creditor consent, as well as the approval by the arbitration court of the debtor-appointed arbitration manager, must be amended.

Despite the need to remove the pro-creditor bias in developing bankruptcy legislation, the proposed measure is deemed unacceptable due to the absence of a mechanism for protecting creditor rights that leaves ample room for the abuse of rights and for responsibility avoidance by debtors.

It appears that the interests of creditors and debtors can be balanced by

(a) instituting a mechanism enabling administrative manager candidacies proposed by creditors,

(b) instituting mandatory annual debt repayments throughout the duration of the financial rehabilitation stage, the amount of which repayments shall be stipulated in the financial rehabilitation plan and shall be no less than that stipulated by law.

It is also necessary to legally stipulate the possibility for creditors will to contest asset valuations for debtors who applied for financial rehabilitation, since the inadequacy of property valuation and the ease of manipulating value in the Russian context may result in the creditors later being deprived of the possibility of recovering outstanding debts.

6. As a possible measure to counterbalance the excessive activity of banks with respect to debtor assets, limitations may be imposed in a timely manner upon banks and companies that are the recipients of state financial support with regards to initiating the quick sale of debtor assets in the bankruptcy process so long as the debtor retains the prospect of restoring solvency. It is also possible to impose limitations on the initiation of debtor bankruptcy procedures whereby threshold indebtedness amounts would be linked to the amounts of state financial support received.

The development of criteria for assessing debtor prospects is a complex but necessary task in this context. As regards the Russian bankruptcy model per se, its pro-creditor bias is evidenced less by the focus on accumulating funds for their further redistribution among creditors than by its ensuring significant creditor influence upon the arbitration manager and his decisions. Given the practices of inadequate valuation of debtor assets and the closed sales of such assets, this is the only available means of ensuring some degree of protecting creditor interests.

7. The demand for special bankruptcy procedures for groups of entities and the increase in the number bankruptcy filings submitted by debtors, as well as large scale payment defaults, point to the need to discuss *possible changes to insolvency criteria* that would supplement the current criterion of outstanding indebtedness amounting to more than RUR 100,000 for over three months by the criterion of outstanding indebtedness in excess of company assets.

Such a proposal is based on the notion that working capital shortages that arise within the day-to-day business operations, especially given the diminished access to financing, shrinking production and sales volumes of late, may not reflect the true financial condition of the business. Furthermore, many industrial assets are significantly undervalued and demand for such assets is relatively low, which is likely to change in the medium term but does not allow for the timely and effective settlement of indebtedness at present. The issue of managing working capital shortages may be addressed by way of out-of-court debt settlement or financial rehabilitation but does not necessarily constitute insolvency as such. Furthermore, the potential for abuse of bankruptcy procedures by a group of related debtors is sufficiently high to merit special consideration.

8. It is also necessary to *change the stipulations regarding the right to file bankruptcy claims at arbitration courts*: whereas previously the right to make a bankruptcy claim at the arbitration court came into effect 30 days after the date of remittance of the executive order to the court bailiff service, at present such a right comes into effect from the date of the legally binding court decision concerning a monetary claim upon the debtor. Thus it becomes possible to start insolvency procedures prior to ascertaining the impossibility of carrying out the court decision and prior to actual insolvency. This allows for the application of bankruptcy procedures to companies that are neither bankrupt nor even in a state approaching bankruptcy. Such a situation is once again advantageous for creditors who at present compete among themselves. From a legal point of view such stipulation of a creditor's right to file a bankruptcy claim prior to the expiration of the deadline for voluntary execution of a court order by the debtor and prior to the start and end of executive proceedings is illegal as it infringes upon the debtor's rights and the subjects the debtor to bankruptcy proceedings that are the last resort measure of protecting creditor rights, without sufficient legal grounds and unjustifiably bypassing the customary process is of protecting creditor rights.

Doubts also arise regarding the stipulation of the right of the competent authorities, primarily a tax authorities, to file a bankruptcy claim. The legal grounds for the stipulation of such rights must undergo a fundamental test of substance, and the procedure must be changed if sufficient grounds exist.

5.4. M&A Market Dynamics (2003–2009)

The period between 2003 and the first half of 2008 saw a considerable and stable increase in activity on the mergers and acquisitions market, with both the number of deals and their amounts growing. The 2008 financial crisis – with its stock market collapse, liquidity squeeze, a drop in industrial production, and a sharp fall in some commodity prices – resulted in a decrease in the volume of transactions on the global M&A market. The first estimates of this market's prospects for 2009-2010 were rather contradictory. Overall, the size of the market was expected to further shrink in 2009 (to 60% of the 2008 level), however forecasts for trends to dominate the market were varied: from a further squeeze of the market due to problems with working capital and access to external funding to a boost in activity starting from mid-2009 through the acquisition of troubled assets and companies.

This section contains an analysis of M&A transactions in Russia between April 2003 and June 2009. Information on the transactions was collected from open sources[1]. Many participants in recorded transactions prefer not to disclose detailed information on the sale or purchase of assets, that is why some of the data used in this analysis derive from analysts' and market players' estimates.

For the purposes of analyzing the available data, a classification of companies' characteristics has been introduced. To systematize company owners involved in the M&A process, a typology has been adopted whereby the owner can be either an insider, an outsider or a government structure. Insiders are owners who work at the company in question. Outsiders are individuals who are not employees of the company. For the purposes of this study, this typology has been slightly expanded for the insider group to further break down into managers, rank-and-file employees and managers and employees together, while the outsider group breaks down into financial, non-financial and financial and non-financial outsiders together.

[1] www.mergers.ru; www.ma-journal.ru; www.finam.ru; lenta.ru and several others.

Instances when the owner is a foreign company or a group of owners from different countries have been grouped into a separate category.

Companies' forms of incorporation were classed according to the relevant Russian legislation. In terms of types of economic activity, companies have been classed according to the Russian Classification of Types of Economic Activity (OKVED)[1].

Between Q2 2003 and Q4 2007 the overall annual volume of transactions, both in terms of their number and value, was steadily on the rise. However, in 2008 there developed a downward trend. In 2004 the number of transactions grew by 32% year on year; in 2005 the figure was 14%; in 2006, 26%; in 2007, 41%, while in 2008, minus 21%. In terms of the amount of transactions, 2004 saw an increase of 18% year on year; 2005, 42%; 2006, 30%. In 2007 there came a sharp rise both in the number of transactions (43%) and in their amount (188% as compared with 2006). Whereas 2008 brought a fall in the number of transactions (21%) and in their overall amount (36%) as compared with the previous year (*Fig. 1*). In Q1 2008 the value of transactions grew by 51% against the same period in 2007. In the second quarter transaction amounts fell by 35% compared with the same period in 2007; in the third quarter, by 75%; and in the fourth quarter, by 90%. *In Q1-Q2 2009, transaction amounts dropped by 66 and 55% respectively, against the same period of 2008.*

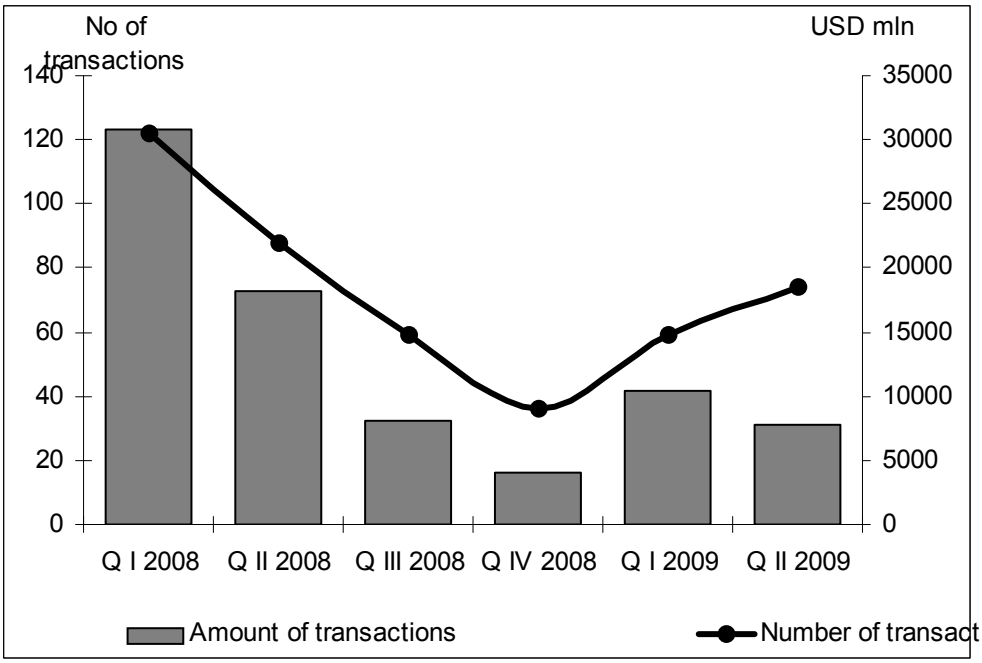


Fig. 1. Number of transactions on the M&A market and their total annual amount between Q1 2008 and Q2 2009.

Despite the fact that the average transaction amount for 2003 was calculated on the basis of data for just April – December, the 2004 figure was 40% higher. In 2005 and 2006 the rate of growth in the average transaction amount somewhat slowed down, to 17% and 4% against the previous year respectively. The growth was the highest in 2007, at 130% compared with

[1] Russian Federal Agency for Technical Regulation and Metrology Resolution No 454-st of 6 November 2001 "On adopting and implementing OKVED".

the previous year. In 2008, despite a drop in the number of transactions, their average amount increased by 30% against the previous year. (*Fig. 2*).

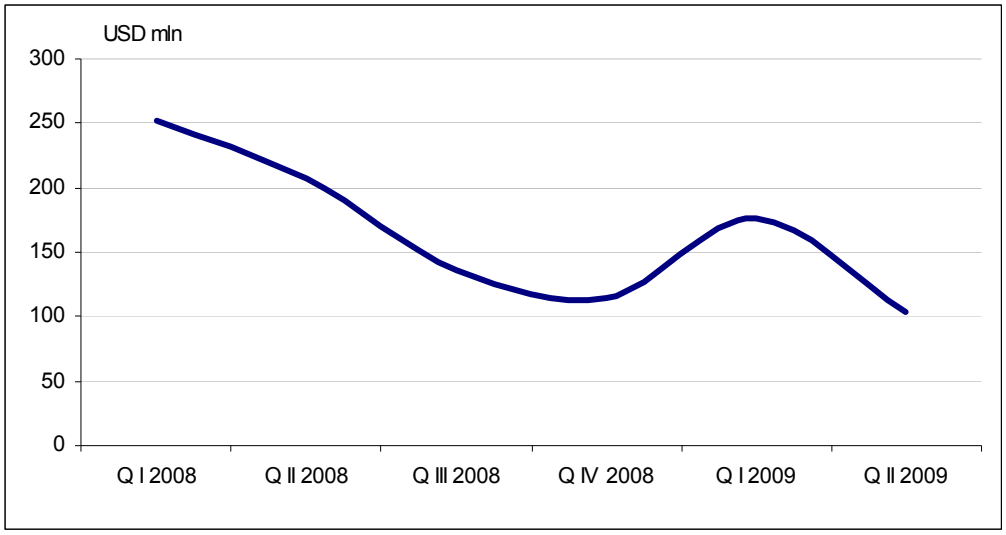


Fig. 2. Average transaction amount per quarter, from Q1 2008 to Q2 2009.

The increase in transaction amounts in 2007 can be attributed both to a growing number of transactions on which amounts were disclosed and to the number of transactions in the oil and gas sector. This situation can also be attributed to objective positive changes at microeconomic level. Spurred by the economic boom in the country, a considerable rise in direct investment year-on-year, corporate management in Russia began to pay more attention to their reputation, made efforts to increase their asset value.

Between Q2 2003 and Q2 2009, some 119 transactions worth over USD 500 mln were conducted, making up about 6.2% of all transactions for the period (*Fig. 3*).

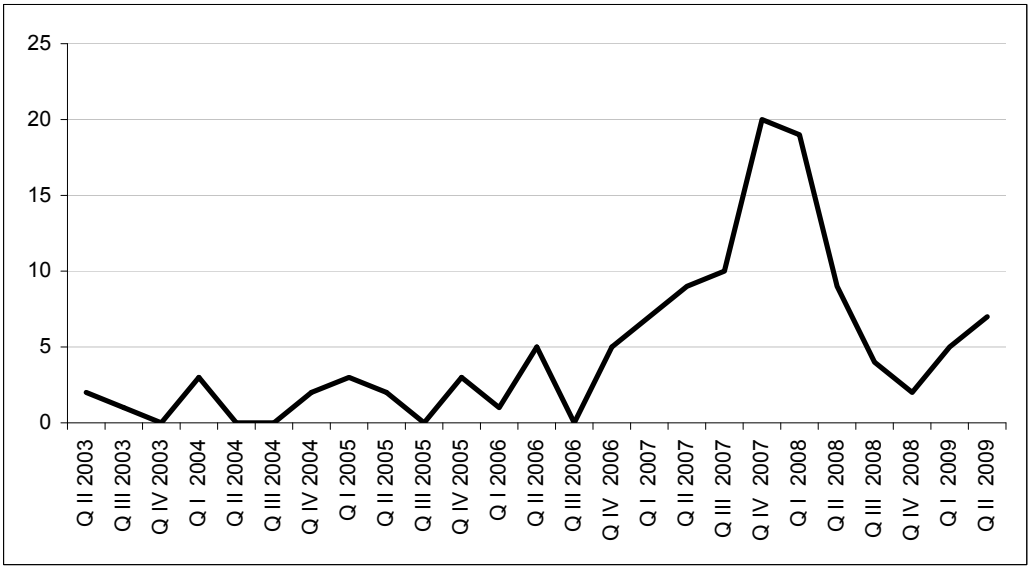


Fig. 3. Number of transactions worth over US$ 500 mln.

In the period between Q2 2003 and Q2 2009, in 81% of transactions on the Russian M&A market the buyers were companies registered in the Russian Federation; in 10% of transactions the buyers were companies registered in the European Union. Companies registered in former Soviet Union republics were buyers in 1% of M&A transactions in the given period, with the rest of transactions effected by buyers from other foreign countries.

The biggest number of M&A transactions were carried out between Russian companies: 69% of the total number of transactions. Russian companies' acquisitions dominate domestic transactions, accounting for 83% of their total number. Russian companies' acquisitions in the former Soviet Union make up 6% of the total number of Russian transactions; in the EU, 5% and in other foreign countries, 6% (*Table 1*, *Fig. 4*).

Table 1

Transactions statistics between Russian and foreign companies between Q2 2003 and Q2 2009*

Statistics of transactions between Russian and foreign companies		M&A target registration				Amount
		Russia	EU	FSU	Other foreign countries	
Buyer's place of registration	Russia	1,292	76	91	66	1,525
	EU countries	164	12	8	13	197
	Former Soviet Union republics	20	0	4	0	24
	Other foreign countries	93	12	4	33	142
Amount		1,569	100	107	112	1,888

*The total number of transactions may differ from the final statistics for the relevant period due to the lack of data on individual companies.

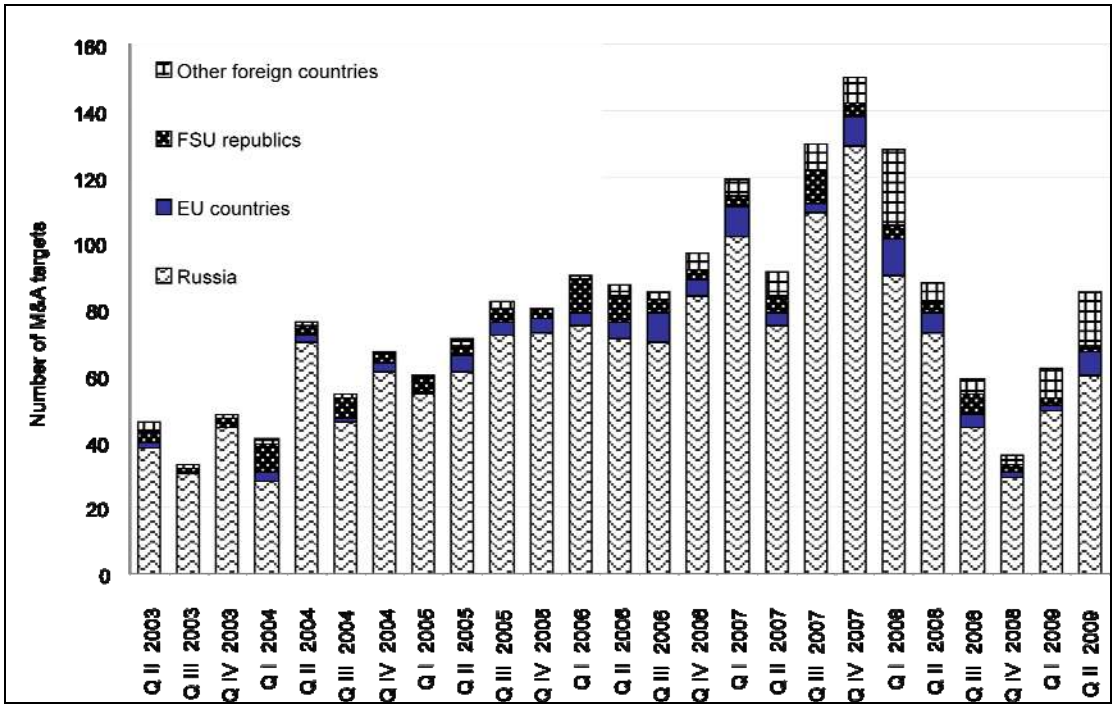


Fig. 4. M&A transaction amounts breakdown between Russia, FSU, EU and other foreign countries

Fig. 4 indicates that the given period was marked by a trend towards a growing number of buyers from EU countries. Restricted access to information on real company owners that operate under other country jurisdictions makes it difficult to say for sure whether they belong to Russian entities.

In the given period, an average of four transactions per quarter involved targets in former Soviet Union countries. Investors are attracted by reasonable real estate prices and the substantial number of yet unoccupied business niches. Entering FSU markets is often easier than those in EU countries.

The Moscow M&A market between Q2 2003 and Q4 2006 saw a rise in the number of M&A targets, with the Q4 2006 figure 227% higher than the Q2 2003 one. However, throughout the year 2007 the number of M&A targets was steadily in decline. Then, in Q1 2008 there came a 40% spike compared with the previous quarter. Between Q2 and Q4 2008 the number of M&A targets was again on the wane. In Q1 2009 the number of acquisitions in Moscow was 29% lower than in Q1 2008, while in Q2 2009 it rose by 50% against Q2 2008. The number of transactions on the St Petersburg market remained stable throughout the given period, not rising above 15 targets a quarter (*Fig. 5*).

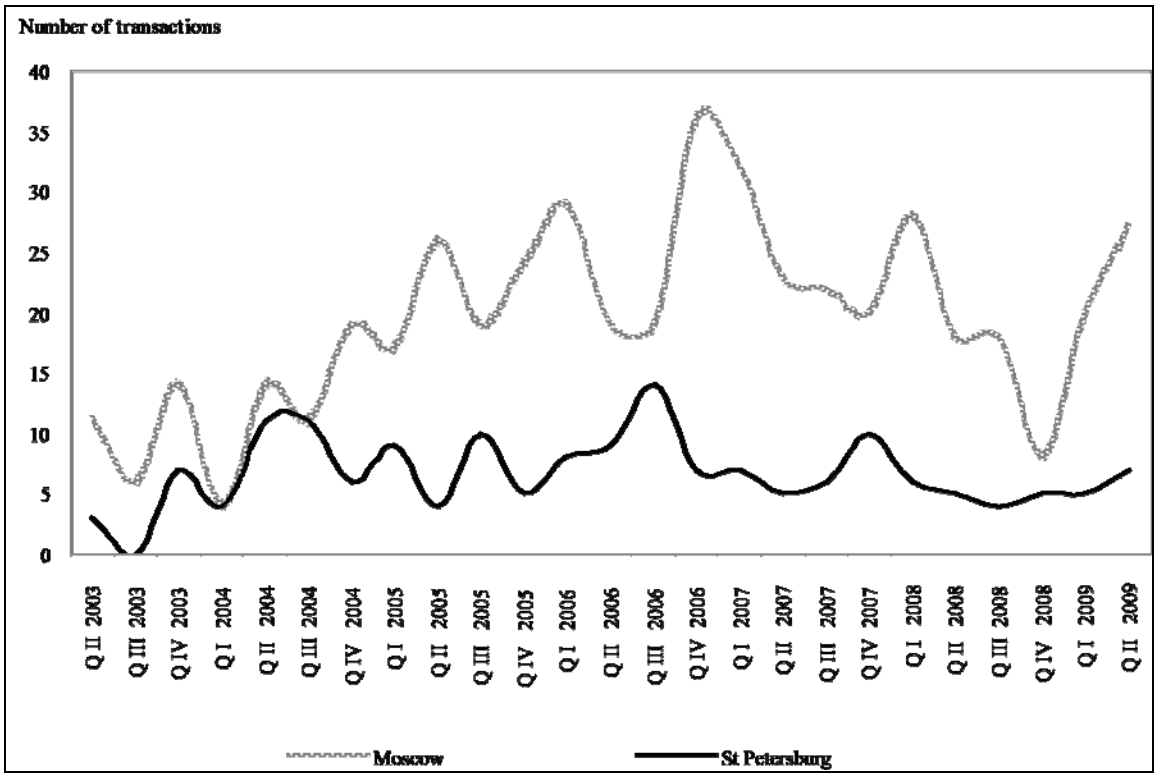


Fig. 5. Number of M&A targets on the Moscow and St Petersburg markets.

As regards an M&A target breakdown per federal district in the period under review, the leaders in terms of the number of targets are the Central and Northwest, followed by the Volga Federal District. The figure for the Central Federal District, including Moscow, was 646 targets; for the Northwest Federal District, including St Petersburg, 245; and for the Volga Federal District, 217 (*Fig. 6*). Despite an emerging trend towards a more even spread

of enterprises across Russia, Moscow and the Central Federal District still remain the most active regions.

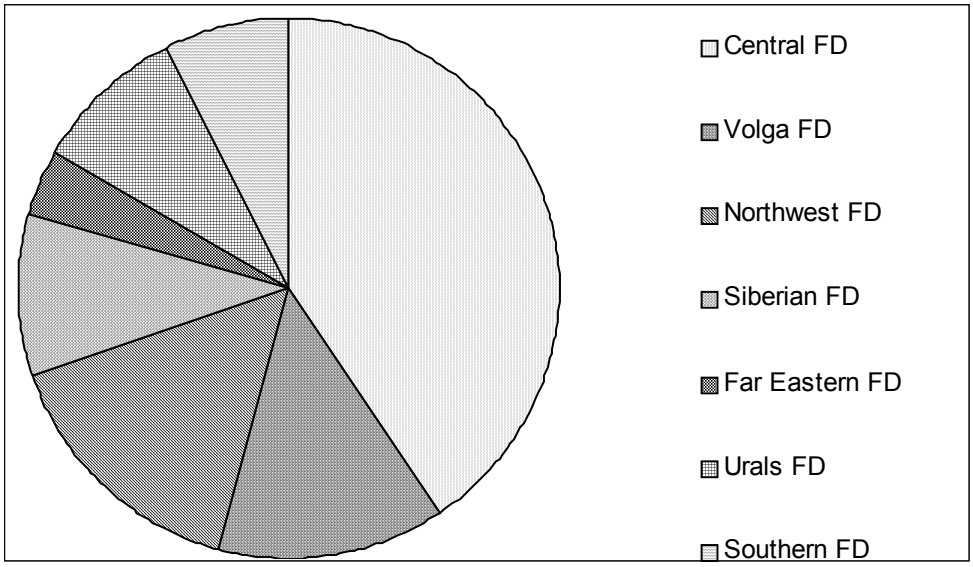


Fig. 6. M&A target share per Russian federal districts between Q2 2003 and Q2 2009.

The most widespread form of integration on the M&A market is sale/purchase of shares, accounting for over 50% of all acquisitions during the period under review.

The most active players on the M&A market are open joint-stock companies (OAO) (*Fig. 7*). They account for 44% of all transactions. They are followed by limited liability companies (OOO), accounting for 25% of all transactions. During the period under review, in six transactions the buyers were state unitary enterprises (GUP). GUPs bought companies operating in the following sectors: manufacturing, hospitality and catering, transport and communications, utilities, finance.

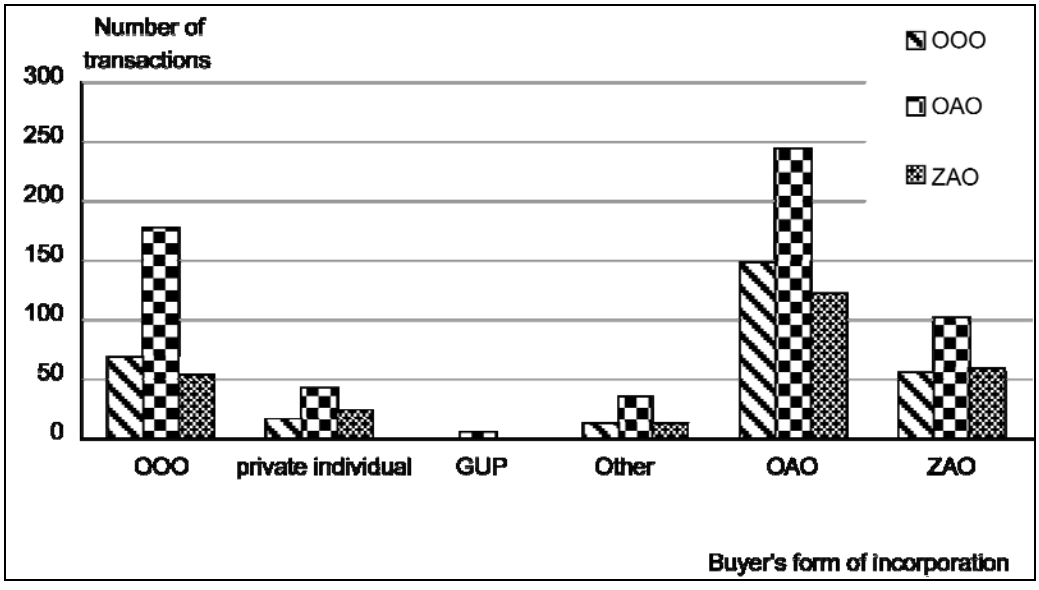


Fig. 7. Number of transactions between companies of different forms of incorporation between Q2 2003 and Q2 2009.

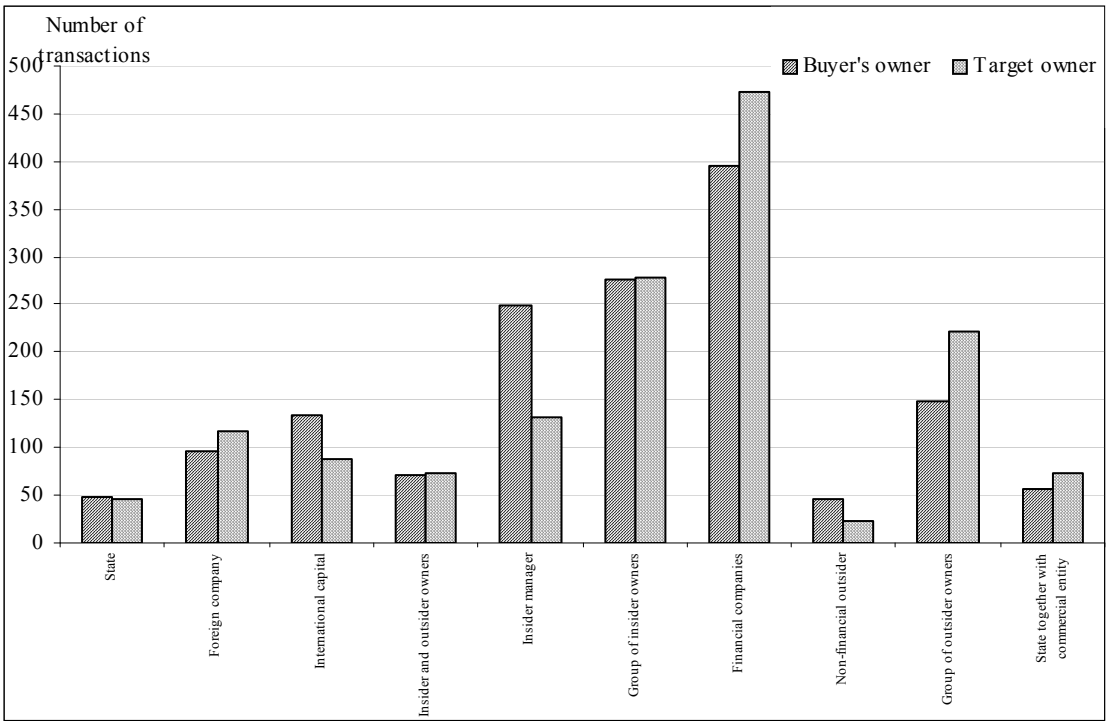


Fig. 8. Classification of M&A transactions per owners of companies involved, between Q2 2003 and Q2 2009.

Fig. 8 shows that most frequently buyers were entities owned by financial companies, accounting for 26% of all transactions (35% of the total amount of transactions) for which ownership information is available. M&A targets also most frequently were assets owned by financial companies, making up 31% of all transactions (33% of the total amount of transactions).

The state acted as the buyer and the seller in 3% of transactions. In terms of amounts involved, the sale of state-owned assets accounted for 2.3% of the total amount of transactions for the given period, whereas acquisitions by the state made up 6% of the total value of transactions.

Foreign companies acted as the buyer in 6% and as the acquisition target in 8% of the overall number of M&A transactions. Acquisitions of foreign companies made up 7% of the total amount of transactions. The biggest transaction involving a foreign target was the acquisition by PKN Orlen of 53.7% of shares in the Lithuanian concern Mazeikiu Nafta (MN) for US$ 1,492 mln from a Yukos subsidiary, Yukos International UK B.V., in May 2006.

International companies acted as the buyer in 9% and as the seller in 6% of M&A transactions. These transactions accounted for 13% of the total amount. The biggest transaction to have an international company as an M&A target was the sale of 50% plus one share in Sakhalin Energy Investment Company Ltd to Gazprom in February 2007 for US$ 7,450 mln. As a result of this transaction, Shell retained 27.5% and Mitsui and Mitsubishi, 12.5% and 10% in the company respectively.

Transactions to purchase companies in joint insider-outsider ownership made up 5% of the total number and 3.6% of the total amount. Companies with this form of ownership acted as buyers in 4.7% of transactions.

Companies owned by an insider manager were M&A targets in 6% of transactions, accounting for 5.5% of the total amount of transactions. Companies owned by an insider manager acted as buyers in 15% of transactions.

A group of insider owners acted as the M&A target and the buyer in 18% of transactions each. Purchases of companies co-owned by management and staff accounted for 5% of the total amount of transactions in the period under review.

Companies owned by non-financial outsiders acted in 3% of M&A transactions as buyers and in 1.5% as targets, accounting for 0.8% of the total amount of transactions between Q2 2003 and Q2 2009.

Acquisitions of companies owned by a group of outsiders made up 19.5% of the total amount of transactions in the given period, while in terms of numbers, companies like these acted as M&A targets in 15% and as buyers, in 10% of transactions.

Transactions in which acquisition targets were companies co-owned by the state and a commercial entity made up 5% of the total amount and 5% of the total number of M&A transactions. As buyers, companies like these appeared in 4% of transactions.

For Russia as a whole, the most frequent M&A targets were manufacturing companies, making up 30% of all targets. The trend was the same for Moscow and St Petersburg, where manufacturing companies were the most frequent M&A targets: 264 out of 1,023 and 27 out of 111 respectively.

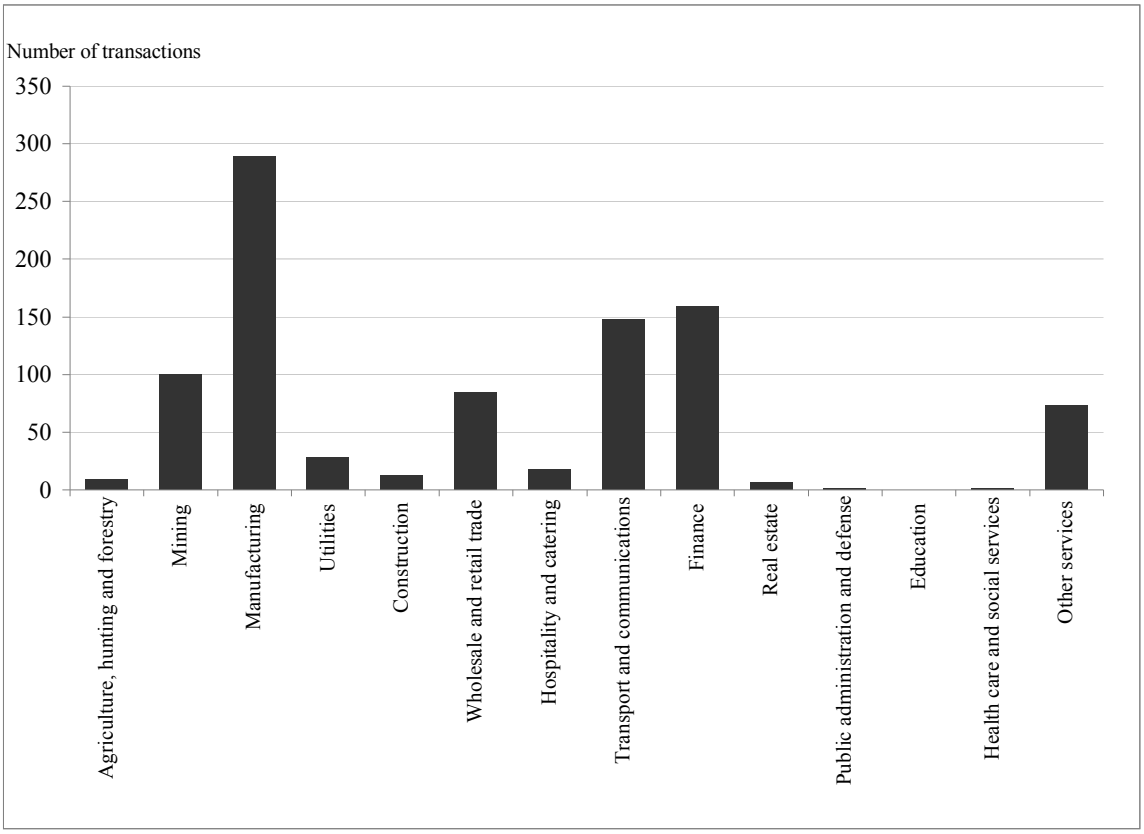


Fig. 9. Intra-industry transactions between Q2 2003 and Q2 2009.

Acquisitions within the same industry range from 8 to 87% between Q2 2008 and Q2 2009. For instance, agricultural and forestry companies purchased companies within their industries in 28% of cases in the given period. For entities dealing with public administration and military security, the share of transactions within their sectors was 8% of the total number of transactions. For utilities companies the figure was 41%, for construction companies, 16%.

Industries with the largest number of acquisitions within their own sector were finance (88%), transport and communications (64%) and services (61%).

The trend towards mergers and acquisitions between companies engaged in the same type of activity was also evident in wholesale and retail trade (67%) and in manufacturing (54%).

Among Russian buyers the highest demand was for companies in manufacturing (31% of all transactions in the period under review), mining (13%), transport and communications (13%) (*Fig. 10*).

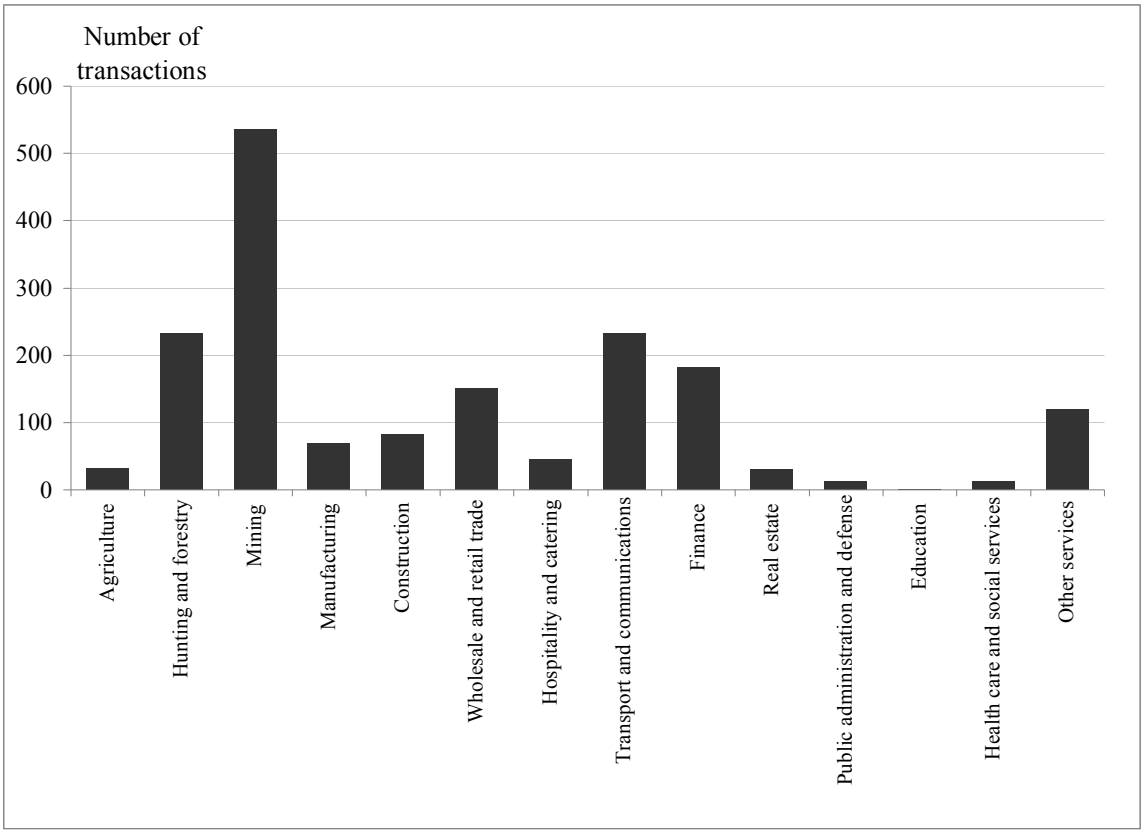


Fig. 10. Breakdown of M&A targets per industry, between Q2 2003 and Q2 2009.

Among agricultural companies the highest demand was for manufacturing and processing assets (65% of all transactions). In the Russian Classification of Types of Economic Activity, the Manufacturing and Processing group consists of 14 subgroups. Out of 26 transactions in which agricultural companies were the buyers, 14 targeted companies from the food, beverages and tobacco subgroup and 9, agricultural companies. There is a trend whereby companies producing raw materials are seeking to expand their circle of consumers by producing semi-finished and end products.

Some 62% of transactions carried out by mining companies involve assets in similar industries. For example, mining, including oil and gas, companies actively buy into manufacturing and processing, mainly metals: 23 out of 27 transactions in manufacturing and processing. In other words, the trend is the same as in agriculture: companies seek to control the whole production cycle in their segment. Given the high cost of this type of business and limited production facilities, this trend leads to monopolistic advantages for companies or businesspeople.

During the period under review, in 73% of cases manufacturing companies conducted transactions within their industry. Out of 395 transactions, 119 were in the food, beverages and tobacco subgroup, 61 in the machine engineering subgroup, 44 in the chemical production subgroup, and 39 in the metals and metal goods subgroup.

Among utilities companies, the highest demand was for assets within the same sector: 47%, or 28 out of 60 transactions. There were 18 transactions in mining, with companies purchasing their own sources of raw materials to reduce their production costs.

Entities dealing with public administration and military security, in five out of 13 transactions bought manufacturing and processing companies, including three machine engineering companies, one chemical and one metals company.

Buyers in wholesale and retail trade in 74% cases purchased companies within their sector, followed by manufacturing and processing companies.

Some 95% of transactions by hospitality and catering companies were to buy assets in the same sector, with the remaining 5% going to communal, social and personal services.

Financial companies bought assets within their sector in 41% of cases. In 21% of cases their targets were manufacturing and processing companies; in 8%, transport companies; in 5%, companies providing communal, social and personal services as well as mining companies; in 4%, construction, utilities and trade companies each; in 2%, hospitality and catering as well as agricultural companies each.

For companies providing communal, social and personal services, intra-industry transactions made up 69% of their transactions. Their second-largest group of targets were transport and communications companies (20%), followed by hospitality and catering and financial companies (6%).

Transactions in which buyers were real estate companies were spread between four sectors, excluding intra-industry acquisitions which made up half of all transactions: 17% of transactions targeted mining assets; 8%, agricultural companies; 8%, manufacturing and processing; and 8%, wholesale and retail trade companies.

For transport and communications buyers, intra-industry acquisitions made up 83% of all transactions, with 4% going to manufacturing and processing targets and 5%, to companies providing communal, social and personal services.

During the period under review, health care entities were buyers in three M&A transactions, with targets coming from the manufacturing and processing sector; utilities and health care.

Fig. 11 shows that foreign companies most frequently bought assets in the following sectors: manufacturing and processing, mining, finance, transport and communications.

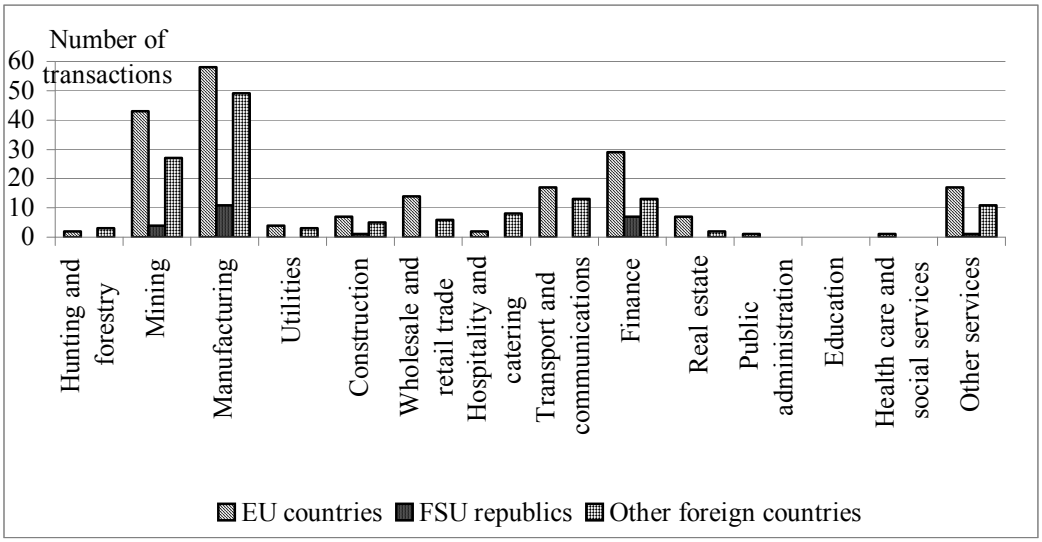


Fig. 11. Breakdown of targets acquired by foreign companies by sector, between Q2 2003 and Q2 2009.

Manufacturing and processing companies were most often a target for acquisition by buyers from EU countries (43 out of 74 of transactions with foreign companies in this sector). As a rule, irrespective of the acceptor's registration, transactions were conducted between Russian businessmen or their groups.

The largest number of transactions between Q2 2003 and Q2 2009 involved the acquisition of companies registered in the Central Federal District, with most targets coming from the manufacturing and processing, transport and communications and finance sectors.

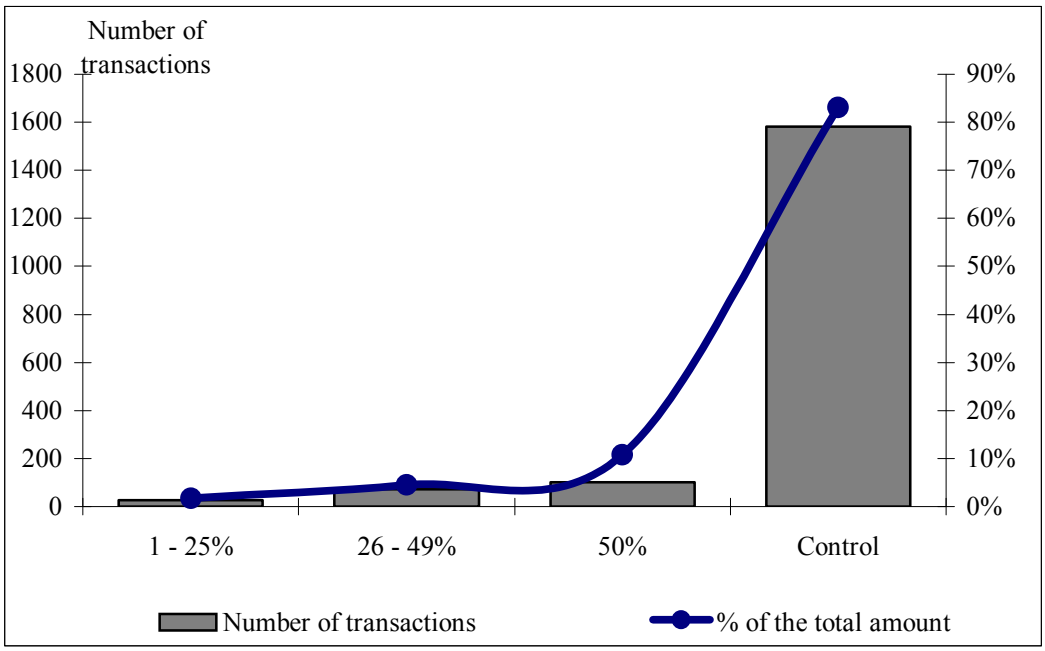


Fig. 12. Share bought in M&A targets, between Q2 2003 and Q2 2009. (Number of transactions; % of the total amount; Control)

In the Siberian Federal District, the majority of M&A targets belonged to the mining and manufacturing and processing sectors; in the Far Eastern Federal District, transport and communications; and in the Urals Federal District, manufacturing and processing and mining companies.

The most frequently used form of integration on the M&A market is gaining control over a company: these transactions accounted for 86.5% of all transactions during the period under review (*Fig. 12*) and made up 68.5% of the total amount of transactions. The term control is used to mean transactions to acquire 51% and more shares in a target company if it is a joint-stock company or full acquisition of companies with other forms of incorporation.

Acquisitions of half a target company – either 50% of shares or half in the company's authorized capital – make up 6% of the total number of transactions, or 11% of their total amount. Acquisitions of a blocking share, or 26-49%, in a company make up 4% of all transactions in the given period, or 5% of their total amount. Transactions to acquire a 1–25% share in a company accounted for 2% of all transactions between Q2 2003 and Q2 2009, or 2% of their value (*Fig. 13*).

When the target is a Russian company, the most frequently used form of integration is assuming control over a company: it accounts for 1,301 purchases of Russian companies out of 1,476, or for 58% of the overall transaction amount in the period under review.

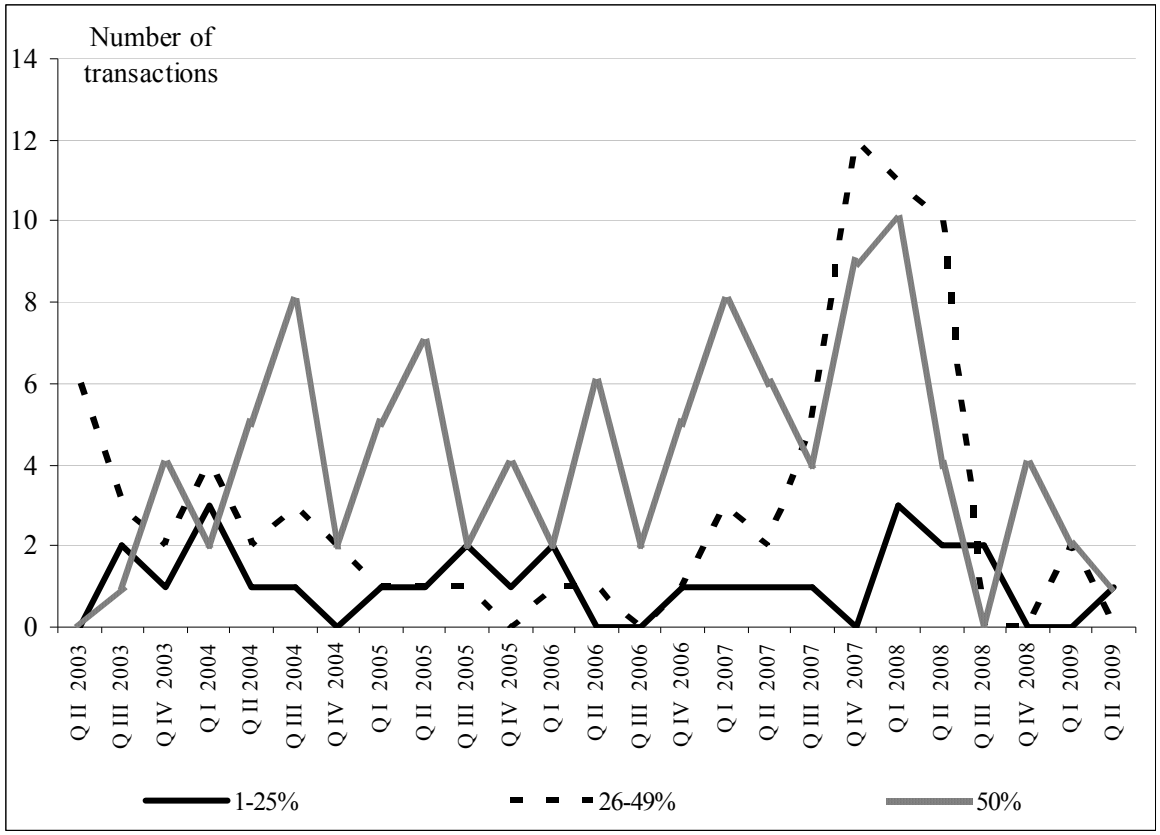


Fig.13. Dynamic of the number of transactions depending on the bought-out share, between Q2 2003 and Q2 2009.

During the period under review, when purchasing companies on the territory of Russia in 92% of cases corporate buyers from EU countries assumed control over the target; in 4% of transactions they bought 50% in the company; in 2%, they purchased a blocking stake, or 26-49% in the authorized capital.

During the same period when purchasing companies on the territory of Russia, buyers from former Soviet Union countries in 80% of transactions acquired a controlling stake and in 20% of transactions, 50% of shares in the target companies. Buyers from other foreign countries in 89% of cases acquired a controlling stake, in 6% of transactions, 50% in the target companies, and in 5%, up to 49% in the companies.

The majority of transactions in which foreign companies bought targets in Russia were controlling stake acquisitions by EU and former Soviet Union countries (*Fig. 14*).

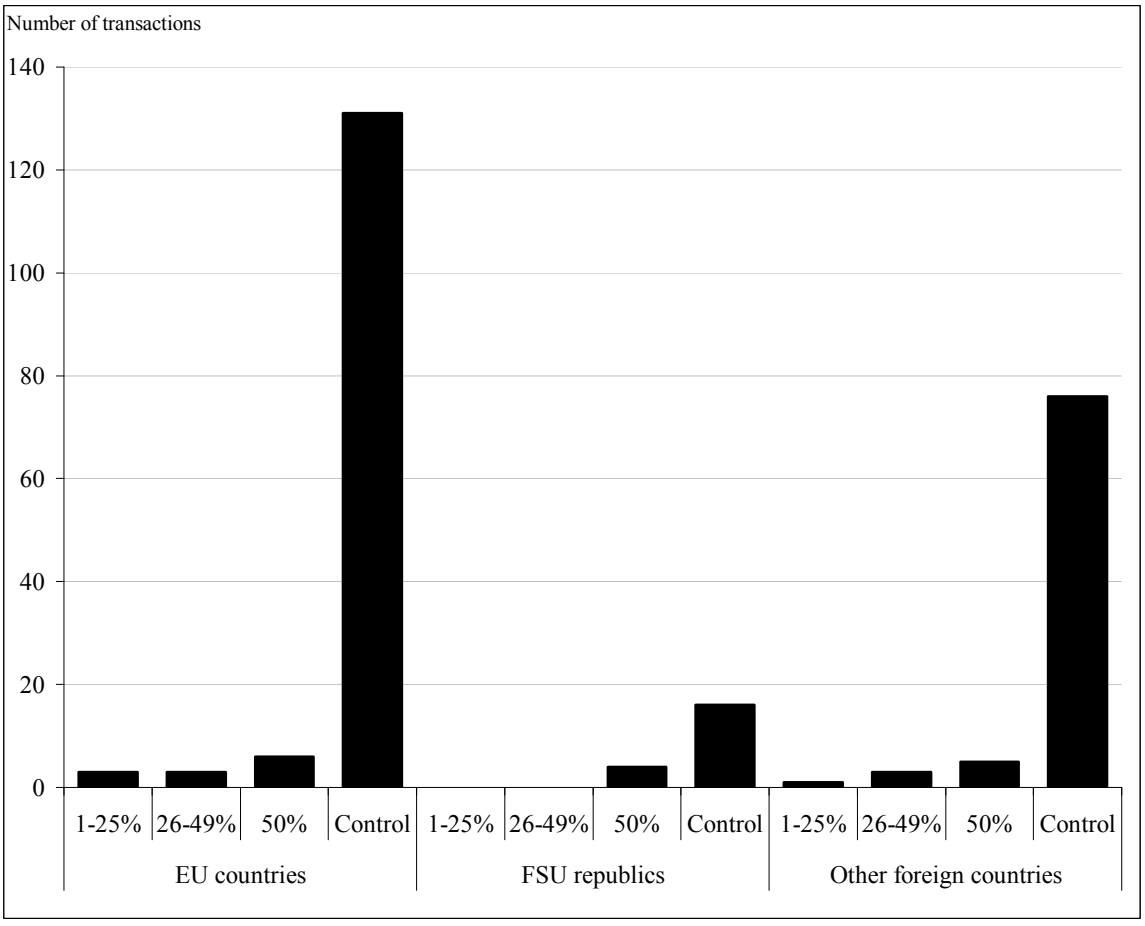


Fig. 14. Share in Russian M&A targets bought by foreign companies, between Q2 2003 and Q2 2009.

The most frequent transactions in the period between Q2 2003 and Q2 2009 were controlling stake acquisitions. The next phase in the development of this market will see the emergence of new technologies for conducting transactions, company expansions through industry concentration, consolidation into specialized holding companies.

Russian companies' attempts to enter the world M&A market are being made more difficult both by competition, which in recent years has become more fierce, and by the absence of

a clear and practicable program of support for Russian investment abroad. In addition to the lack of access to new assets inside the country and a growing competition on the domestic market from Russian and foreign companies, the drive towards acquiring assets abroad is largely informed by the desire to reduce dependence on the state and the tax base and to ensure the safety of assets.

According to available preliminary data, in the first nine months of 2009[1] a total of 546 completed transactions were recorded (including 24 transactions carried out within the framework of Russian Federal Property Fund auctions), which is 43% fewer transactions than in January – September 2008 (964). The decrease in the value of the Russian M&A market slowed down: in the first nine months of 2009 the value of the market dropped from $98.2 bln in 2008 down to $41.4 bln in 2009. According to the findings of the study, the aggregate data on the Russian M&A market look as follows:

- in terms of the number of transactions, the year 2009 (546 transactions) is comparable to 2003 results;
- in terms of the amount, the year 2009 ($41.4 bln) is comparable to 2006 results;
- the average transaction price was $97.7 mln;
- ratio to macroeconomic indicators (4.6% — ratio between the amount of transactions and Russian GDP) is comparable to 2004;
- 52 transactions worth over $100 mln;
- management buyouts (MBO) account for 2% of the market in terms of the amount and 3% of the market in terms of the number of transactions;
- transactions in the energy sector make up 68% of the market in terms of the amount and 10% of the market in terms of the number of transactions;
- controlling state acquisitions make up 37% of the market in terms of the amount and 19% of the market in terms of the number of transactions;
- 13% of transactions account for 90% of the value of the market;
- diversification transactions make up 18% of the market in terms of its value and 33% of the market in terms of the number of transactions;
- foreign companies' acquisitions of Russian companies make up 9% of the market in terms of the number of transactions and 18% of the market in terms of its value.

Below are the more significant features of the Russian M&A market that make it different from the Western practice of capital consolidation:

- weak direct control from state regulators over M&A processes in progress;
- little use of organized stock market instruments in M&A transactions (the majority of transactions involve not publicly listed but private companies, although there is some positive dynamics there);
- minority shareholders' inability to have considerable influence over company operations;
- lack of transparency as regards companies' ownership structure (end beneficiaries);
- single ownership of, on average, considerably larger blocks of shares than in Western companies;
- high level of transactions carried with the use of offshore entities;

[1] A study of the Russian M&A market conducted by ReDeal analytical group within the Mergers.ru project/ "Mergers and Acquisitions in Russia". The study covers completed processes of the transfer of corporate control rights (M&A processes) in Russia.

– continued prevalence of hostile takeovers[1] and criminal seizure of assets;
– lack of disclosure on a considerable number of M&A transactions caused by desire to maintain confidentiality both to conceal data on beneficiaries and to prevent undesirable transactions on the part of competitors, including hostile takeovers and seizure of assets (according to some estimates, at least 30-40% of the total amount of public transactions are shadow transactions);
– use of administrative resource and non-market methods to facilitate the acquisition of assets by the state, state corporations and state-controlled companies with mixed ownership.

Such factors as high concentration of ownership, insufficient development of market-economy institutions, low effectiveness of the judicial system, lack of transparency in ownership rights, and corruption have a systemic influence on all aspects of the Russian M&A market. At the same time, low transparency and little information on transactions, lack of professional intermediaries and active involvement of state companies suggest, among other things, that the corporate control market is experiencing efficiency problems.

5.5. Corporate Governance and Legislation on Legal Entities

In March 2009, submitted for the debate was the draft Concept of Development of the Legislation on Legal Entities (hereinafter, the Concept) which was developed in accordance with the Decree No. 1108 of July 18, 2008 of the President of the Russian Federation on Upgrading of the Civil Code of the Russian Federation and set the guidelines for development of the legislation on legal entities[2]. The document was expected to be submitted to the President early in summer 2009.

A typical complaint about the Law on Joint-Stock Companies of 2005 as amended since 2002 was the fact that it excessively reproduced the Anglo-Saxon scheme of protection of shareholders' rights (minority shareholders). The Concept of Development of the Corporate Legislation until the Year 2008 (prepared by the Ministry of Economic development of the Russian Federation) which became the main program document in the 2000s in that particular area is to some extent a manifesto favoring the scheme of protection of majority shareholders' rights. In fact, it suits to a great extent such actual economic processes in corporate governance as are typical of the most Russian companies (the continental European scheme). At the same time, radical changes in the regulating strategy should not result in new imbalances to the detriment of one or another group of entities of the corporate relations.

The draft Concept of 2009 is a new effort to carry out a system-based development of mechanisms of corporate governance and solve the most topical Russian problems in that

[1] In the West, the term "hostile takeover" is used to mean the acquisition of a company's assets without its shareholders' consent, often without paying an adequate compensation and/or with the violation of shareholders' other civil rights and interests. In Russia this term is often used to describe actions related to acquiring assets through committing criminal offences (fraud, forgery, share register theft, bribery, etc.). This approach appears erroneous. It is important to have a clear definition of the term since the authors propose countering criminal seizure of assets with the same measures that have been developed in the West to counter hostile takeovers and cannot be effective when applied to quite different phenomena.

[2] Draft Concept of Development of the Legislation on Legal Entities is an integral part of the general draft Concept of Development of the Civil Legislation of the Russian Federation which is being prepared by the Private Law Research Center under the President of the Russian Federation by order the Council for Codification and Upgrading of the Civil Legislation of the Russian Federation under the President of the Russian Federation.

area. From the conceptual viewpoint, it is important to understand if substitution (may it be a gradual one) of the corporate governance scheme and growth in level of responsibility of the business' actually take place.

5.5.1. "Corporate" Rights

A specific feature of the Russian scheme of corporate governance is a limitation of rights of participants in Russian economic entities, including shareholders as regards the company's property. Shareholders are recognized to have statutory rights – the right of demand to the company (Article 2 of the Federal Law on Joint-Stock Companies, the notion of a "share" set forth in Article 2 of the Federal Law on Securities). In accordance with the Civil Code, participants in economic relations are recognized to have either statutory rights to the company or proprietary rights to the company's property (Article 48 (2) of the Civil Code). Without elaborating on theoretical aspects of the issue, it is to be noted that statutory rights are relative to the extent that they are a sort of derivatives from proprietary rights which include the right of ownership which factor is reflected in every aspect of realization of such rights (including protection thereof).

The architects of the Concept suggest that apart from statutory rights participants in economic entities, including shareholders should be legally recognized the rights of participation in the company, and that would permit amendment of the status of founders and shareholders of the company. Participants' aggregate rights (statutory rights, that is, the right of demand to the company and the right of participation in it) are proposed to be called "corporate" rights of participants in economic entities.

In addition to the above, the Concept provides for the following:

– Introduction of a possibility for participants to dispute decisions passed by general meetings of shareholders and other collegial bodies, as well as conditions of withdrawal or exclusion from the number of participants (for all the types of legal entities) ;
– Inclusion in the Civil Code of a provision granting participants in any corporation the right to receive information.

5.5.2. Dependence of the Boards of Directors

Expansion of the rights of founders and shareholders is accompanied by efforts to change to some extent regulation of activities by boards of directors of joint-stock companies. By admitting the fact that the overlap of the management function and the supervision function is a key problem, the architects of the Concept propose "introduction of a more efficient structure of bodies of a joint-stock company" with an explicit division of the above functions between such bodies. However, the proposed measures, that is, a refusal to use the name "the Board of Directors" and call it instead "the Supervisory Council", as well as the ban on a simultaneous holding of offices both in the Supervisory Council and the Board of a joint-stock company are not enough to contribute to any resolution of the above problem.

The Russian corporate governance of joint-stock companies was modeled in 1990s after the US scheme where the structure of corporate governance is characterized by a higher dispersion of the equity capital which factor prevents the board of directors to be put under control by a single shareholder.

In Russia, the situation is quite the opposite: according to the outputs of the information transparency survey carried out in 2007 by the Standard&Poors Rating Agency out of eighty large Russian companies 74 companies had at least one major shareholder which owned more

than 25% of the equity, while 57 companies were controlled ones in which over 50% of the equity was owned by a sole shareholder or a group of shareholders which made an agreement between themselves. Such a breakdown of corporate ownership is a mirror reflection of the composition of boards of directors: 46% of directors surveyed are direct representatives of controlling shareholders, while another 21% of directors are made up of different insider-directors, including senior executives. Such a situation in leading companies (along with an empirical estimate) permits to assert that in other 180,000 Russian joint-stock companies which activities lack transparency the extent of control over the board of directors by major shareholders is much higher.

Controllability of the board of directors by a major shareholder or a group of shareholders often results in taking of such decisions which suit the interests of the controlling shareholder rather than the company. Due to a lack of mechanisms of settlement of disputes, conflicts between different groups of shareholders often overgrow into corporate wars and takeovers of corporate assets.

To reduce that extent of control over the board of directors by the controlling shareholder (which problem is the most topical in the Russian system of corporate governance), it is important to carry out the following:

1) Introduce changes in the composition of the board of directors and the decision-making procedure and legislative consolidate mandatory representation in the board of directors of minority shareholders and representatives of controlled entities along with the expansion of the range of issues on which the board of directors is required to take unanimous decisions[1]. The basic idea of adjustment of different interests within the frameworks of the board of directors should be supplemented by mechanisms which would prevent members of the board of directors from abusing their rights;

2) legislatively consolidate a provision under which controlling shareholders or a group of such shareholders are obligated to enter into such an agreement with minority shareholders as would make the former liable to buy sharers of the minority shareholders on their demand in specific cases. Such cases may include insufficient profit, such a change in the equity capital as would infringe the interests of minority shareholders and other;

3) for the purpose of fighting corrupt practices and raising efficiency of joint-stock companies controlled by the state (many of which are of strategic importance), it is necessary to introduce a ban on a simultaneous holding of a public office and an office in the governing bodies of a company whose equity is owned by the state or a state-controlled joint-stock company and legislatively consolidate a norm which would require members of governing bodies of such joint-stock companies to be independent directors.

It is important to establish specialized public control over both joint-stock companies with state participation and state-controlled joint-stock companies. At present, such companies cannot be controlled by authorities who set objectives to them because the same authorities take part in management of those companies. The existing system of relations is of an unofficial nature, so no actual supervision is exercised. Nor can it be carried out by the Auditing Chamber since such companies do not deal with budgetary funds.

It will not be easy to introduce and implement the above measures due to the fact that many Russian companies lack transparency and controlling owners, including the state are

[1] See in detail here and below: A. Radygin, R. Entov, E. Apevalova and other. Internal Mechanisms of Corporate Governance: Some Applied Issues. Moscow: IET, 2009.

unwilling to provide information on their company's activities (the company's expenditure, counterparties and other). Efforts to be taken in that area mean direct infringement upon the private property. To do so, the government should ensure inviolability and protection of private property from, in particular, a discriminatory use of measures of criminal prosecution and corporate takeovers. At the same time, it means a principally different level of fighting the corrupt practices, including those at the higher level because discrimination in that area would bring all the bona fides intensions to naught.

Consequently, introduction of such norms should be well thought-out, gradual and, probably, tested first on a small number of companies and both in analyzing of problems that arise and in development of mechanisms of settlement thereof. In addition to the above, to effectively separate the management function from the supervision function in corporations it is important to make quality changes in protection of ownership rights and reduce the extent of corrupt practices, including those at the higher level.

5.5.3. Legal Entities: Establishment of a System or Redistribution of the Spheres of Interest?

The Concept provides for establishment of a slender system of organizational and legal forms of legal entities, simplification of the legislation on legal entities and, as far as possible, uniform regulation of the main aspects of their activities. All the legal entities are proposed to be divided into:

– Corporations based on the principle of incorporation: economic entities (joint-stock companies and limited liability companies), partnerships, producers' cooperatives and most non-profit institutions;
– Other unincorporated legal entities: unitary enterprises, foundations and institutions.

Meanwhile, effort is being made on the legislative level to bring entities' activities into compliance with their legal status. Non-profit institutions' activities presently called entrepreneurial activities will be renamed as "activities bringing additional income". Such activities are to be auxiliary ones, and permitted types of such activities are to be listed in the entity's charter, while the charter capital in such a case is to be equal to that of a profit-making institution.

In addition to the above, it is proposed to consolidate legislatively the notion of 'a public company" which acquires its public status from the date of state registration of its securities prospectus for unlimited public offering. The status of a public company suggests that such a company has a higher level of charter capital, independent directors and a specialized registrar who keeps the register and carries out duties of the auditing committee at shareholders' meetings. Also, the company is liable to make its information public.

Furthermore, it is proposed to put an end to existence of closed joint-stock companies and state corporations and later, to unitary enterprises.

Closed joint-stock companies may become joint-stock companies (non-public) if they manage to increase their charter capital to two million rubles within a year or two, or be transformed into limited liability companies (with a charter capital of at least a million ruble) or, into producers' cooperatives.

Unitary enterprises which are authorized to deal in economic activities will be transformed into economic entities with the government holding a dominating interest in them. Such a situation will permit to influence the most important decisions those entities take. Only state-

run companies (not municipal ones) with the right of operating management are expected to remain.

It is proposed not to establish new state corporations in future while the existing ones are expected to be subsequently transformed, and the legal basis for creating of such legal entities will be eliminated. For that reason, Rosnanotekh, Rostekhnologii, Olimpstroi, Vneshekonombank and Deposit Insurance Agency are to become economic entities with 100% state participation. The Fund for Assistance in Development of Municipal Housing will be obligated to bring its founding documents in compliance with the requirements which are standard to all the funds, while Rosatom and Olimpstroi are to become the government's federal agencies[1].

As an instrument of such a transformation, "a reversal of restructuring" ("a reverse restructuring") is proposed. It permits to carry out in exceptional cases a mandatory restructuring on the basis of the court's decision (in case of an illegal merger of legal entities they will be split up, while in case of illegal break up they will be merged together and etc.) or in case the court has found that the company has failed to comply with its status (that is, the company has made serious violations which infringe upon the rights of participants in the restructured legal entity, for instance, in a situation where a corporate control over the legal entity has been lost).

Persons who have lost partially or completely their interest in the restructured legal entity as a result of illegal restructuring are provided an option to *restore their lost corporate control*. Persons who took advantage of such restructuring may be bound by the court's decision to give back the respective share of interest to the person whose rights have been infringed upon. Deals by legal entities which were established during restructuring that was later found illegal are, by general rule, valid, while legal entities which existed before the restructuring was found illegal are not. Invalid may be found only those deals which caused damage (or were designed to cause such damage) to the restructured legal entity provided that counterparties to such deals were found acting in bad faith.

Establishment of state corporations has provoked much debate as regards efficiency of their activities. It can be noted right now that state corporations have high resource potential while their place in realization of the government policy is not quite determined[2]; they have a considerable effect both on development of industries related to them and reduction of competition in such industries[3]; and they enjoy a privileged legal position which negatively affects interests of other market participants.

Consequently, the idea of transformation of state corporations and elimination of such organizational and legal forms is justified and can be reflected in the Civil Code of the Russian Federation. However, mechanisms of realization of the above idea (the reverse restructuring and a possibility of restoring the lost corporate control) are not to be adopted as general norms due to the following factors:

– Increase in instability on the market for corporate control;
– Reduction in protection of corporate proprietary rights;

[1] The State Duma planned to develop and pass the draft Law on State Corporations. Its approach was based on the idea that state corporations had been established for a certain period of time to solve specific goals.

[2] See in detail: A. Radygin, R. Entov, E. Apevalova and other. Internal Mechanisms of Corporate Governance: Some Applied Issues. Moscow: IET, 2009.

[3] The Federal Anti-Trust Service of Russia admits that abnormal growth in the number of large Russian companies poses a serious threat to competition. See in detail: the Report of the Federal Anti-Trust Service of Russia on the State of Competition in Russia (2007).

– Abuse of the rights of "former" shareholders whose approval was required for carrying out of restructuring (it does not refer to instances of administrative pressure or discriminatory use of criminal responsibility measures);
– Creation of a new mechanism which can be used in corporate takeovers.

Furthermore, in the existing judicial system there is a high risk that "exceptional cases" whenever the reverse restructuring is possible may often be determined by administrative means and/or through corruption. In addition to the above, such formal legal approach to evaluation of evidence as is widely practiced in arbitration courts at present overlooks both the economic content of the deals and consequences of such deals which situation prevents the mechanism of "the reverse restructuring" from being effective.

It appears that legal norms which are not aimed at development of general or special legal regulation but at solution of specific political goals (even such important as redistribution of control over the most significant Russian assets) are not to become a component of Russia's civil legislation basis[1]. Stagnation in development of the institutions of property, bankruptcy and etc. which situation is currently observed in civil regulation can be explained by use of the above approach.

Such legal norms included in the system of basic norms and aimed at solution of specific objectives:
– are inefficient in regulation of the respective sphere as regards other participants;
– cease to become topical once the specific problem has been solved;
– result in inconsistent and "patched" legal regulation in future;
– Provoke higher uncertainty about legal situation with a large number of people.

5.5.4. Raising of Responsibility of Managers and Founders of Legal Entities

Another line of development of the legislation on legal entities pursues *raising of the level of responsibility of mangers and founders*. Such a need to heighten responsibility of mangers, founders (participants) and other persons and bodies of legal entities has become long overdue. It is proposed to carry out the following measures:
– Introduce such property liability of members of the board of directors and other collegial executive bodies for the damage caused to the legal entity as provided for in respect of joint-stock companies (Article 71 (2) of the Federal Law on Joint-Stock Companies);
– Legislatively consolidate a provision that persons may be brought to responsibility before the legal entity for actions committed with gross negligence (indiscretion) or unjustified risk. (For example, sale of the legal entity's property at a much lower price in case of a conflict of interests and a lack of due discretion in selection of counterparties and/or preparation of the deal.);
– Annul a possibility of limitation or elimination of property liability of the body (manager) of the legal entity by means of an agreement between such a body and the legal entity (Article 53 (3) of the Civil Code of the Russian Federation);
– Introduce a subsidiary (additional) property liability of founders/participants, beneficiaries and other persons who have an opportunity to determine decisions by the legal entity on deals with its counterparties;

[1] Such objectives can be solved by means of legal documents of another level.

– Introduce a subsidiary liability of the founder (participant) of a one-man company for debts (deals) in case he/she lacks property and if the deal was carried out on instructions of the sole participant;
– Change the beginning of the limitation period as regards lawsuits brought by the legal entity against its former managers to the date new bodies of the legal entity learnt or were to learn about the respective damage, but it should not be in excess of the period set by the law (for example, 10 years).

However, it appears that the proposed measures cannot ensure more responsible behavior of the above persons for the following reasons:

1) such mechanisms of indirect lawsuits (Article 71 (2) of the Russian Law on Joint Stock Companies) as are proposed to be applied in respect of members of the board of directors and other executive bodies are rarely used in practice (only a dozen of such instance are known, and they mostly concerned managers of banks which were later found bankrupt);
2) due to the specifics of the Russian judicial system, evaluation by the court whether the entrepreneurial risk was justified is a highly complicated matter in arbitration proceedings. Both formal legal approach and lack by judges of sufficient economic knowledge prevent objective assessment of the cases where the extent of entrepreneurial risk needs to be determined. Furthermore, legislative regulation of the process of information disclosure in case of a conflict of interests is highly inefficient. Most conflicts are outside the legal sphere, and due to that fact a possibility of bringing of legal entities' mangers to responsibility will be rather limited;
3) Bringing of beneficiary parties and other persons who can determine the legal entity's decision-making is a serious problem. In Russia, since early 90s actual owners of a considerable volume of corporate assets have been known neither to the administrative authorities, nor to law-enforcement bodies, which situation can be explained by corruption and personal security reasons. Nor has the situation been changed by new measures related to mandatory disclosure of the information. As regards related deals, instances of disclosure of beneficiary parties are very rare, while such mechanism is the most inefficient in the existing corporate governance scheme;
4) The idea of establishment of a 10-year limitation period as regards lawsuits brought against managers of legal entities is rather dangerous as it can be used both for political purposes and in carrying out of soft re-privatization. Discriminatory bringing to justice of owners of large Russian assets in regions, as well as similar trends in regions is at present a common Russian practice. For the time being, there are no reasons to believe that the proposed legal norm would limit the "inventory" of state instruments employed in redistribution of assets and that it would not be used for the same purposes at a lower level of redistribution of assets (in corporate takeovers).

5.5.5. Change in Rules of Registration of Legal Entities

According to the architects of the Concept the main "ailment" of the Russian corporate sector, that is, takeover of corporate assets should be handled by means of amendment of the rules of registration of legal entities. However, unlike the Concept of Development of Corporate Legislation in the Period until the Year 2008 the Concept in question to that extent tends to system-based solutions.

It particular, it is proposed to carry out such upgrading of the system of registration of legal entities as would provide for:

- Introduction of rules of verification of the data required for registration of the legal entity;
- Legislative consolidation of the charter as the only founding document of the legal entities, including unincorporated legal entities;
- Mandatory legal expertise of the content of founding documents as regards compliance of such documents with the legislation (nonstandard charters); development of standard forms of charters;
- Transfer of the function of registration of legal entities and that of keeping of the unified state register to judicial authorities, for instance, to arbitration courts;
- Considerable increase in the amount of the charter capital to a million rubles, while for joint-stock companies, to two million rubles; in founding of the legal entity the charter capital is to be paid up by cash funds;
- A possibility for claiming damage from the legal entity if such damage resulted from a failure to provide or undue provision of the information to the state register of legal entities.

In general, the proposed measures appear *to be adequate and meet the existing needs*. However, they will entail considerable costs both on the part of the government and legal entities. Together with measures aimed at raising of responsibility of founders and managers of legal entities and promotion of the rights of founders and shareholders, the above measures will create such an additional pressure on the business as would be excessive and unjustified in the existing economic conditions. Such measures will eliminate both *"one-day" firms and a considerable bulk of small and mid-sized businesses*. The statement that entities which fail to pay an increase in their charter capital will be able to do business as the producers' cooperatives, while their founders, as individual entrepreneurs is only partially justified. Formally, they will, but in reality large enterprises which are rendered services to by a large number of small companies give preference to joint-stock companies or, at least, limited liability companies while selecting their counterparties. Consequently, as a result of the status change many companies would lose their customers, consumers etc., which situation is similar either to a loss of business or a considerable drop in business volumes.

Due to the above, introduction of the complex of such measures should be done on a step-by-step basis and in line with the economic situation of Russian companies. Apart from a period of a year or two proposed in the Concept for facilitating such a transfer, increase in the amount of the charter capital of the existing limited liability companies should be accompanied by introduction of mechanisms of reduction of the taxable base by the amount of an increase in the charter capital. Also, payment by installments within the above period is to be provided for. In that case, one can be sure that "a baby will not be thrown away with water".

Generally, the trend in development of the legislation on legal entities is correct. However, the quality of updating of the Concept, as well as efficiency of subsequent implementation thereof will depend to a great extent on the following:

- Practical experience in the sphere of legal entities' activities is to be taken into account;
- Mechanisms of implementation of the proposed measures are to be updated to the acceptable level from the practical point of view and be economically justified;

– There must be such a political will to solution of topical Russian problems which concern ownership as would overcome lobbyists' resistance on the one side and take into account the public opinion so that a justified compromise could be found, on the other.

5.6. Monopoly Price Regulation in 2008–2009

In monopoly price regulation, the time between revealing a breach of antimonopoly legislation and mitigating the damage caused to customers by a dominant company can sometimes be quite long. For instance, the investigation by the Russian Federal Antimonopoly Service (FAS) of monopoly prices for parking at Moscow air hub airports (Domodedovo, Sheremetyevo and Vnukovo) that was launched in mid-2007 made it possible to reduce the cost of an hour of parking at these airports from 150 to 100 rubles only in May 2009.

There are restrictions on how long the Russian antimonopoly regulator can take to consider a monopoly price case and to pass a decision on it. According to Law No 135 "On protecting competition", a monopoly price complaint can be considered within a month with the possibility of extending this period for two more months. After a case is opened, its investigation has to be completed within three months, after which it can be extended for six more months. Thus, it can take nearly 12 months from the time a complaint is lodged till the time FAS rules that it is a monopoly price case.

When a monopoly price case is being investigated, in addition to establishing that the company in question has a dominant position on the market, it is necessary to establish the level of costs and profits or the difference between the price in question and prices at a comparable market. Overall, despite the fact that the Russian Federal State Statistics Service records industry-average profitability indices for different types of production, it is difficult to use these data in establishing instances of monopoly prices because a particular production can be represented by a sole producer whose actions can constitute a breach of competition laws. In addition, there is no methodology for establishing the level of economically justified costs and profits.

After an antimonopoly regulator has established that a company charges high monopoly prices, it issues an injunction that sets:

– the amount of penalty;
– behavior requirements such as the requirement to stop abusing one's dominant position, to inform the regulator of a single price rise of more than 10%, to provide one's financial and statistical reports on a regular basis.

After that, a ruling passed by FAS can be contested in court. That is why a ruling by the antimonopoly regulator will have an impact on the market only if it has been upheld by a court or if an amicable settlement has been reached, reducing the amount of penalty and defining measures to be taken to reduce damage to customers.

Legal proceedings in connection with monopoly price instances revealed in 2008 are presented in *Table 1*.

Table 1.

Violations under para 1 Part 1 Article 10 (monopoly price) identified by FAS in 2008[1]

No	Company	Goods/Services	Legal proceedings in 2008–2009 in connection with monopoly price incident
1	OOO Gazprom Dobycha Orenburg (Gazprom Group)	Granulated sulfur	Ruling was contested, upheld by three levels of courts, came into force
2	OAO MMK, OAO Oskol Electrometallurgical Combine	Metal products used to manufacture bearings	FAS's ruling was accepted
3	ZAO Metallorukav, OOO Metallorukav Trading House	Metal braid for aircraft and rocket engines	Penalty was paid, injunction followed, ruling was not contested in court
4	OAO SUEK, OAO Yakutugol Holding Company	Thermal coal	No information available
5	OOO Sibuglemet Holding Company, ZAO Sibuglemet, OAO Mezhdurechye, ZAO Mezhdurechye, ZAO OF Mezhdurechenskaya, ZAO OF Antonovskaya, (Sibuglement Holding Company group)	Metallurgical coal concentrate	FAS's ruling was accepted
6	OAO KD avia	Office space rent in the air terminal building	Ruling was contested, upheld by three levels of courts, came into force
7	OAO Vnukovo-Invest	Parking outside airport terminal	Ruling was contested, confirmed by third-level court, came into force
8	OOO Alkoa RUS, OAO Samara Metallurgical Plant	Aluminum shapes	Penalty was paid, injunction followed, ruling was not contested in court
9	OAO Yuzhkuzbassugol	Coking coal	Penalty was paid, injunction followed, ruling was not contested in court
10	OAO Ruspolimet	Nickel alloy ring blanks	Penalty was paid, injunction followed, ruling was not contested in court
11	NK Rosneft	Motor gasoline, diesel fuel, jet fuel, fuel oil	Ruling is being contested in court
12	OAO LUKOIL	Motor gasoline, diesel fuel, jet fuel, fuel oil	Ruling is being contested in court
13	ZAO Domodedovo Aerohotel	Parking outside airport terminal	Ruling was contested, was upheld by third-level court, came into force
14	TD Mechel, OAO UK Yuzhnyy Kuzbass, OAO Yakutugol Holding Company, OAO Raspadskiy Ugol	Metallurgical coal concentrate	Penalty was paid, injunction followed, ruling was not contested in court
15	OAO Gazprom, TNK-BP Holding	Petroleum products	Ruling was contested and cancelled by third-level court
16	OOO Zhanr	Access to cable TV	No information available
17	OAO NK LUKOIL, OOO LUKOIL-Ukhtaneftepererabotka, OOO LUKOIL-AERO (LUKOIL Group)	Jet fuel	Ruling is being contested in court
18	ZAO Fuel Supply Company	Jet fuel	Ruling is being contested in court
19	OAO Dagestani Airlines	Air tickets	Ruling was contested, was upheld by three levels of courts
20	OAO LUKOIL-Nizhegorodnefteorgsintez, OOO LUKOIL-AERO	Jet fuel	Ruling was contested and cancelled by three levels of courts
21	ZAO BRK Invest Limited, ZAO Domodedovo Aerohotel	Parking outside airport terminal	Ruling was contested, out-of-court settlement reached
22	OAO Silvinit	Potassium chloride	Ruling was contested, out-of-court settlement reached
23	Bryansk Dairy Factory	Dairy products	Ruling was contested, upheld by three levels of courts, came into force
24	OAO Uralsvyazinform	Cable rent in telephone conduit	Ruling is being contested in court
25	Elektrostal Metallurgical Plant	Ring blanks	Penalty was paid, injunction followed
26	Magadan Center for Standardization, Metrology and Certification	Equipment testing services	Ruling was contested, is currently being considered by court of cassation
27	Bread-Baking Factory No 1	Bread	Ruling was contested, upheld by three levels of courts, came into force
28	OAO Uralkali	Potassium chloride	Ruling was contested, out-of-court settlement reached

An interesting example was the Federal Antimonopoly Service's investigation into a several-fold increase in the cost of granulated sulfur in Q2 2008 (ruling was passed in December

[1] Data have been systematized on the basis of press releases for 2008 posted on the Federal Antimonopoly Service's official website www.fas.gov.ru and a data bank of rulings by courts of arbitration http://kad.arbitr.ru/.

2008). The ruling was contested in court but upheld by courts of three levels in December 2009. In six out 28 cases, court rulings on monopoly prices passed in 2008 were still not in force in 2009. An analysis of monopoly price cases in 2008 has revealed that in only six cases out of 28, commercial companies in questions followed FAS's injunctions (*Fig. 1*).

Practice shows that the most difficult to regulate are petroleum product markets, specifically jet fuel and gasoline. Out of six rulings passed in 2008 in connection with high monopoly prices for petroleum products, two were overturned by courts at three levels while the remaining four are being considered by courts at different levels.

For example, the Chelyabinsk Region court of arbitration overturned a ruling passed by the Chelyabinsk Region directorate of FAS in connection with high monopoly prices for jet fuel set by the Chelyabinsk airport supplier.

The court did not contest the fact that OAO "LUKOIL-AERO" enjoyed a dominant position on the market that Chelyabinsk airport is part of. However, it noted that there were currently no regulations setting pricing mechanisms for jet fuel since jet fuel had not been included on the list of products and services which fell under state regulation of prices and tariffs, as approved by the Russian government's resolution No 239 of 7 March 1995 "On measures to streamline state regulation of prices (tariffs)".

This reasoning shows that, on the one hand, a court may erroneously interpret the establishment of the amount of necessary costs and profits as compulsion for setting a certain price level. On the other hand, it shows that antimonopoly regulators have little methodology support in proving instances of high monopoly prices.

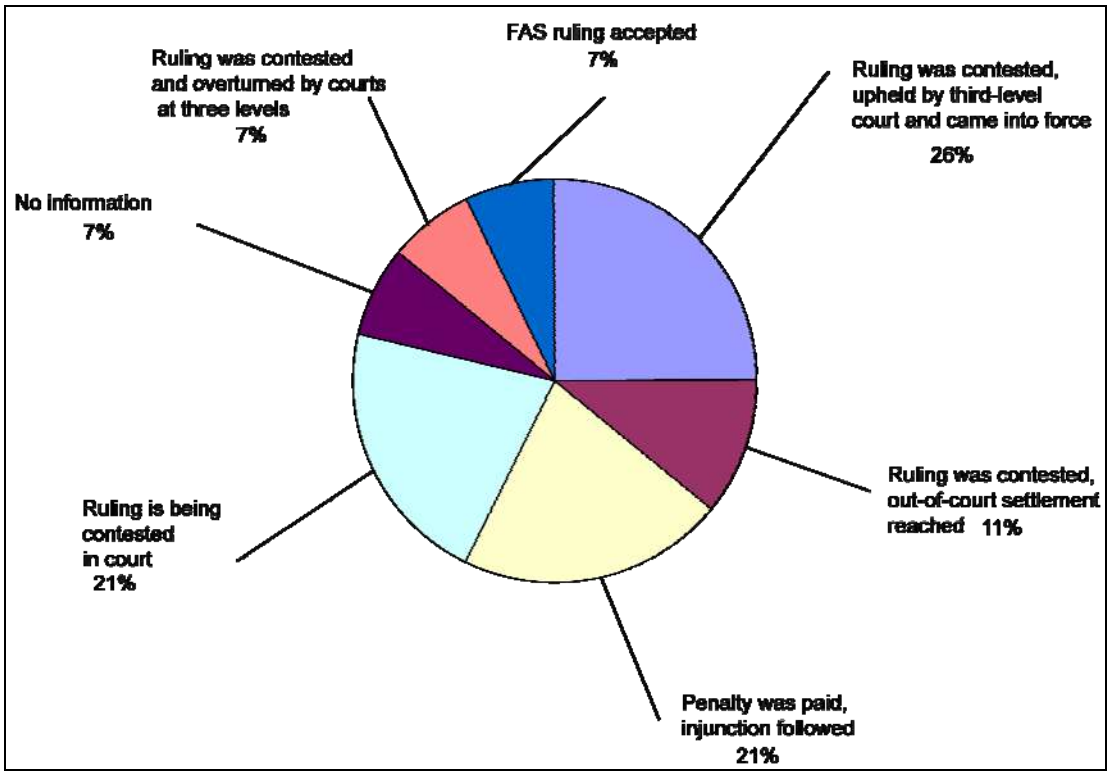


Fig. 1. Legal proceedings on monopoly price rulings passed by antimonopoly regulators

Thus, the length of time that monopoly price regulation takes depends, first and foremost, on how long it takes to contest FAS rulings in courts.

To make the task of identifying instances of high monopoly prices easier, amendments to Federal Law No 135-FZ of 26 July 2006 "On protecting competition" were adopted in 2009, providing a more specific definition of what a high monopoly price is. Conditions for identifying instances of high monopoly prices include:

a) the costs necessary to produce and distribute the goods in question remained unchanged or their change does not match the change in the price of the goods;
b) the list of sellers or buyers of the goods remained unchanged or changes in it are insignificant;
c) terms of goods circulation on the market, including those driven by state regulation, including taxation and tariff regulation, remained unchanged or changes in them are not comparable to changes in the price of the goods in question.

It is worth noting that, under the new version of the law on protecting competition, the price of a product that results from innovation activities, i.e. activities that lead to the creation of a new, not interchangeable, item or a new interchangeable item with reduced production costs and/or improved quality, is not considered to be a high monopoly price. In addition, the term "comparable market" against which the comparable price level is determined can now include markets outside the Russian Federation.

However, these changes have not resulted in a clearer definition of a high monopoly price. For instance, the fact of economically justified costs and rate of return is in each case proved differently: through comparison with the industry-average level of profitability, through comparison of costs with the similar costs of a manufacturer who uses the same type of equipment and so on.

Amendments passed in the "second antimonopoly package" make it more difficult to prove the fact of a monopoly price for a particular product because in the process of establishing this fact it is necessary to analyze the existence of comparable markets not only in Russia but also abroad. In addition, there are no restrictions on the time during which surplus profits from setting high monopoly prices for innovation products can be received. That means that any company, with the exception of producers of commodities, can prove that it has introduced considerable innovations to a product and set any price for that product without the risk of being subject to antimonopoly regulations.

According to press releases posted on the Russian Federal Antimonopoly Service's official website, in 2009 instances of setting high monopoly prices were established in 19 cases (*Table 2*). The length of time during which the revealed violations remained in place varied from 21 days to 18 months, the smallest share of market dominance was 42%, while the minimal difference between the monopoly price and the industry-average price was 10.7%.

Table 2

Instances of high monopoly prices revealed in 2009

	Company	Goods (services)	Market	Probe initiated by	Violation
1	OAO Gazpromneft-Omsk	Petroleum products	Regional	FAS	Unjustified price rise
2	OOO LUKOIL-Volganefteprodukt	Petroleum products	Regional	FAS	Unjustified price rise
3	OAO Gazpromneft-Ural	Petroleum products	Regional	FAS	Unjustified price rise
4	OAO LUKOIL-Permnefteprodukt	Petroleum products	Regional	FAS	Unjustified price rise
5	OOO Kurskoblnefteprodukt	Petroleum products	Regional	FAS	Unjustified price rise
6	OOO Energiya Holding Company	Power generation	Regional	Consumers	Comparatively high price level
7	OAO Vorkutaugol	Transport services	Regional	FAS	Unjustified price rise
8	FGUP Main Center of Special Post	Postal services in relation to materials containing state secrets	National	Consumers	Unjustified price rise
9	OAO Sibirtelekom	Internet access	National	Consumers	Comparatively high price level
10	OAO Ryazannefteprodukt	Petroleum products	Regional	FAS	Unjustified price rise
11	OAO Russkiy Solod	Brewers malt	National	Customers	Unjustified price rise
12	OAO LUKOIL	Petroleum products	National	FAS	Unjustified price rise
13	OOO RN-Vostoknefteprodukt	Petroleum products	Regional	FAS	Unjustified price rise
14	ZAO FosAgro AG	Ammophos	National	Prosecutor's office	Unjustified price rise
15	OOO LUKOIL – Zapad-Nefteprodukt	Petroleum products	Regional	FAS	Unjustified price rise
16	Sole trader Y.V. Kistanov	Liquefied gas	Regional	FAS	Comparatively high price level
17	OAO Sakhaneftegazsbyt	Petroleum products	Regional	FAS	Unjustified price rise
18	OAO Belgorodnefteprodukt	Petroleum products	Regional	FAS	Unjustified price rise
19	ZAO Tambovnefteprodukt	Petroleum products	Regional	FAS	No reduction in price despite a reduction in costs

The 2009 practice is different from the 2008 one in that all product markets (petroleum products, ammophos mineral fertilizer and brewers malt) are commodities markets, whereas in 2008 there were instances of high monopoly prices for such high-tech products as metal braids for aircraft and rocket engines, nickel alloy ring blanks and metal products used in the manufacturing of bearings (*Table 3*).

Table 3

Instances of high monopoly prices in 2008 and 2009

	2008		2009	
	No of cases	%	No of cases	%
Number of revealed instances of high monopoly prices	28	100	19	100
Including:				
on the local market	8	29	1	5

	2008		2009	
	No of cases	%	No of cases	%
on the regional markets	8	29	13	68
on the national market	12	43	5	26
In the following sectors:				
energy sector	10	36	14	74
food industry	2	7	1	5
chemical industry	3	11	1	5
services market	8	29	3	16
industrial production	5	18	0	0
Probes initiated by:				
FAS	13	46	14	74
consumers	15	54	4	21
prosecutor's office	0		1	5
Type of violation:				
comparatively high price level	19	68	15	79
price maintenance	6	21	3	16
failure to reduce prices following a reduction in production costs	3	11	1	5

The year 2009 saw the investigation of a large number of cases on regional petroleum product markets. Violations in the energy sector make up 74% of all investigations and 68% of probes conducted on regional markets (*Fig. 2,3*).

The effectiveness of passed decisions can be only assessed on the strength of court rulings in 2010, since – according to the established practice – all of FAS's decisions taken in relation to companies belonging to the energy, chemical and food industries are contested in court.

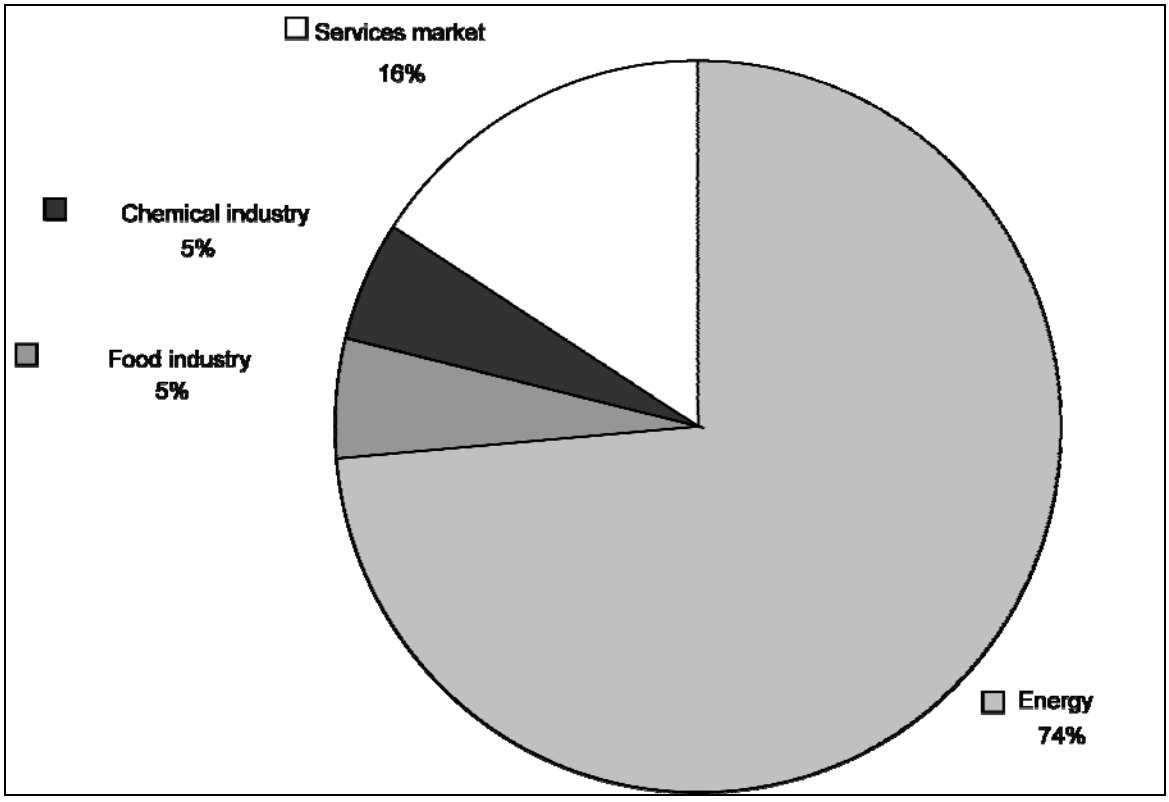


Fig. 2. Sectors in which instances of monopoly prices were revealed in 2009 (Services market, Chemical industry, Food industry, Energy sector)

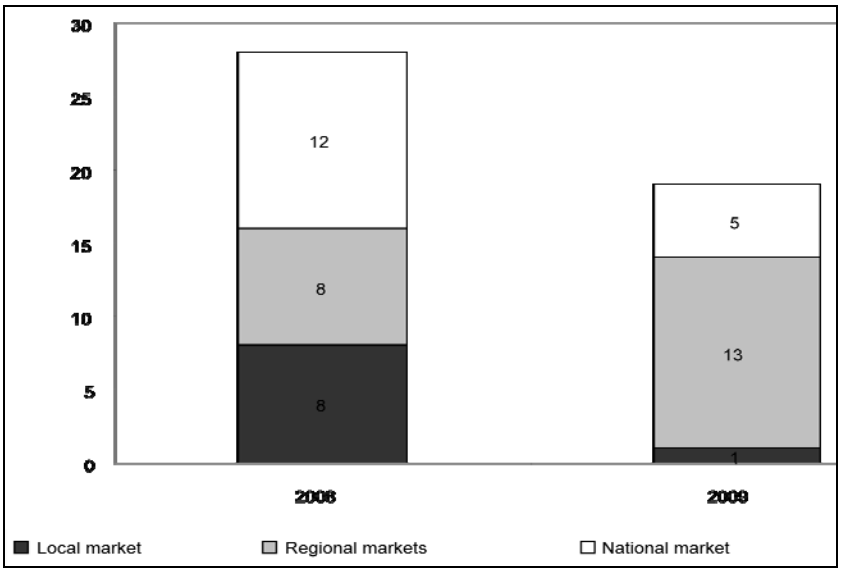


Fig. 3. Breakdown of instances of monopoly prices by size of market, in 2008 and 2009

While comparing who different investigations were initiated by, it is worth noting that the year 2009 saw a drop in the number of cases of high monopoly prices identified on the strength of consumers' complaints (*Fig. 4*). This may be attributed to a slowdown in the rate at which prices for manufactured goods were growing and fewer opportunities for dominant companies to set high monopoly prices given a slump in demand. For example, the producer price index in manufacturing in December 2009, as compared with December 2008, was 105.2%.

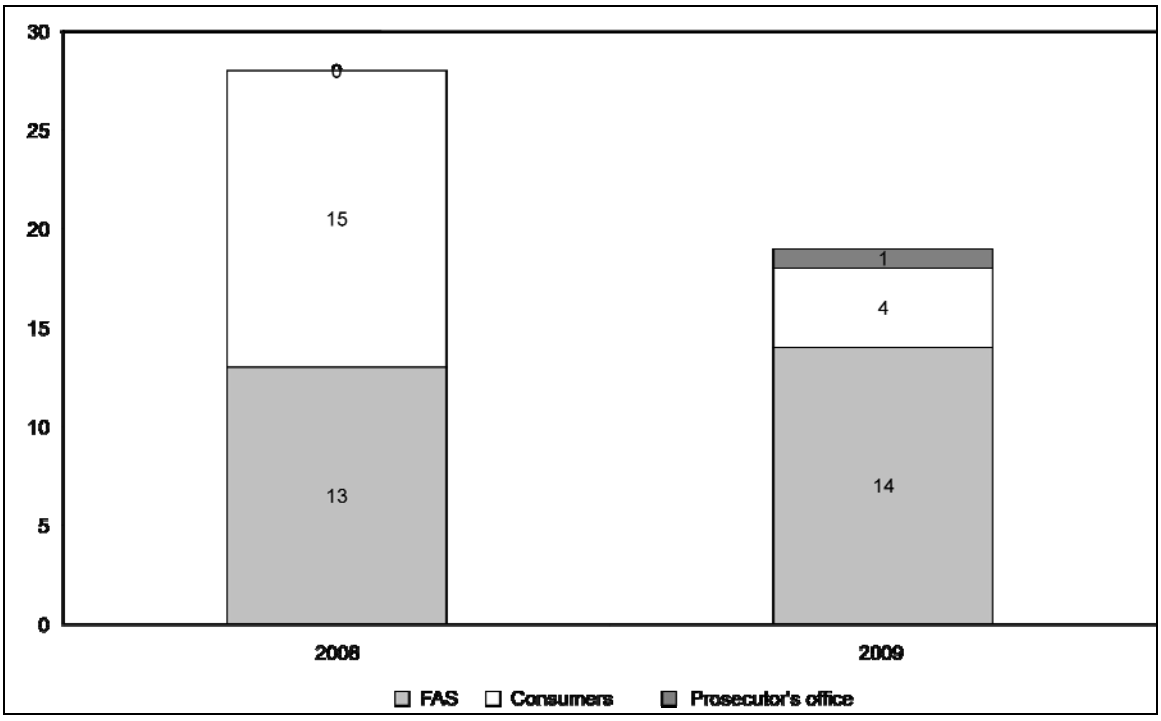


Fig. 4. Breakdown of monopoly price instances by who initiated probes, in 2008 and 2009

On the strength of established instances of monopoly prices in 2008 and 2009, antimonopoly regulators' efforts at monopoly price regulation had an impact on just 16 markets (six local markets, three regional and seven national ones).

An analysis of the practice of monopoly price regulation in 2008 and 2009 shows that the main problem as far as increasing the effectiveness of regulation and reducing the impact on consumers are concerned may be insufficient methodological support for the process of proving the establishment of economically justified costs and profits.

It was expected that amendments to the definition of a high monopoly price adopted in the "second antimonopoly package" in 2009 would make the process of establishing an instance of a high monopoly price considerably easier. However, in reality the procedure of establishing an instance of a high monopoly price became much more complicated, especially when studying markets other than commodities ones. The introduction of the requirement to search for a comparable foreign market also makes the process of investigation considerably more difficult. All that, in turn, limits the capabilities of antimonopoly regulators to defend in court their decisions that the actions of dominant companies on some markets constitute instances of high monopoly prices.

5.7. RF Real Estate Market

5.7.1. Land Market

On January 1, 2009 there was 7.3% of all the land of the Russian Federation in the ownership of citizens of the Russian Federation and 0.5% in the ownership of legal entities (*Table 1*).

Table 1

Structure of the Lands of the Russian Federation as Broken Down by Forms of Ownership as of January 1, 2009

Forms of ownership	Ha, mln	%
Federal and municipal property	1576.9	92.2%
The property of individuals	124.3	7.3%
Including individual land shares	107.4	6.4%
Property of legal entities	8.6	0.5%
Total	1709.8	100.0%

Source: Federal Service of State Registration, Inventory and Mapping ("Rosreestr") data.

Of the 132.9 million hectares of land in private ownership in 2008, there was 2.42 million hectares in circulation (*Table 2*), or only 1.8%.

Table 2

Areas Involved in Transactions with Land in Private Property, by Federal Regions of the Russian Federation in 2008 (Ha)

Federal regions of the Russian Federation	Land sales by individuals and agencies	Transfer by way of gift	Inheritance	Pledge	Total
Russian Federation	1 067 302.6	335 042.2	596 197.3	416 637.0	2 415 179.1
Central Region	340 376.0	35 152.9	208 874.2	128 049.2	712 452.3
North-West Region	30 924.2	3 194.0	5 264.6	17 858.8	57 241.6
Southern Region	34 257.3	67 678.3	36 967.8	4 515.9	143 419.3
Volga Region	196 346.9	123 100.0	278 490.1	168 654.3	766 592.1
Urals Region	160 390.8	11 628.3	31 167.7	5 435.4	208 622.2
Siberia Region	293 819.0	93 181.7	35 014.3	89 045.7	511 060.7
Far East Region	11 188.4	1 106.2	418.6	3 077.7	15 790.9
Structure of transactions with the private land plots in the RF within 2008, %	44.19	13.87	24.69	17.25	

Source: Federal Service of State registration, Inventory and Mapping ("Rosreestr") data.

The turnover of federal and municipal land in 2008 amounted to 114.5 million hectares – land transferred to lease (*Table 3*). This figure is comparable with the total area of land in private ownership - 132.9 million hectares. A significant area of land leased in Russia belongs to the Urals Region, 27.4% of the total area of leased lands of federal and municipal property, the Far East Region (22.7%), and Siberia (22.3%) federal districts, where to large areas of deer pastures are leased. In particular, in the Chukotka Autonomous District there registered leases for the area of 24780.0 thousand hectares, in Yamalo-Nenets Autonomous District - 30,109.2 thousand hectares, mainly for deer pastures.

Table 3

Characteristics of the Turnover of State, Municipal and Private Land

Federal regions of the Russian Federation	Total land area (by State Register), ha, thousand	Land in the state and municipal ownership (by State Register) ha, thousand	Including: transferred to lease		Land owned by individuals and legal entities (by State Register), ha, thousand	Including: sold, inherited, gift, mortgaged in the reporting year	
			Ha, thousand	The share of leased land the total Region area (percentage of total leased land) %		Ha, thousand	Share of land in the turnover versus land in private ownership in the Regions, %
Russian Federation	1 709 824.2	1 576 884.2	114 531.9	7.26 (100)	132 940.0	2415.2	1.82
Central Region	65 020.5	40 532.3	2 721.6	6.71 (2.4)	24 488.2	712.5	2.91
North-West Region	168 696.8	163 764.7	13 189.8	8.05 (11.5)	4 932.1	57.2	1.16
Southern Region	59 131.5	35 643.8	8 527.2	23.92 (7.4)	23 487.7	143.4	0.61
Volga Region	103 697.5	68 047.5	7 210.6	10.60 (6.3)	35 650.0	766.6	2.15
Urals Region	181 849.7	171 998.0	31 361.5	18.23 (27.4)	9 851.7	208.6	2.12
Siberia Region	514 495.3	482 326.5	25 553.8	5.30 (22.3)	32 168.8	511.1	1.59
Far East Region	616 932.9	614 571.4	25 967.4	4.23 (22.7)	2 361.5	15.8	0.67

Source: Federal Service of State registration, Inventory and Mapping "Rosreestr" data.

In 2008 there were executed 441.8 thousand lease transactions with the state-owned and municipal land area of 15.7 million hectares against 19.9 million hectares in 2007. There was sold 0.5 million hectares sold of the state and municipal land through 292.8 thousand transactions, more than in 2007, when there were 233.7 thousand transactions with the total land area of 0.37 million hectares. In the private sector in 2008 there were committed 794.8 thousand transactions with the land area of 2.415 million hectares. In 2007, there were a little less transactions, 643.4 thousand with a smaller area - 1.2 million ha. Altogether, in 2008, there were 1.545 million transactions with the land area of 18.9 million hectares. The number of transactions involving the sale of land at the auctions, as compared with 2007 in Russia has increased from 16.337 to 22.916 plots, in terms of the square area - from 138.019.6 ha to 164.477.7 ha (*Table 4*).

Table 4

Transactions with Land in the Russian Federation

Transaction type	Number of transactions (area, Ha)			
	2005	2006	2007	2008
1.Rent of the state and municipal land (accrued total), including:	3 621 086	3 737 574	3 628 109	3 677 315
	(68 230 403.0)	(104 827 034.0)	(114 103 370.5)	(114 531 856.7)
1.1 Transactions made in reporting year	474 128	522 487	472 732	441 842
	(14 580 742.0)	(5 775 551.0)	(19 941 450.0)	(15 698 127.8)
2. Sale of lease rights for the state and municipal land	5 854	7 068	13 835	15 684
	(23 316.0)	(124 954.0)	(149 275.9)	(315 888.9)
3. Sale of the state and municipal land, including:	154 702	176 751	233 706	292 847
	(91 446.0)	(262 791.0)	(369 382.7)	(503 813.3)
3.1. Through auctions	9 562	10 793	16 337	22 916
	(35 250.0)	(57 406.0	(138 019.6	(164 477.7

Transaction type	Number of transactions (area, Ha)			
	2005	2006	2007	2008
Total effective transactions with state and municipal lands (accrued total), including:	3 781 642	3 921 393	3 875 650	3 985 846
	(68 345 166.0)	(105 214 779.0)	(114 622 029.1)	(115 351 558.9)
In the current year	634 684	706 306	720 273	750 373
	(14 695 504.0)	(6 163 296.0)	(20 460 108.6)	(16 517 830.0)
4. Land sale/purchase by individuals and legal entities	378 215	400 075	405 670	473 190
	(293 955.0)	(467 686.0)	(560 285.5)	(1 067 302.6)
5. Gifted	31 824	43 437	49 715	73 334
	(57 528.0)	(70 355.0)	(126 596.4)	(335 042.2)
6. Inherited	147 653	165 847	162 151	218 244
	(133 820.0)	(524 352.0)	(336 091.7)	(596 197.3)
7. Pledged	7 479	14 388	25 907	30 024
	(16 959.0)	(169 437.0)	(198 856.0)	(416 637.0)
Total transactions made by individuals and legal entities	565 171	623 747	643 443	794 792
	(502 261.0)	(1 231 830.0)	(1 221 829.6)	(2 415 179.1)
Total transactions with regard to all existing leases (accumulated total), including	4 346 813	4 545 140	4 519 093	4 780 638
	(68 847 427.0)	(106 446 609.0)	(115 843 858.7)	(117 766 738.0)
Transactions within	1 199 855	1 330 053	1 363 716	1 545 165
Current year	(15 197 765.0)	(7 395 126.0)	(21 681 938.2)	(18 933 009.1)

Source: Federal Service of State registration, Inventory and Mapping “Rosreestr” data.

The highest land prices are formed near the major centers. However, the information on land plots, as defined in the contracts of the land sale does not always correspond to actual market prices. As a rule, according to the authors of the State (National) Report on the Status and Development of Land in the Russian Federation in 2008"[1], the prices specified in the contracts for land sales are underestimated, and sometimes standard indicators of the land price of 1992-1993 are used, as well as legally established prices for land owners of buildings, structures and facilities located on the land. ***Table. 5*** shows the average prices of the state and municipal lands as of the result of sales in 2008.

Mortgage of land in 2008 in the turnover of land in private ownership amounted to 3.8% of the total number of transactions and 17.25% of the area. In 2007 – 4.03% of the number of transactions and 16.27% of the area.

The number of transactions secured by land in 2008 increased by 15.8% as compared with 2007, and the increase in the area of mortgaged land plots was more than doubled (***Fig. 1***).

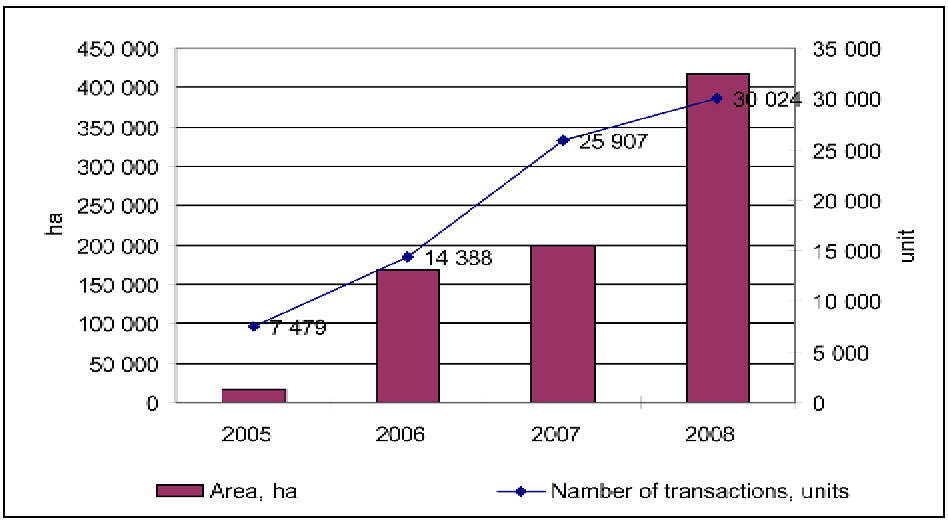
[1] "The National report on the status and development of lands in the Russian Federation in 2008." Ministry of Economic Development, Federal Agency for Real Estate Cadastre, Rosnedvizhimost, 2008, Federal State Unitary Enterprise "FCC Earth ", 2008.

Table 5

Average Prices for State and Municipal Land Sold to Individuals and Legal Entities in the Russian Federation in 2008, RUR /sq. m and an Increase in Average Prices in 2008 as Compared with the Preceding Year,%

Federal regions of the Russian Federation	To individuals and associations thereof for:				To legal entities for industrial use and other targeted purpose		Farmers, other agricultural enterprises	
	For individuals and associations thereof for housing construction		Individual household farming, gardening, and husbandry					
	In settlements	Outside settlements	In settlements	Outside settlements	In settlements	Outside settlements	In settlements	Outside settlements
Russian Federation	118.96	8.92	11.93	5.62	46.5	6.96	29.92	1.42
2008/2007	3.8	1.4	1.9	0.8	0.8	0.4	8.4	1.6
Central Region	72.29	7.72	16.22	8.7	47.27	16.22	65.84	0.85
2008/2007	1.3	1.0	1.1	0.7	0.8	0.6	65.2	0.5
North-West Region	604.5	9.29	41.39	9.53	32.62	4.91	3.95	2.35
2008/2007	44.4	2.6	11.5	2.8	0.6	0.5	1.3	0.9
Southern Region	129.94	176.16	21.3	1.94	85.06	4.67	6.37	0.47
2008/2007	3.2	X	4.2	2.0	1.7	0.3	0.7	0.1
Volga Region	23.68	8.56	5.09	9.69	40.44	3.21	5.27	2.75
2008/2007	1.4	1.2	1.0	1.4	0.6	0.8	1.9	10.2
Urals Region	16.62	0.72	1.32	0.54	28.79	1.21	1.89	0.05
2008/2007	0.5	X	0.8	0.9	1.0	0.2	2.1	0.0
Siberia Region	43.12	0.41	5.11	7.01	42.5	6.48	0.49	1.49
2008/2007	2.0	0.2	2.9	4.4	0.8	2.2	0.3	3.2
Far East Region	11.38	0.1	3.34	0.1	24.38	1.36	0.1	0.03
2008/2007	1.7	0.1	1.7	1.4	1.3	0.2	0.0	3.0

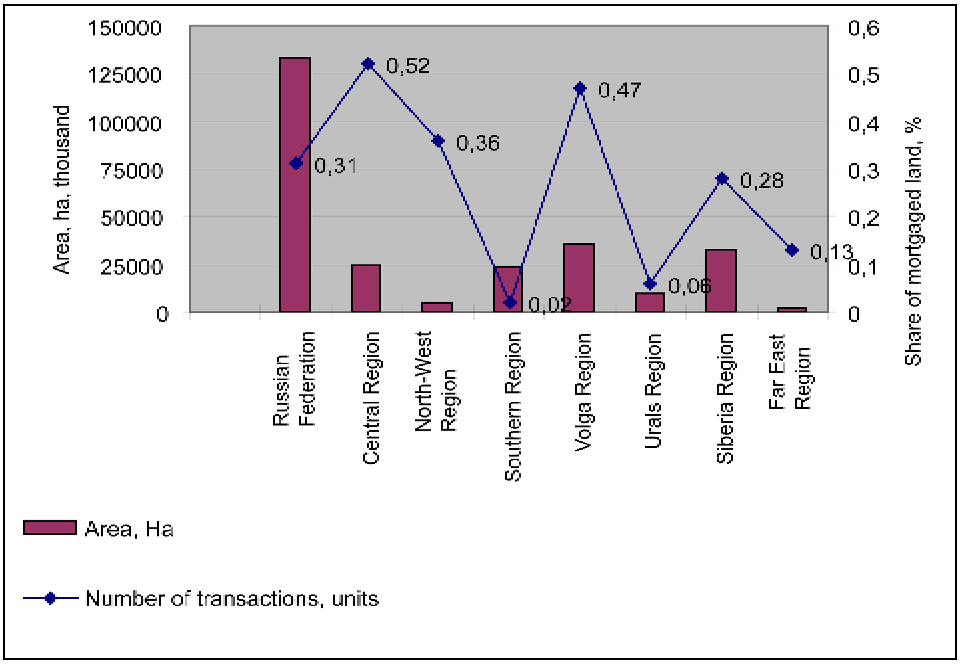
Source: Federal Service of State Registration, Inventory and Mapping ("Rosreestr") data



Source: Federal Service of State registration, Inventory and Mapping ("Rosreestr") data

Fig. 1. Dynamics in the Land Pledges

In 2008, the area of mortgaged land plots in the total area owned by individuals and organizations in Russia made on average 0.31%, varying from 0.02% in the Southern Federal District to about 0.52% in the Central Federal District (*Fig. 2*). While the bulk of the mortgaged land (85.5%) is agricultural land (356,020.7 hectares), they account only for 4.7% of mortgage contracts for land (1403 units). The average area of the mortgaged land for agricultural purpose is 253.7 hectares, and the average area of the mortgaged land plot from the lands of other categories is 2.12 ha.



Source: Federal Service of State registration, Inventory and Mapping “Rosreestr” data

Fig. 2. Land Mortgage in Federal Regions of the Russian Federation in 2008

Changes in the state system of registration of immovable property rights and transactions, including the registration of mortgages, based on the law as amended in 2004, have been continued in the reform of the entire system of registration of real property and registration of rights thereto. In the end, the Government of the Russian Federation, in accordance with Presidential Decree of 25 December 2008, on June 1, 2009 adopted a resolution № 1847 "On the Federal Service of State Registration, Cadastre and Mapping (Rosreestr). According to the Resolution, the Federal Service, along with the implementation of state registration of rights for immovable property and transactions with it and state cadastre maintaining state registries of: cadastral engineers, self-regulating organizations of appraisers, arbitration managers and self-regulating organizations of arbitration managers, as well as supervision of self-regulatory organizations compliance with the relevant federal laws and other legal acts regulating their activity. Rosreestr has the functions of state land and geodetic control, for the land evaluation and monitoring and land monitoring. The Service provides licensing of geodesic and cartographic activities, is the authorized body in terms of geographic names, and is monitored by the RF Ministry of Economic Development.

On September 14, 2009 the RF Government adopted Resolution № 732 "On maximum fees to be charged by agencies for issuing of extracts from accounting and technical documents,

statements on buildings, structures, premises or on the unfinished construction, state technical registration of which was made before the day of entry into force of the Federal Law "On National Real Estate Cadastre" or in the transitional period of its application".

The State Duma passed the law that extends the "country house amnesty" for another five years until March 1, 2015.

5.7.2. Russian Housing Market in 2009: from the Crisis Downfall to Stagnation

The situation in the Russian housing market in 2009, like in other sectors of the economy was dependant on the highly negative dynamics of macroeconomic and financial indicators, which has gained force since the fall of 2008.

First of all, it is worth noting a large external debt of Russia, which by the beginning of October 2008 reached more than 540 billion dollars (43% of GDP)[1]. It was mainly due to the receipt of relatively cheap and "long" credits abroad by the Russian banks and companies of the real sector (including a significant share – by the developers). In view of the global financial crisis, since spring-summer 2008, foreign banks have stopped lending and restructuring the debts of Russian borrowers. In August and September there began a liquidity crisis in the banking system and investment in construction was suspended. At the same time lending to the population, primarily mortgage was sharply reduced.

Since September 2008, there was observed an increasing decline in real monthly disposable income. Outlined in 2009 revenue growth has not yet inspired the population to spend savings, as the people did not have enough confidence in the stability of the economic situation. According to the surveys conducted by the State Statistics Service, the share of respondents who make savings in order to purchase real estate, which was 23-25% in the I-III quarter of 2009, in the IV quarter exceeded 28% (against 15.6% in the last quarter of 2008)[2].

Therefore, an accumulation of deferred demand is taking place in the housing market, and the transfer of the potential financial reserve to the real market depends not only on the general economic situation, but also on internal factors of the real estate market.

Secondary housing market: the major results of the year[3]

[1] Financial crisis in Russia and in the world/ Ed. E.T.Gaidar. M., Prospect, 2009, p. 155.

[2] Socio-economic situation of Russia, 2009, M., Russian Statistical Service, p. 257.

[3] All estimates were performed by the author basing on monthly data on the average unit price of housing market offers in the cities of Russia, presented by RGR certified real estate market analysts V.M. Lutskov (ASC holding "Miel"), S.G.Sternik (LLC Sternik's Consulting), independent analysts A.G.Beketov, A.Y.Sapozhnikov (Moscow and Moscow region), S.V.Bobashev, "Bulletin of Real Estate" (St. Petersburg), M.A. Khorkova, A.A.Antasyukom, G.T.Tukhashvili (RITS UPN, Ekaterinburg), A.V.Derbusaliev, "ISC" Volga - Group "(Samara), A.M.Cheremnikh, MC ACCA Story" (Izhevsk), A.A.Stepanova, SUN "Expert" (Ufa), N.N.Afanasyeva, "Adalyn Examination of property" (Yaroslavl), E.A.Ermolaeva, RID Analitics (Novosibirsk, Kemerovo, Barnaul, Krasnoyarsk), V.M.Troshina, "Information-Analytical Centre BROCK" (Tyumen), A.M.Chumakov, "Title ", G.V.Pivovarova, " Dong-NT ", E.A.Proskurin, YUGRO (Rostov-on-Don), E.D.Epishin, Yu.V.Epishin, "Kama Valley" (Perm), V.M.Kaminsky, TITAN (Tver), G.N.Zyryanov, "KuzbassInvestStroy" (Kemerovo), N.I.Kovalchuk, RC "Service Real Estate" (Chelyabinsk), S.V.Taruta, “Magazine Real Estate" (Omsk), M.Yu.Savina, "Press and Information Agency" (Ryazan), N.A.Yarsina, "Center for Real Estate" (Ulyanovsk), A.V.Trushnikova, "B.I.N.-Ekspert" (Sterlitamak), G.U.Eidlina, "Realty" (Chakhty).
The information was presented by analysts in the currency of nomination at the market of relevant city. M.V.Preminina, graduate student in “Economics and Management of Urban Construction" Department,GV Plekhanov REA took part in the estimates.

Before the analysis of price dynamics in the Russian housing market in 2009, it should be reminded that in 2007-2008 nearly in all cities in Russia there was an increase in prices, especially in dollar terms, and herewith, after the phase of stabilization, from the end of 2007, average unit bid price continued to grow, having reached a historical peak in September-November of 2008.

It should be noted that in recent years, due to the continued RUR strengthening, a gradual transfer to ruble denomination was noted at the housing markets, and by the end of 2007, all cities, including the historically established since the 1990's area of dollar-denominated prices (Moscow and Moscow region, St. Petersburg), started to nominate prices in local currency. This fact largely affected the behavior of buyers and sellers during the crisis (we would like to remind, that during the 1998 crisis, this behavior was totally different in cities with the ruble- and dollar-denominated prices). Remarkably, during the current crisis there was no reverse transfer to dollar denomination of prices in the markets (with the exception of a small elite housing segment). In this connection, recalculation of prices in dollar equivalent at the current rate of the ruble against the dollar is given only for reference.

Since the end of 2008 a decline was started in housing prices denominated in rubles and their dollar counter value. In some cities (Ekaterinburg, Izhevsk, Ufa) ruble prices started to decline since spring of 2007, but their dollar equivalent continued to grow until autumn of 2008. The most acute phase of the downfall in prices continued until May of 2009, after which the decrease in ruble prices continued at a slower pace, and by the end of the year virtually stopped in many cities. The dollar-denominated prices, both due to the fall of the ruble prices and due to the devaluation of the ruble fell down much more by May, but then, in view of the slowing of the ruble prices decline and some strengthening of ruble exchange rate that took place in line with minor variations within an established by the RF Central Bank range, got practically stabilized.

Overall, as of the 2009 results, the downfall in prices at the housing market was country-wide.

As follows from the data of *Table 6*, the group leaders in the depth of the prices downgrading in the secondary market (from 20% to 30%) includes Izhevsk, Samara, Moscow region, Novosibirsk, Kemerovo, Tver, Perm, Chelyabinsk and Krasnoyarsk. As opposed to them, in Ulyanovsk prices grew by 3.6% within the year, while in Ryazan prices fell only by about 5%. In the majority of cities, presented in *Table 6*, Including Moscow and St. Petersburg, the downfall was from 13% to 20%.

It can be stated that at the end of 2009 prices, despite the occurred downfall, as a rule were at a higher level than at the end of 2006. The most significant price growth was observed in Shakhty city (more than twice), Ulyanovsk and Ryazan (by 36-37%), Krasnoyarsk (by 1/3). In Novosibirsk and Tyumen, the price growth did not exceed 5%. Exceptions to this trend were Yaroslavl, where the average unit price offers of apartments in December 2009 was 10% lower than in December 2006, Ufa (by 14.3% lower), Yekaterinburg (by 16.5% lower) Izhevsk (by 31.2%). At the same time, the vast majority of cities the prices by the end of 2009 fell back below the level of late 2007. The only exceptions are Moscow and Moscow Region, St. Petersburg, Ulyanovsk and Shakhty city .

Table 6

Dynamics of the Average Unit Bid Price of Apartments in the Secondary Housing Market within 2006-2009

City (region)	RUR thousand/m^2				Index			
	December 2006	December 2007	December 2008	December 2009	December 2007/ December 2006	December 2008/ December 2007	December 2009/ December 2008	December 2009/ December 2006
Moscow	126.93	133.38	186.8	153.0	1.051	1.401	0.819	1.205
St. Petersburg	68.17	77.76	101.3	81.1	1.141	1.303	0.801	1.190
Moscow Region	66.3	62.13	91.0	71.5	0.937	1.465	0.786	1.078
Ekaterinburg	63.5	64.1	62.2	53.0	1.009	0.970	0.852	0.835
Samara	…	59.9	64.4	51.0	…	1.075	0.792	…
Izhevsk	48.4	45.4	41.7	33.3	0.938	0.919	0.799	0.688
Ufa	48.3	45.2	50.2	41.4	0.936	1.111	0.825	0.857
Yaroslavl	46.2	46.9	51.6	41.6	1.015	1.100	0.806	0.900
Novosibirsk	43.59	59.0	59.4	45.5	1.354	1.007	0.766	1.044
Tyumen	42.0	53.7	52.5	43.1	1.279	0.978	0.821	1.026
Rostov-on-Don	41.093	52.0	56.4	48.4	1.265	1.085	0.858	1.178
Perm	37.61	55.8	58.2	42.4	1.484	1.043	0.729	1.127
Twer	36.5	49.4	62.6	46.1	1.353	1.267	0.736	1.263
Kemerovo	36.0	45.8	53.0	40.3	1.272	1.157	0.760	1.119
Krasnoyarsk	30.29	54.3	57.0	40.3	1.793	1.050	0.707	1.330
Chelyabinsk	…	…	50.5	36.8	…	…	0.729	…
Omsk	27.82	44.2	40.0	33.4	1.589	0.905	0.835	1.200
Barnaul	…	…	39.8	34.4	…	…	0.864	…
Ryazan	26.02	36.8	37.4	35.4	1.414	1.016	0.947	1.360
Ulyanovsk	22.58	30.6	29.9	31.0	1.355	0.977	1.037	1.373
Sterlitamak (Bash-kortostan)	22.08	26.3	28.1	22.9	1.191	1.068	0.815	1.037
Shakhty (Rostov Region)	12.6	22.1	31.1	27.0	1.754	1.407	0.868	2.143

In dollar terms price reduction as of the year results made less than 3% in Ulyanovsk, nearly to 34% in Krasnoyarsk (in Moscow and St. Petersburg 23% and 25% respectively).

Turning to the analysis of real housing prices (excluding the impact of inflation), it is necessary to remind the dynamics of basic macroeconomic indicators. In the past year, consumer prices rose by 8.8%. The value of the index of real (regardless inflation) housing prices index (IGS index) as per results of 2007, 2008, 2009 and 2007-2009 as of December 2006 for a sample of cities is shown in *Table. 7*.

As follows from *Table 7*, in 2009 the decline in real housing prices by more than 1/5 was countrywide, with the exception of Ulyanovsk (less than by 5%) and Ryazan (by 13%). The group of cities with the highest (30-35%) decline of housing prices (with regard to inflation in the consumer market) included Krasnoyarsk, Chelyabinsk, Perm, Tver, Kemerovo.

If we review a three-year period of 2007-2009, during which consumer prices rose by 37.9%, the real price of housing fell to a greater extent in Izhevsk (by 50%). More than by 1/3 it fell down in Ekaterinburg, Ufa, Yaroslavl.

As opposed to that, there was a group of cities with relatively low housing prices: Shakhty city, where the real price of housing has grown in three years by more than one 1.5 times, as well as Ulyanovsk and Ryazan, where it has remained almost unchanged. Similar result was observed in Krasnoyarsk, where housing price with regard to inflation at the consumer market has declined by only 3.5%.

As to the two capitals, in Moscow and St. Petersburg real price of housing has decreased by 13-14%.

The logical consequence of falling housing prices and a crisis in the economy in general was the reduction of activity in the real estate market, what is well illustrated by data from Moscow and Moscow Region in 2008-2009.

Table 7

Indices of Nominal and Real Prices for Housing in 2006–2009.

City (region)	Nominal price index				IGS Index			
	December 2007/ December 2006	December 2008/ December 2007	December 2009/ December 2008	December 2009/ December 2006	December 2007/ December 2006	December 2008/ December 2007	December 2009/ December 2008	December 2009/ December 2006
Moscow	1.051	1.401	0.819	1.205	0.939	1.237	0.753	0.874
St. Petersburg	1.141	1.303	0.801	1.190	1.020	1.150	0.736	0.863
Moscow Region	0.937	1.465	0.786	1.078	0.837	1.293	0.722	0.782
Ekaterinburg	1.009	0.970	0.852	0.835	0.902	0.856	0.783	0.606
Samara	…	1.075	0.792	…	…	0.949	0.728	…
Izhevsk	0.938	0.919	0.799	0.688	0.838	0.811	0.734	0.499
Ufa	0.936	1.111	0.825	0.857	0.836	0.981	0.758	0.621
Yaroslavl	1.015	1.100	0.806	0.900	0.907	0.971	0.741	0.653
Novosibirsk	1.354	1.007	0.766	1.044	1.210	0.889	0.704	0.757
Tyumen	1.279	0.978	0.821	1.026	1.143	0.863	0.755	0.744
Rostov-on-Don	1.265	1.085	0.858	1.178	1.130	0.958	0.789	0.854
Perm	1.484	1.043	0.729	1.127	1.326	0.921	0.670	0.817
Twer	1.353	1.267	0.736	1.263	1.209	1.118	0.676	0.916
Kemerovo	1.272	1.157	0.760	1.119	1.137	1.021	0.699	0.811
Krasnoyarsk	1.793	1.050	0.707	1.330	1.602	0.927	0.650	0.964
Chelyabinsk	…	…	0.729	…	…	…	0.670	…
Omsk	1.589	0.905	0.835	1.201	1.420	0.799	0.767	0.871
Barnaul	…	…	0.864	…	…	…	0.794	…
Ryazan	1.414	1.016	0.947	1.360	1.264	0.897	0.870	0.986
Ulyanovsk	1.355	0.977	1.037	1.373	1.211	0.862	0.953	0.996
Sterlitamak (Bashkortostan)	1.191	1.068	0.815	1.037	1.064	0.943	0.749	0.752
Shakhty (Rostov Region)	1.754	1.407	0.868	2.143	1.567	1.242	0.798	1.554

According to the Federal Registration Service (FRS) of Moscow, in 2008 the number of sale-purchase transactions with apartments in the capital has reduced as compared with 2007 by more than 15%, to 65.12 thousand and 76.82 thousand respectively. The number of transactions made in the I-st quarter of 2009 (8993), was by 24% less than in 2008, and in April (4757) – almost by 30%. Further decline in the volume of transactions has stopped.

In general, according to the Information of the Federal Service for the State Registration, Inventory, Cadastre and Mapping (Rosreestr) for Moscow, the number of sales-purchase transactions of apartments concluded in 2009 has decreased by 14.5% as compared with 2008 and by 27.5% against the similar indicator of 2007, accounting to 55.68 thousand. In December 2009 there were by 34% more transactions than in December 2008, but by 16.3% fewer transactions than in December 2007.

The crisis blow was much stronger to the mortgage segment of the capital housing market. The number of sales-purchase transactions in housing with mortgages in the I-st quarter of 2009 was by 62-63% lower than the similar indicators in 2008 and 2007. The share of mortgage transactions, which reached 28-30% in Moscow on the eve of the crisis, as well as in the IV quarter of 2008, has decreased to minimum values (1.5-2%) in March-April 2009. In the future, in the second half of 2009, there was a steady increase in the number of mortgage

transactions and their share in the total number of transactions with housing in December reached 16%.

A somewhat different trend in activity was observed in the housing market in the suburbs of Moscow.

According to the Federal Registration Service (FRS) of Moscow Region, the number of sales-purchase transactions with apartments in 2008 has increased considerably as compared with 2007, by more than 48%, having made 53.19 thousand and 35.85 thousand respectively. But in the IV quarter of 2008, the volume of transactions decreased as compared with the same quarter of previous year by 20% - from 15.11 thousand to 12.10 thousand (not so much as in Moscow). As a result of the downfall, occurred later, in the I-st quarter of 2009 the market "reached the bottom" and later the number of transactions each quarter was growing, gradually approaching to the previous year. If in the I-st quarter of 2009, the number of transactions (6,753) was nearly half less than in the relevant period of 2008, in the second quarter (9,974 transactions) and in the third quarter (11,558 transactions) the backlog was about 29% and 19% respectively. In the fourth quarter of 2009 the number of transactions (16,516) exceeded the indicator of the same quarter of 2008 by 36.5%, being higher than that in 2007. The total number of transactions in 2009 amounted to 44.80 thousand, which is by 15.8% less than in 2008, but by 1/4 more than in 2007.

The number of sale-purchase transactions in housing with a mortgage in the Moscow Region in the I quarter of 2009 (674) was lower than the relevant indicators of 2008 and 2007 by 74% and by 12% respectively, which far less than the level of decline in the number of transactions in the capital as compared with the beginning of 2007, but more than the decrease in the number of mortgage transactions in Moscow in the I quarter of 2009 when compared with I quarter of 2008. However, in the IV quarter of 2009, it exceeded the similar indicator of 2008 by 38% and reached the level of IV quarter of 2007. The share of mortgage transactions reached in the III quarter of 2008 25%, having decreased in the I quarter of 2009 to 10%, but in the IV quarter it has grown to 18.7%.

In St. Petersburg, the volume of registered sales-purchase transactions in housing declined in 2009 to 16%. In the Rostov Region the market turnover fell down by 25%, in Nizhny Novgorod - by 35%, in the Far East Region – by 16%. In Perm Region a growth of 2% was recorded.

In general, in 2009 Federal Service for the State Registration, Inventory, Cadastre and Mapping has recorded in Russia 1.943 million transactions in housing by individuals (including exchange transaction) against 2.367 million in 2008 and 2.326 million in 2007. Therefore, the decline in 2009 amounted to about 18 % as compared with 2008 and 16.5% against 2007.

Reduced turnover in the market of apartments was accompanied by changes in other market indicators.

Total offer in the Moscow market started to grow since September 2008 and has grown from 20-25 thousand to 35-40 thousand in December. In December of 2008 - January of 2009 as a result of the outbreak of ruble devaluation and falling prices (in dollar terms) the sellers left the market, and the volume of renewed offers dropped down from 10-12 thousand to 2.4 thousand. In February-March, after the devaluation of the ruble stopped, the sellers started to come back to the market in the hope they can save the proceeds from the sale of housing, as well as the buyers, who accumulated ruble equivalent of their dollar savings and did not have further inflationary expectations.

The period of exposure of apartments on the secondary housing market of Moscow from September 2008 to January 2009 increased from 50-55 days to 104 days, but by April it was reduced to 79 days.

Therefore, in complete accordance with the dynamics of macroeconomic and financial indicators, by summer of 2009 the acute phase of the crisis on the real estate market completed and there appeared signs of stabilization in the secondary housing market of Moscow (the offers volume reached the average rate, nearly 25-30 thousand of apartments, which increases during periods of low demand up to 35-40 thousand or more. The number of transactions ceased to drop and the term of apartments exposure in the market started decrease), which led to the slowdown in the fall of the ruble prices, and in line with the trend of ruble strengthening - to the positive dynamics in housing dollar prices.

Situation in the Primary Market

Analyzing the primary housing market during the crisis, it can be noted that in Moscow the demand in it started to decline since spring of 2008 and the end of the year decreased to minimum values.

The volume of offer, due to slowdown in construction rates was declining in the past three years, and in 2007-2008 it was not only due to stagnation and reduction the total volume of housing construction, but also due to the retargeting of the economy class new buildings mainly for the implementation of various social programs. As a result, by September 2008 the volume of offer in the market was below the level of demand. In principle, such situations have occurred before, which in summer of 2008 gave hope for relatively smooth transition to the market stabilization scenario of 2007 or at worst of 2004.

As a result, according to the Analytical Consulting Centre MIEl, sales in new buildings in Moscow declined in general from 2.43 million square meters (34.2 thousand apartments) in 2005 to 1.94-1.95 million square meters (27.3-27.5 thousand apartments) in 2006-2007. However, the sales of mortgages were steadily growing from 0.31 million square meters (4.4 thousand apartments), or 12.9% of the total scope in 2005 to 0.58 million square meters (8.1 thousand apartments), or 29.5% of the total in 2007. In 2008, total volume of sales fell down by nearly 60% to 0.8 million square meters (11.3 thousand apartments), including the sales of 0.22 million square meters in mortgage (3.1 thousand apartments), or 27.6% of the total volume.

Thus, the decline in sales in the housing market started with the primary market, what happened due to the buyers' understanding of the high risk of such purchases, based on the slowdown in construction rates and the threat of freezing construction projects, what inspired the inflow of buyers to the secondary market. However, from the summer-autumn the banks started tightening mortgage lending terms up to total suspension thereof. There was almost complete suspension of sales in the market of new buildings and reduction of their volume in the secondary market. The resumed devaluation of the ruble against the dollar has provoked uncertainty among the population and pushed away from the market not only sellers, but the buyers as well. In early 2009, those processes were slowed down, and even some positive signs were noted.

In contrast to the sales of apartments in the secondary market, the market sales of apartments in new buildings (equity rights) in Moscow, the average (ruble) prices have decreased slightly in November-December 2008, but then returned to the level of September-October. In this case, not agreeing to decrease the offer prices, developers in the situation of the falling

demand were ready for unprecedented individual discounts. When converted into dollars, with ruble devaluation, the price equivalent dropped before February 2009, then began to upgrade gradually along with ruble strengthening. Only from May ruble price for the new buildings started to decline, having reached RUR 181 thousand/ sq. m.

Developed within the last 3-4 years the excessive average unit prices in the primary market over the prices of the secondary market (in ruble terms) at the end of 2009 amounted to 18.3%. Herewith, the reduction from historic peaks in April 2009 (204 thousand rubles/sq.m) was approximately twice less (by 11.3% against 20.1% in the secondary market as compared with historic peaks in November, 2008).

However, in contrast to Moscow, in the other cities, the average unit prices in the secondary housing market have always been higher than in the primary market.

In Moscow Region the average bid price in the primary market continued to grow, having reached the historic peak of 70.1 thousand rubles per sq. m in February 2009, while in the secondary market occurred in November 2008 (93.2 thousand rubles per sq. m). By December, prices in the primary market fell down to 63.5 thousand rubles per sq. m, and in the secondary market - up to 71.5 thousand rubles per sq. m (the difference was 12.6% in favor of the secondary market). Therefore, the depth of the downfall in prices was about 2.5 times higher (23.3% vs. 9.4%).

In Perm, in 2007, the average unit price of the offers in primary and secondary markets were equal, but by autumn of 2008 the gap was 13-14% in favor of the secondary market, but then prices in the primary market have fallen by December 2009 to 37 thousand rubles/sq. m (by 33% as compared with the historical maximum of 55.49 thousand rubles per sq. m in March 2008), and in the secondary market - up to 42.4 thousand rubles per sq. m (by 31% versus the historic peaks of 61.4 thousand rubles per sq.m in September 2008) and the gap was 14.6%.

In Novosibirsk in December 2009 prices in the primary market amounted to 40.4 thousand rubles per sq. m, having declined to historical maximum in March 2008 by 18,1% (to 49.3 thousand rubles per sq. m). Prices in the secondary market have fallen from a peak of 65.1 thousand rubles per sq. m in August 2008 to 45.5 thousand rubles per sq. m, or 30,1%. The gap amounted to 12.6%.

In Izhevsk the offer price in the primary market remained stable until autumn 2008 at the level of 43-44 thousand rubles per sq. m (with a historical peak of 45 thousand rubles per sq. m in August 2008), while in the secondary has prices have declined since February 2007, when the historical maximum was recorded at the level of 51.8 thousand rubles per square m. At that time, the gap in favor of the secondary market amounted to 26.4%, but then it decreased to minimum values within the one-year term from October-November 2007 (in some months the price of the primary market were even getting ahead). After an insignificant increase in the difference between the prices in the secondary and primary market in November-December 2008, prices were declining almost simultaneously, having practically matched in summer of 2009 (34-35 thousand rubles per sq. m). In subsequent months, with stabilization of secondary market prices at the level of 33 thousand rubles per sq. m (i.e. 35.8% as compared with the historical maximum), prices in the primary market continued to decline. As a result, in late 2009 they fell down to 31 thousand rubles, down from the historic peak by 31.1%. Therefore, the excess of secondary market prices over the prices of the primary market amounted to 7.3%.

In Omsk, from the beginning of observation in the primary market (January 2009) the average unit price proposal was 31.7 thousand rubles per sq. m against 42.2 thousand rubles per sq. m in the secondary market (the gap was 1/3), but later the prices only declined or stagnated, having reached the value of 27.5 and 33.4 thousand rubles per sq. m, respectively by the end of the year (the gap was 21.5%).

Thus, it is clear from the above examples that the decline in prices versus the historic peaks in the secondary market, as a rule, was higher than in the primary market (Moscow, Moscow, Novosibirsk, Omsk). The exceptions (Perm, Izhevsk) are examples of when a drop in prices in the secondary market is only slightly below that in the primary market. Herewith, the price gap between secondary and primary markets in late 2009 varied in a wide range from 7% (in Izhevsk) to 21.5% (in Omsk) in favor of the secondary market, with an apparent loss of this trend in Moscow, where prices of the primary market exceeds the prices in the secondary more than by 18%.

Currently here is no data on sales in new buildings. According to expert estimates, in the cities, where developers (including those under the intensive influence of federal and regional authorities) have reduced the offer price in the primary market, the stagnation of sales overcome. In Moscow, where such decline did not occur, the increased activity of buyers in the market so far is expressed only in the increased number of calls and visits to the departments of sales of real estate agencies, but the real sales are executed in a limited scope only with the specific objects and with a high degree of preparedness to a significantly adjusted price.

Dynamics of Housing Construction Commissioning

In the past 2009, for the first time since 2000 in Russia have been observed reduced volumes of housing construction. Herewith, the depth of incidence (6.7%) has exceeded the relevant value of 2000, when the construction industry experienced an annual lag due to the impact of 1998 crisis. Nearly the same decline was observed in 1994 (6.2%) and 1998 (6.1%). As per the preliminary data in 2009 there were commissioned 701.3 thousand apartments with the total area of 59.8 million square meters (*Table 8*).

Table 8

Residential Buildings Commissioning in Russia within 1999-2009

Year	Total area, sq.m, mln	Growth rates, %	
		Against the preceding year	Against 2000
1999	32.0	104.2	105.6
2000	30.3	94.7	100.0
2001	31.7	104.6	104.6
2002	33.8	106.6	111.5
2003	36.4	107.7	120.1
2004	41.0	112.6	135.3
2005	43.6	106.3	143.9
2006	50.6	116.0	165.7
2007	61.0	120.6	201.3
2008	64.1	104.6	210.6
2009	59.8	93.3	197.4

Source: Russian Statistical Yearly Report. 2007: Stat. Report/Russian Statistical Service, M., 2007, c. 507; Socio-economic situation in Russia, 2009, M., Social and Economic Situation in Russia, M., Russian Statistical Service, pp. 86-87, authors' estimates.

The main failure in the volume of housing construction occurred in the country in the IV-th quarter of 2009. Before that time quarterly figures eventually did not differ from those achieved a year earlier, what was based on smooth transition of available construction reserves.

Only at the end of the year one could see the impact of slow-down of the buildings construction, freezing of a number of construction projects and investment collapse, which took place in 2008. One can expect that this effect will be seen to the full extent in 2010-2011.

Consequences of financial and economic crisis, provided the most negative impact on the activities of developers, have been partially damped by individual housing construction, which has demonstrated positive dynamics in contrast to the construction industry in general. The growth of the housing construction performed by individuals at their own and borrowed funds amounted to 4.3% by 2008, and as a result, the share of such housing in the total construction increased to 47.7% against 42.6% in 2008, which is the maximum indicator for the entire period of 2000-s.

Despite the apparent decline in housing construction, in majority of the Russian regions, as per results of 2009, the volume of housing construction still increased, but among the 40 regions where there was a decrease, there were many areas, the centers of which were city-millionaires (Tatarstan, Samara, Volgograd , Rostov Region, Perm, Sverdlovsk, Chelyabinsk, Novosibirsk, Omsk Region), as well as Moscow and St. Petersburg. In this category there those regions which demonstrated better performance, i.e. Nizhny Novgorod region and Bashkortostan, where one could observe increase or in housing construction volume and preservation of the previous levels respectively.

Table 9 represents groups of regions with the highest growth rates in housing construction and with the deepest downfall by more than 10% in the past 2009.

Table 9

Housing Construction in the Russian Regions in 2009 (Sorted in the Order of Completion)

Regions with positive growth	Growth by the relevant period of preceding year, %	Regions with negative growth	Growth by the relevant period of preceding year, %
Chukot Autonomous Area	2.6 times	Rostov Region	–10.1
Adygea	+ 48.6	Tyumen Region	–10.4
Chechnya	+ 30.1	Orel Region	–12.4
Kalmykia	+ 26.9	Chuvashia	–12.9
Tver Region	+ 26.9	Volgograd Region	–12.9
Pskov Region	+ 25.9	Novosibirsk Region	–12.9
Astrakhan Region	+ 25.0	Krasnodar Territory	–13.8
Khabarovsk Territory	+ 22.7	Moscow	–17.2
Jewish Autonomous Region	+ 22.3	Tomsk Region	–17.2
Kostroma Region	+ 18.7	St. Petersburg	–18.9
Leningrad Region	+ 13.5	Perm Territory	–18.9
Tuva	+ 13.0	Amur Region	–19.3
Dagestan	+ 11.9	Buryatia	–20.4
Karelia	+ 11.7	Voronezh Region	–22.1
		Kirov Region	–22.3
		Krasnoyarsk Territory	–22.8
		Samara Region	–22.9
		Kaliningrad Region	–24.2
		Arkhangelsk Region	–25.6
		Chelyabinsk Region	–29.3
		Nenets Autonomous District	–33.5
		Komi	–37.8
		Omsk Region	–40.4
		Yamalo-Nenets Autonomous District	–43.1
		Ingushetia	–46.1

Source: On housing construction in 2009, www.gks.ru.

We would like to note, that the majority of regions where there was a marked growth in the volume of housing construction, are relatively small in population, where the volumes of hous-

ing construction are small in absolute terms. Besides, there are no cities with population exceeding one million of people and individual housing construction prevails in the total area of the completed construction.

As for the other group, it is worth noting a continued decline in housing construction in Moscow, although at a somewhat slower rate (over 17% against almost 1/3 in 2008). According to preliminary estimates of housing construction in Moscow as of 2009 results are lower than in 1996, and more than 1/3 of the volume of housing constructed in the framework of the city government programs, was performed outside of Moscow (against about 10% in 2005-2007 and more than 20% in 2008). Herewith, in Moscow, against the background of the stagnation observed a year earlier, positive dynamics of housing construction was noted (an increase of 4.5%).

In 2009, the downfall (about 19%) has reached St. Petersburg, which a year ago was among the leaders of growth. It is also worth noting the strong decline in housing construction in Samara (about 23%), Chelyabinsk (more than 29%) and Omsk (over 40%) regions. As compared with 2008, the share of the capital region in the total volume of housing construction in the country (Moscow Region (13.8% versus 12.2%) and Moscow (4.5% versus 5.1%) has insignificantly grown due to the Moscow Region, corresponding to the level of 1999.

Causes of Decline in Housing Construction

In purely quantitative terms, it is possible to assess not in the most pessimistic way the tentative data on the situation in the construction industry as of the outcome of 2009, developed under the influence of the crisis, as compared with the situation in the industry, particularly in the majority of manufacturing industries. The milestones achieved after the commencement of the National Project "Affordable housing", when some of them have been preserved and the volume of completed housing construction were close to the level of 2007, when prices in the housing market got stabilized after two years of “mortgage-oil" growth.

However, there is a possibility of further decline in housing construction in the next two years, as evidenced by the outpacing decline of investment (with regard to the dynamics of GDP) and construction materials output (with respect to the dynamics of the total industrial production), decreased number of construction companies contracts and orders, inevitably raises the issue of internal inherent to the construction, crisis developments.

Even before the second half of 2008, when the Russian economy more and more clearly started to feel the impact of the crisis in the world economy (including the "second wave" of the mortgage crisis in the US, where the growth in the share of overdue credits was accompanied by a decline in housing prices) the downfall in the rate housing construction since 2007 in Moscow and other Russian regions were indicating the trouble in this area.

Specifics of Housing construction and models of its financing became the result from the preceding development of the Russian economy, where since the early 90-s previously dominated public investments in the new construction from the state budget[1] has sharply declined, and the banking system, capital market, institutional investors and even the market as it is were only under formation.

[1] Complemented with the social funds of state enterprises, collective farms and public organizations. A part of the new housing construction was built by the individuals at their own expense and with the help of loans, as well as by housing cooperatives. However, all those sources were complementary.

In such circumstances the only available source of financing for the developers were the resources of citizens possessing them for the purchase of housing, and as a result, there started to develop an Institution of equity financing. This situation has become a significant hindering factor in the further development of the sector. With the establishment of financial institutions, there appeared new sources of funding in the market, and over time their importance is growing. However, until now their equity financing plays a very important role.

Today, there are four sources to raise funds for the housing construction in Russia:

– assets of citizens who have the assets to purchase housing - equity participants (holders);
– assets of large investors;
– assets of the stock market;
– credit assets.

If the development of equity financing in the 90-s was an objective process, in future the companies specializing in residential construction, actually became hostages of that scheme. This can be easily seen by comparing trends in housing market with the development of commercial real estate market. Due to the fact that the purpose of the office and retail buildings imposes their long-term utilization to generate regular income in the form of lease payments, the operators of that sector have not been able in the 90 years to attract easy money like the individuals who wanted to purchase housing facilities.

The work in this market required from the companies to make this segment more attractive to bank crediting, which would impose, first of all, the earliest legalization of cash flow and building of management systems in accordance with international standards of corporate governance. This eventually led to more rapid adaptation of this segment to the market conditions and improvement of its functioning efficiency.

Therefore, as an inheritance, the housing market has received from the 90-s a funding base, in which the key role is played by co-investors and equity participants. However, there were no legal provisions for the transactions of that type. There were no regulations on information disclosure, safeguarding, and most important - on the targeted funds utilization.

Following the entry into force of the Federal Law № 214-FZ dated December 30, 2004 "On Participation in the shared participation in construction of blocks of apartments and other real estate objects and on amendments to some legislative acts of the Russian Federation" on 1 April 2005, the situation in the legal area has changed. The law provisions were intended to recover the imbalance in the distribution of risks, having eliminated the discrimination of investors' rights. The idea was that the Law provisions were to reverse the situation and assist to increase the share of truly market-based funding instruments, providing better protection for the rights of all market participants.

However, the real state of affairs can be estimated only on the basis of statistics. We can compare the information on sources of financing the construction before and after the introduction of the Law[1].

In 2004, even at the earliest stages of the project (working trench) participation of equity investors exceeded 35%, which was higher than the share of bank financing. A comparable share was financed from their own funds. However, given the low standards of control over the targeted utilization of funds and shortage of land, one can assume that in the category of

[1] Housing finance / A.B.Kopeykin, N.N. Rogozhin, A.A. Tumanov, M.O.Yakubov - M.: Foundation "Institute for Urban Economics", 2007.

their own funds there was a substantial share of contributions in other projects, which were used for other purposes. And in the later stages of construction, the share of co-investment did was even prevailing. Based on the data for 2007, it is easy to see that both, the volume of completed construction in natural terms, and the volume of investments in equity financing accounts to nearly 30% of funding for a multi-storey building[1].

Many expert assessments, in particular, experts Foundation "Institute for Urban Economics" (IUE), indicate that after the adoption of the Federal Law on equity participation in the construction, some part of equity participation transactions was legalized, and the other part has change the legal status in order to allow developers to continue to shift much of the construction risk to the co-investors. Experts tend to estimate the true share of equity financing in a residential multi-storey buildings in 70-90%.

So confident dominance of the transitional in its essence funding scheme indicates that the market is not ready yet to accept more civilized instruments.

As to another source of financing, i.e., bank loans, it was hindered by the institutional barriers. Banks actively enjoyed a favorable situation in the housing market, actually applying discriminatory policy to the developers. This can be confirmed by the terms offered by the banks to the potential borrowers, which were significantly worse than the average market terms. While the average interest rate on loans to commercial organizations accounted for 10%, with an average annual rate of refinancing of 10,25% (CBR), the interest rates for construction loans were rarely below 12-15% (IUE).

The rights for the land plot were not regarded by the banks as a possible security for the loan. The situation has not changed much even after the adoption of Land and City-Planning codes. As a result, companies were likely to attract funds under the security of its extraneous assets, nor involved in the project, what expanded the risks, affecting the company in general.

Another disadvantage of the existing system of construction financing was inconsistency of credit arrangement with project financing schemes. No doubt, crediting of a development can not be implemented in the same way as project financing. But the key feature inherited from the project financing is the ability to repay the bulk of the debt only after the object completion. In Russia, the majority of credit are provided under condition of monthly repayment of the basic debt, which implies that a developer has an alternative source of funds. In other words, even the available credits do not relieve developers from the use equity participants' funds.

In such circumstances, bank crediting has taken a very specific place in the market. Since the overall attractiveness of the bank credit are inferior to equity participants' funding, investors do not use bank credits as the main resource for construction. However, bank credits are easier to be obtained. As a result, banks' funds are often used by large companies to address the acute shortage of funds, often occurring due to the misuse of investments, which in particular, leads to the predominance of short-term bank instruments in the market.

An important feature of construction credits is a close monitoring of the banks over the targeted use of funds. There is a number of examples, where embezzlement of borrowed funds to other projects of the developer led not only to the failure of the project, but also to the bankruptcy of the development company. This explains the fact that construction credits are

[1] Note that data for 2007 are not completely comparable with the data for 2004, as they are based on different surveys. 2004 data reflect the structure of financing for a multi-storey residential building, while the 2007 data also include the information on individual housing construction, which makes it necessary to exclude the share of private houses.

granted by parts as per the needs arising in construction project, rather than by lumpsum. Three are three ways to break down credit payments:

1) stepwise method: the funds are disbursed upon completion of certain stages of the object, and in this case the creditor, providing the next tranche, acquires the rights for the finished stage of the object;
2) draft method: the creditor provides the next share of the funds only upon the receipt of confirmation from an architect or a supervisor of the construction;
3) a voucher system: the creditor receives invoices from the subcontractors for actual works performed and provides the necessary funds.

Such a scheme, from the viewpoint of the developer, introduces additional complexity in the management of investment and construction projects.

Along with the rapid growth of the Russian stock market at the beginning of the XXI century Russian construction companies obtained an access to one more source of funding. In the pre-crisis period, corporate bond issues became a widely used form of fundraising. The main reason that inspired the Russian construction companies to take this step, was the situation described above with bank credits. At the beginning of 2008 the there were more than 40 construction companies in the bond market. With the global financial crisis, this factor has contributed to the fact that these companies were in the sector of the highest risk.

Therefore, in the first half of 2008, stability in the financial standing of construction companies has significantly deteriorated. Companies' capital structure in general was satisfactory in terms of the standards of construction industry. But the problem was that too large share of the debt was short-term.

Results of financial analysis imply that in a rapidly growing market and increasing access to bank credits, companies have been actively engaged in development by investing in new projects, neglecting the maintenance of their own financial sustainability.

This phenomenon can be explained by the following features of the Russian housing financing system and institutional factors affecting the market.

- With the rapid growth of the market, companies face the need to rapidly expand their operations. But for this there is a natural restriction, i.e., the land plot for future construction, as well as the complexity of its acquisition. Realizing the importance of this limitation, and understanding that the land for future construction should into regard in advance, the companies put all available funds in new land plots.
- The bulk of the funds is involved by companies from equity investors. At the background of the increasing importance of investment in future projects, the funds of interest holders are being withdrawn from the projects and used for other purposes.
- To avoid the construction suspension and incompliance with liabilities of the interest-holders, developers seek short-term credits from the banks. Credits Loans do not always correspond to the requirements of traditional construction loan. In the event of a possible reservation of a new land plot, the credit funds are also readdressed at the non-targeted application.
- All the housing finance system is inspired by the general optimism in view of rising prices and overall demand for residential real estate. Even bankers share this trend, which improves the availability of credits to the developers.

There should be noted another point that influenced the development of the housing sector in Russia. An important factor and a resource for the construction market is the land. Ever

since the establishment of market relations in Russia the system of land distribution and a lack of legally defined property rights to land plots were hindering factors, leaving a wide area for corruption and bureaucracy.

In the western practice there is a wide-spread scheme, according to which the preparation of the project and acquisition (lease) of the land plot is performed at the expense of the funds of developer investors' funds. Financing of the construction and other costs is made at the expense of borrowed funds. However, in Russia this scheme is difficult to be implemented. As rule, the developer usually does not have sufficient assets to provide them as a loan security: one cannot use the land as a security because property right is not properly registered, the pledge of the objects under construction is difficult, the cost of equipment owned by the developer, according to market experts in average is less than 10% of the value of objects under construction. In such circumstances, the main source of funding are the assets of direct investors, as well as of prospective housing purchasers.

An important factor which hindered the work of both developers in the market and launching of the new projects in 2007-2008, were the results of the revision of the land cadastral value in accordance with the RF Government Decree № 206, dated of April 11, 2006 "On amendments to some acts of the Government of the Russian Federation in view of the improvement of the state cadastre assessment of land plots", which led to the growth of land prices and land rent rates.

Thus, as a result, in Saratov Region the land tax increased on average by 6 times, and land rent - by 15 times, and in some cases, the growth reached 160 times. The land tax rate in Tomsk Region for different categories of land has increased from 2 to 4 times, and in Moscow the growth was about 3 times. This was one of the major additional sources of unprofitability of a large range of construction projects in the situation of financial and economic crisis.

Many experts consider the reason for this excessive growth of the land value in the failures of the applicable methods for its assessment and inappropriate, economically unjustified position of regional and local authorities to the fiscal objectives through the appointment of the maximum of permitted upgrading rates[1]. Thus, in the Sverdlovsk Region the cadastral value of land exceeds on average 5 times of the current average market value of fixed assets located on this land. It turned out that the organization authorized in due time to perform the cadastral land assessment, made more than 4 thousand violations. In Omsk Region there were filed dozens of lawsuits from companies on the revision of the land cadastral value.

As a result, we can conclude that the initial crisis dynamics with a reduction in demand and housing prices was inevitable in the prevailing global environment. But the depth and the scale of the crisis in the market were the results of undeveloped system of funding and institutional environment.

During the global financial crisis the greatest financial difficulties arise in the companies that made large-scale borrowing in foreign markets (promissory notes, bonds, through the IPO).

There is a high probability of bankruptcy for those companies that relied on loans of domestic non-specialized banks, which in the past eighteen months have suspended credit provision to the developers or drastically tightened their terms. Despite the measure, taken by the gov-

[1] This situation is largely a natural consequence of the distinction of powers between different levels of public authorities and the existing system of intergovernmental fiscal relations, which resulted in the maximization of land payments has become a prerequisite for the implementation of the authorities at the local level with their obligations and responsibilities, which is especially important for municipalities.

ernment since autumn of 2008 for the financial support of the banking system, the real sector of the Russian economy still faces great difficulties in the access to credits.

The companies estimating the project budget basing on the outdated expectations of a rapid return on their small investments through selling shares to private investors despite the provisions of the Law on shared participation in construction found themselves in a difficult financial situation.

The companies operating in accordance with the Law are experiencing difficulties in organizing the construction process at an early stage due to re-focusing to project financing from affiliated banks, which later reduces their risks of the falling demand in the market. These companies were able to partially damp the impact of the crisis in several regions, having ensured positive dynamics in the scope of construction.

The prospect of bankruptcy of a number of developers and construction companies and the high probability of extension of the number of defrauded interest holders, like in 2004-2005, once again updated the issue of the adoption of specific amendments to the Law on financial insolvency (bankruptcy) of developers who have attracted the assets of individuals to finance the construction of apartment buildings.

It is proposed to regard the executive body of the state power of the RF Subjects, monitoring and supervising the shared construction of apartment buildings as the person involved in the bankruptcy of the developer.

In the case where the collection of funds in favor of the legal person is carried out by the organization, which has neither land plot in the ownership, nor a permit for building construction, shall be deemed as deals which overlaps a contract with the developer on the transfer of residential premises.

Citizens will have the right to bring claims to arbitration court to terminate the agreements on transfer of residential premises with the developer and the return of unjust enrichment in the form of monetary payment, as well as damages, if the satisfaction of the requirement to transfer the housing premises is impossible.

Priority should be given to the participants of construction, who have no dwelling either in the ownership or under a contract of social rent, suitable for habitation, or have such premises with the area of less than 15 square meters per each member of the family of the member of shared construction[1].

It is premature to talk about the new configuration of the institutional structure of the construction market, which will emerge after the crisis.

In 2008, as a result of mergers and acquisitions, the market of the construction and real estate has nearly doubled as compared with 2007 (145 transactions for USD 12.4 billion against 37 transactions for USD 6.2 billion). More than 2/3 of this scope occurred in real estate transactions, whereas a year ago their share was about 1/3, basing on which it can be concluded, that mergers and acquisitions in construction are maintained at the same level (about USD 4 billion). However, the objects of transactions, along with hotels, business centers, shopping centers were, as a rule, companies engaged in construction of infrastructure facilities. Among a few examples of transactions relating to housing construction, one can mention the acquisition

[1] Interest holders will be protected from bankruptcy of developers, www.finansmag.ru, February 27, 2010. The negative aspect of such an option would be even greater mosaic structure of bankruptcy legislation, which already included the cpecifics in the implementation of insolvency proceedings in respect of strategic enterprises, city-forming, agricultural, financial institutions and natural monopolies.

of 49.91% in the real estate development company "scale" by "Augur Estate" company, which is implementing a project on construction of residential real estate in Moscow suburbs for 1.75 billion dollars[1].

An additional factor contributing to the institutional troubles in the industry, has become chaotic abolition of licensing in construction since early 2010, when the majority of developers did not hurry to join the self-regulatory organizations (SROs) (the membership in which is considered as an alternative to the government licensing), hoping for previously issued documents to stay in the effect. The process of establishment and registration of CPO in the construction, design and engineering surveys, in which membership was compulsory from January 1, 2010, has been intensified only in the second half of 2009. If according to the first round of monitoring the development of self-regulation (July 1, 2009) conducted by the National Institute of System Studies of Entrepreneurship Issues, there were registered 23 SROs, in the second round there were 294 of them[2]. The formation and registration of CPOs should be completed by mid-2010, although a number of issues of their operation is not entirely clear (standards, the list of construction works, an access to which is provided by the CPOs, formation of compensation funds to meet claims from clients and t . etc.)[3].

The program of antirecession measures of the RF Government for 2009, promulgated only in early April, envisaged a certain list of measures for the support of housing construction for a variety of purposes (the government obligations to provide housing to the specific groups of population (servicemen, veterans, young families), participation in development programs for municipal infrastructure, assistance in the restructuring of mortgage debt, support for low-rise housing). However, their practical implementation has started, when the housing market activity has already collapsed and the impact of the program obviously leaves much to be desired, as was confirmed by the results of 2009, especially in the IV-th quarter, as mentioned above.

The main instruments of the national policy in this area became the activities of the Fund for Assistance to the Reforming of Housing and Utilities to relocate citizens from the old and dilapidated houses, regarded not only as a measure to improve the living conditions of the population (mainly through the major repair of houses, supplemented by the purchase of new apartments) but as a way of maintaining its utilization, as well as the policy of restructuring of mortgage loans to citizens who find themselves in a difficult financial situation, pursued by banks with government participation and the Agency for Housing Mortgage Lending (AHML). For these purposes, the authorized capital of AHML was increased in 2008 to 60 billion rubles., and in 2009 – by another 20 billion rubles and 40 billion rubles more in the form of the credit.

Federal Fund for Housing Construction Promotion, established in 2008, only in September 2009 has held its first auction for sale of 4 land plots, which are in the federal property in Chuvashia, Kursk, Kirov and Tyumen Regions with the total area of 150 ha for the construction of 1.1 million square meters of economy-class housing. In the immediate prospective it is planned

[1] Mergers and Acquisitions in the CIS. Overview of the market. Ernst & Yong, 2009, pp. 8-9; Market mergers and acquisitions in 2008. Ernst & Yong, 2009, pp. 26-27.
[2] Monitoring the development of self-regulation in the regions of Russia. Round 2. M., NISIPP, February 2010, p. 5.
[3] C. Domnin. Dutch concert. B: Apartments, January 14-20, 2010, № 1 (776), pp. 1, 3.

to sell the land plots for the construction of 5,5-6,0 million square meters of housing, or 10-12% of the total annual construction completion[1].

In general, the same approach is contained in the Guidelines for the Anticrisis Actions of the RF Government for 2010, approved at its meeting (Minutes № 42 of December 30, 2009). Thus, the Fund for Assistance to the Reforming of Housing and Utilities, which has the status of Public Corporation will be replenished with the additional contribution of 15 billion rubles.

A relatively new points can be considered the direction of the parent capital for housing acquisition, the completion of SniPS reform with regard to the current level of development of construction technologies, reform of the technical regulation and promotion of implementation of the Law on the support of housing cooperatives with the creation of the first cooperatives across the country with the participation of the Federal Fund for Assistance to Housing Construction.

However, apparently, the major stake is still placed, on the mortgage. This is evidenced by the articulated in February 2010 plans to support the relevant programs in the amount of 250 billion rubles through the purchase of mortgage bonds by Vnesheconombank and AHML from banks, provided that the final borrower receives credits in rubles at the rate below 11% per annum.

As the object of the mortgage should be the economy-class housing in the primary market, it is likely that this mechanism can serve as a good incentive for the revitalization of housing. The questions, however, are the actual timing of its launch and to what extent it will be backed by an actual offer from the developers and what impact will be provided on the housing market in general and its affordability to the public.

Outlook for Housing Market

We would like to remind, that in the onset of the financial and economic crisis in the early fall of 2008 all the different possible scenarios in the real estate market at the beginning of October was restricted by four scenarios[2].

Scenario No.1 – Conservative: "soft" - transition to stabilization before summer of 2009 c followed by a new stage of growth of prices similar to 2007.

ScenarioNo.2 – moderately pessimistic: "tough" - transition to stabilization, similar to 2004. In this scenario, from October-November, it was possible to start reducing the prices of housing offer in Moscow, and in six months, according to our expert estimates, the prices in dollars could be reduced by 5-10%, and would be followed by further growth. Such scenario implementation during 2009 would require high efficiency of the financial authorities and market players, backed up by national consensus of elites, the media community and the public.

ScenarioNo.3 – Crisis: despite the declared by the authorities decisions (too slowly passing to the stage of implementation), the Russian financial crisis becomes an economic one through a reduction of staff in the financial sector, trade, construction, followed by the reduction of orders and dismissals in the industry (including production of construction materials) and the economy in general. As a result, the solvency of population is decreasing together with the demand for housing. A large-scale mergers and acquisitions are observed in the construction

[1] C. Domnin. The first pancake is not a clod. B: Apartments, 209, October 15-21, № 36 (763), pp. 1, 3.

[2] G.M.Sternik The housing market of the Russian cities in 2008: status and prospects. - Report on Petersburg Housing Congress, October 1, 2008, www.realtymarket.ru; Russian Economy in 2008. Trends and Outlooks (No. 30). M, March 2009, p.p. 547-565.

sector. In this scenario, it was expected that housing prices in Moscow by mid-2009 in dollar terms may be reduced against September 2008 by 40-45%, and in December - by 30-35%. Subsequently within two to three years there will take place stabilization of high volatility.

Unlike the crisis of 1998-1999, when price trend had the U-shape, in the current crisis the beginning of growth in housing prices was expected in 2011-2012 (price trend of L-shape).

In the framework of this scenario it was assumed that the ruble prices in 2009 will also will fall down, but the degree of reduction will depend substantially on the overall inflation. If inflation is maintained within the estimated by the Government rates of 13-14%, the decline in housing prices will be no more than 10-15%. If consumer inflation rises to 20-40%, the decline in the ruble prices for housing can pass into their improvement. And then the decline in prices in 2009 in dollar terms will be also reduced to 20-25%. The scope of housing construction in 2009-2010 will be reduced. There will be a change in the structure of housing (among other reasons, due to the increasing share of budget financing) from the Business class houses in favor of economy-class houses with smaller apartments and lower level of prices. The offer will be decreased but its structure, by contrast, will be changed in favor of high-quality housing, as in a the segment of economy class housing a significantly greater share could be the housing provided to executive authorities of all levels within the program of support to construction companies, which is therefore is not supplied to the open market. By the end of 2010, in the situation of effective demand recovery with a reduced volume of construction and housing offer, a new cycle of market recovery and increase in housing prices can take place to a level that ensures a reasonable return on investment to the developers.

The average yield of the construction business has declined and did not return to the previous outstanding level. The big players, who have survived in the market, should give up their previous aggressive strategy and be more careful in estimates of business development. In general the market under *Scenario 3* could make another major step in its formation and development.

As discussed by experts as "extraordinary case" was the *Scenario number 4 - Catastrophic*: despite the measures taken by the United States, European Union and supported by other countries (including Russia), the global financial system, based on the dollar will finally collapse, whereas the establishment of a the new system will require considerable effort and time.

There will be started a transition to a barter exchange of goods between the countries, accompanied by limited use of regional currencies. Due to the distortion of import structure, the economies of the US , Europe, and Russia as well as other countries (including the real estate markets) will collapse after the financial market, and it will take years, if not decades to restore it (with an optimistic assessment of the armed conflict curbing).

The contents of all four scenarios for the situation in the Russian housing market was complemented by tentative estimates of their implementation, allowing to select the most likely one as a weighted average of the four scenarios.

Since the *scenario number 1* was relevant up to spring of 2008 (when the forecast as to the level of price changes up to September was confirmed by the actual data), with regard to the developments in the autumn months of 2008, the most preferable in terms of implementation was the *scenario number 2*, but unfortunately, already in December, it became clear that it can never be implemented in reality.

Explicit incompleteness, retarded character and poor effectiveness of the authorities' anti-crisis measures made necessary to revise the probabilities of each of the scenarios when prepar-

ing the estimates for 2009. As a result, the *scenario № 3* (crisis one) was assessed as the only probable one, which began to be implemented from November-December 2008. The *scenario № 4* (catastrophic) to autumn of 2009 has lost its, albeit small, probability of implementation.

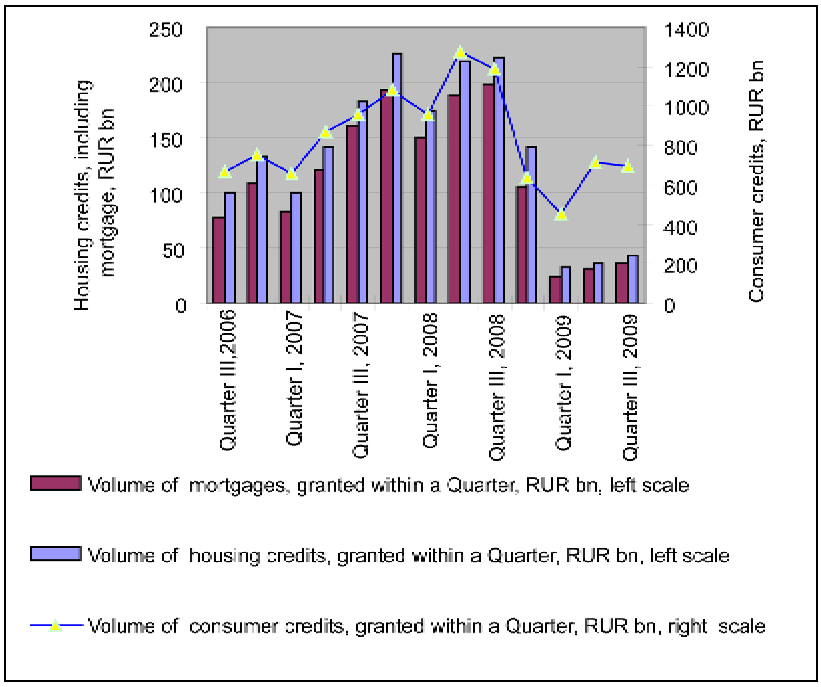
Results of 2009 show that the estimates of ruble prices in the secondary housing market in Moscow were quite accurate (ruble price reduction made 19% against the estimated level of 15-20%), while excessively pessimistic in dollar terms (the reduction was 35% with the estimated 40-45%). The reasons for this were unexpectedly rapid growth in oil prices started in I quarter of 2009 and the related ruble strengthening, which contributed to the increased housing prices in dollar terms.

Available estimates of the global and Russian economy for the coming years are contradictory, but the consensus forecast of oil prices and related parameters of the budget for 2010, approved by the government of Russia imply that the previously estimated price change for 2010 does not require adjustment: fluctuating stability of prices with high volatility will be maintained. Fluctuations in the ruble price are expected within the range of +/-5% with a possible increase by the end of the year for no more than 5%; the dollar prices - ranging from +5% to -10% within a one-year time interval with a possible decrease by 5% to end of the year as compared with December 2009.

We can expect that for the Russian housing market the year of 2010 will become the completion period of the crisis and entering a phase of stabilization, as indicated by the stagnation in prices which is now observed in the secondary market, where you can expect a gradual increase in sales volume and the beginning of recovery after stagnation. Herewith, in the primary market there might be a decline in prices and a delay in recovery rates before 2011-2012.

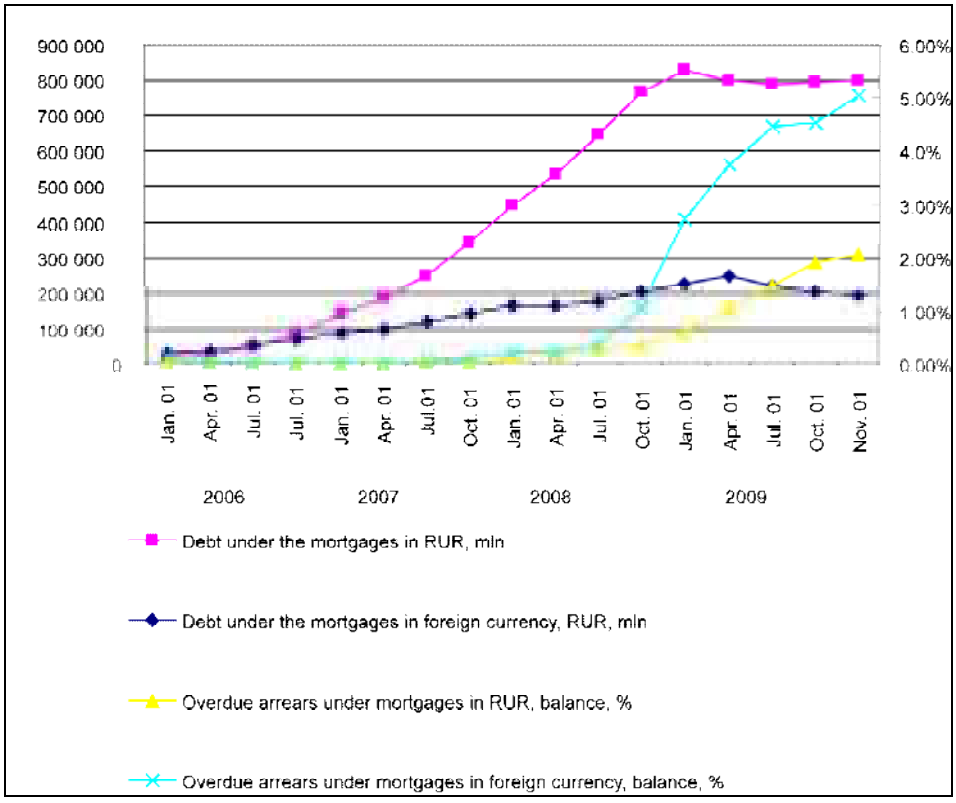
5.7.3. Mortgage Market

Since the beginning of 2009 through December 1, 2009, according to the RF Central Bank, there were issued 106,864 mortgage loans in the amount of 124 451 million rubles with the debt balance for credits granted in previous years, mortgage home loans in the amount of 1,000,738 million rubles. The volume of mortgage loans granted within 3 quarters of 2009, makes only 17.03% of the volume of mortgages over the relevant period in 2008, and 25.17% of the corresponding volume of mortgage credits granted in 2007. The total volume of housing loans on December 1, 2009 amounted to 149,977 million rubles or 148,432 loans. It is seen from *Fig. 3* that the growth of lending in 2008 was continued. Herewith, the growth rate of loans granted in 2007 and within the first two quarters of 2008 were close to each other, and only in the third quarter the growth was nearly stopped. In the 4-th quarter there started a twofold downfall in the volume of loans, as well as in their quantity against the 4-th quarter of 2007. In the 1-st quarter of 2009 the volume of loans fell down nearly 6 times as compared with the 1-st quarter of 2008. In the 2 and 3 quarters of 2009 there was a small increase in volume, but still at the same low level. Issuance of consumer loans to individuals had a similar dynamics, but the decline in crediting was noted already in the third quarter of 2008.



Source: RF Central Bank.

Fig. 3. Dynamics of Credit Granting to Individuals within the Quarter



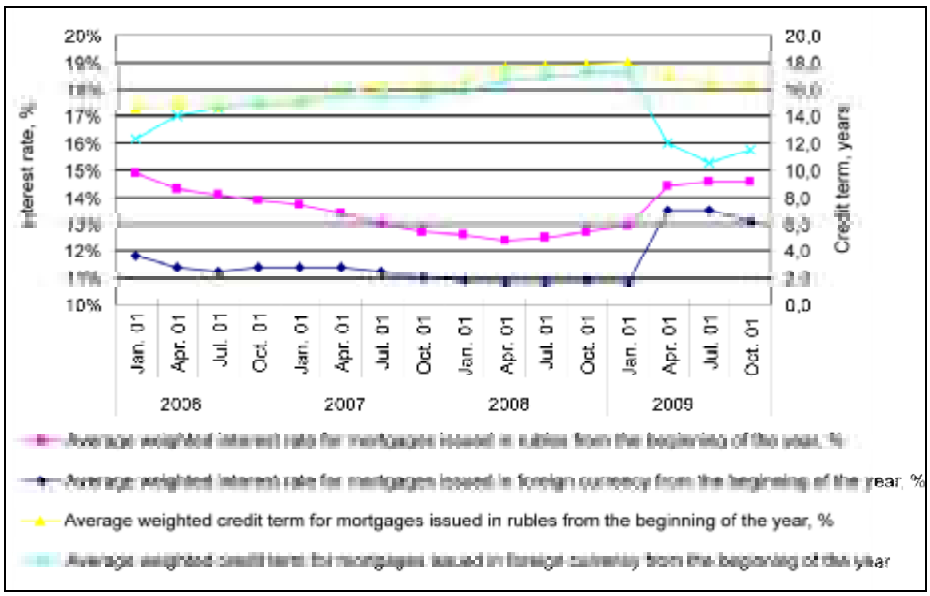
Source: RF Central Bank.

Fig. 4. Dynamics of the Debt and Stale Debt Share

By early 2009 the growth of debt for mortgages in rubles at the background of falling lending volume in the IV-th quarter of 2008 has been suspended at the maximum value of 828,463 million rubles, followed by a slight decline to 800 billion rubles. (*Fig. 4*). The debt growth rate under mortgages in foreign currency in 2007 and 2008 was significantly lower than the relevant growth rate of debt under loans in rubles. The maximum amount of the debt under mortgages in foreign currency, 267,491 million rubles was noted at the beginning of February 2009. The debt under mortgages in foreign currency has reached the annual minimum on November 1, 2009, accounting to 195 billion rubles.

Since the second half of 2007 a smooth increase in the overdue arrears share against the mortgages residual debt is observed, accompanied with the growing share of stale debt in foreign currency as compared with the outstanding debt in rubles. (*Fig. 4*). Since quarter III of 2008, the growth rate of the share of arrears on mortgage loans in foreign currency rises sharply, significantly exceeding the growth rate the of outstanding debts in rubles, which is growing as well. The share of outstanding debt on December 1, 2009 amounted to 2.16 % in rubles and to 5.24% for credits in foreign currency.

Before mid-2008 the average weighted credit interest rates for mortgages issued since the beginning of the year both in rubles and in foreign currency had a tendency to decrease. Since the RF Central Bank provides an averaged interest rate over the year, a sharp change in the transition from 2008 to 2009 indicates the presence of changes already in late 2008. *Fig. 5* shows an inverse relationship between interest rate and the term of loan: interest rate increase corresponds to a shorter loan term and vice versa. On December 1, 2009 the average weighted interest rate on mortgage loans issued since the beginning of the year in rubles decreased to 14.4%, while for the loans in foreign currency - up to 13.0%. Accordingly, the weighted average term of lending in rubles as of December 1, 2009 was 16.5 years and for the mortgages in foreign currency – 11.2 years.



Source: RF Central Bank.

Fig. 5. The weighted average interest rates (in%) and the loan terms (in years) for mortgages provided since the beginning of the year in rubles and in foreign currency – by years

The crisis in the mortgage market is also evident in the further monopolization of the market of mortgage loans. One can see from *Fig. 6* that among the credit institutions, ranked by total assets, the share of the top five largest lenders - Sberbank, VTB 24, Bank of Moscow, Russian Agricultural Bank and Gazprombank has grown over 2009 from 37.4% to 61.64%, i.e. by 24 p.p. Shares of the second, third and fourth groups have decreased, and the share of the most numerous fifth group has somewhat grown: from 5.5% to 9.7%. All groups demonstrated the growth of the stale debt share against the total outstanding debt. If at the end of 2008 the largest share of stale debt was demonstrated by the first group, a year later the leader is the third group, which share of overdue arrears grew almost 4 times.

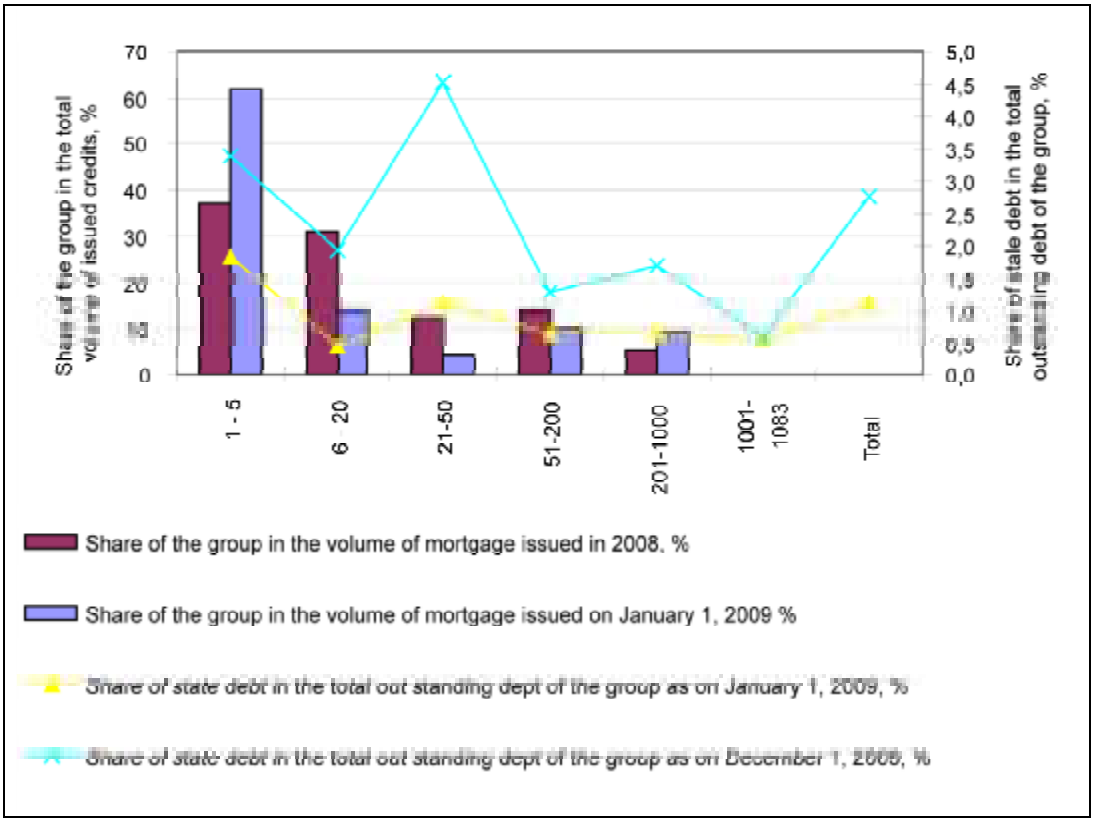


Fig. 6. Dynamics of mortgage housing loans and stale debt by groups of credit agencies, ranked by total assets

From April 24 to December 28, 2009 in view of the adjustment of the interest rates for the operations of the Bank of Russia, the RF Central Bank has reduced the refinancing rate ten times, as a result having lowered it from the maximum rate of 13% to 8.75%. At the same time interest rates for other operations of the Bank of Russia were reduced as well. After the Central Bank, JSC "Agency for Housing Mortgage Lending" (AHML) has reduced the interest rates for housing mortgage loans refinanced by the Agency.

On December 1, the minimal interest rate of the AHML standards in the presence of private insurance amounted to 9.47%, and 10.17% in the absence of personal insurance. The maximum values are 11.43% and 12.13% respectively. Table 10 shows changes in the minimum and

maximum rates for a number of banks within one week of November. Only AHML Eurotrust have lowered their interest rates, following the decline in the CBR refinancing rate.

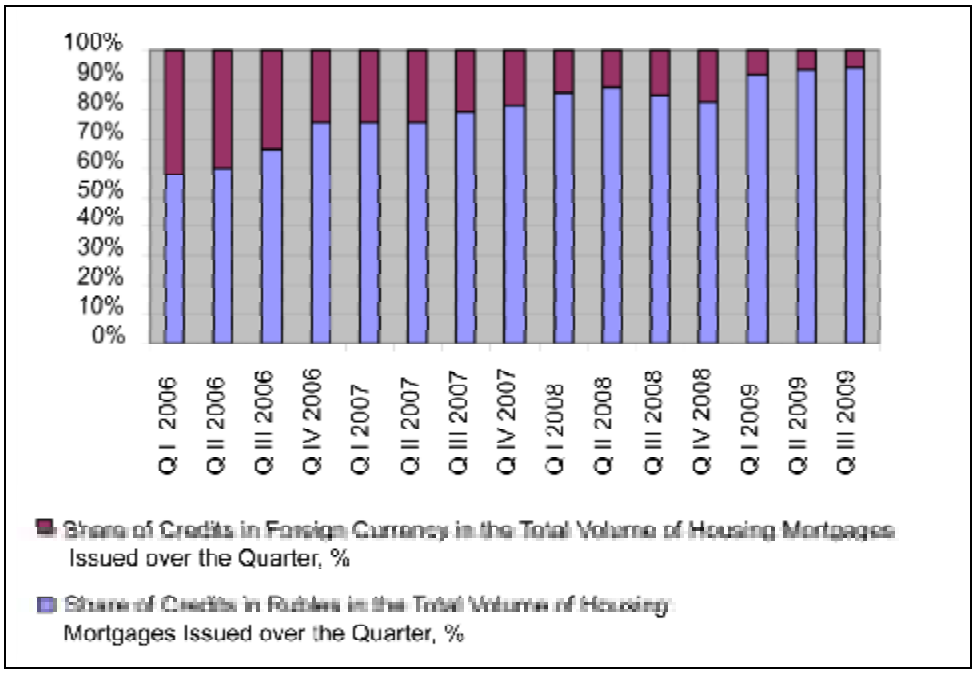
Table 10

Minimal and Maximum Rates on Mortgage Loans and their Changes as of November 30, 2009

N	Credit Agency	Minimal rate, %	Change in the week, pp	Change from baseline (06.02.2008), pp	Maximum rate, %	Change in the week, pp	Change from baseline (06.02.2008), pp
1	Agency for Housing Mortgage Lending (AHML)	9.05	–0.50	–1.70	11.71	–0.50	–2.29
2	European Trust Bank	9.05	–0.50	0.00	11.71	–0.50	0.00
3	City Mortgage Bank	10.05	0.00	0.00	12.91	0.00	0.00
4	Revival Bank	11.00	0.00	–0.50	21.50	0.00	5.75
5	Housing Finance Bank	11.99	0.00	2.24	16.75	0.00	4.00
6	Sberbank	13.50	0.00	3.00	16.00	0.00	4.00
7	Deltacredit	13.75	0.00	3.50	28.45	0.00	14.95
8	VTB-24	14.10	0.00	3.10	17.10	0.00	3.60
9	UniCredit Bank	15.50	0.00	0.00	18.00	0.00	0.00
10	MIA	15.50	0.00	4.50	15.50	0.00	0.50
11	RosEvroBank	16.00	0.00	4.50	18.00	0.00	1.50
12	Bank of Moscow	16.50	0.00	5.50	18.50	0.00	5.50
13	Uralsib	19.00	0.00	8.20	19.50	0.00	6.00
14	Uniastrum Bank	19.00	0.00	6.50	20.00	0.00	5.50
15	Credit Europe Bank	19.00	0.00	7.50	26.00	0.00	11.00
16	Raiffeisen bank	20.00	0.00	8.10	23.50	0.00	10.60
17	Alpha-bank	20.60	0.00	7.40	25.30	0.00	9.30
18	Absolut bank	25.00	0.00	15.00	30.00	0.00	14.00

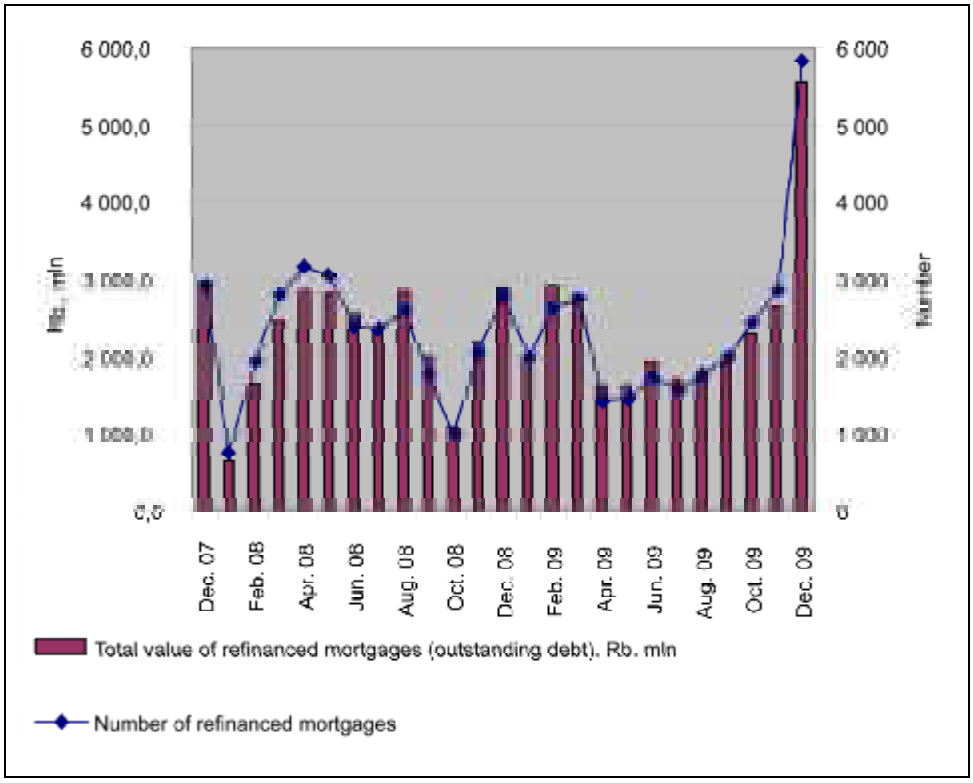
Source: Credit Mart estimates and monitoring for AHML.

The share of foreign currency loans in the volume of mortgages issued over the quarter, continued to decline (*Fig. 7*) from 17.33% in the 4 th quarter of 2008 to 5,57% in 3 quarter of 2009. In parallel with decreased 21.63% in the Quarter 4 of 2008 to 20.53% in Quarter 3 of 2009. At the same time, the share of debt for credits in foreign currency against the debt for housing mortgage is getting reduced. It is seen from *Fig. 4* that the decline of the share of housing mortgage in foreign currency in the total amount of loans, as well as in outstanding debts, is accompanied by more rapid growth of stale debts as compared with such growth in ruble credits. Nevertheless, the rate of growth of stale debts in rubles was higher in quarter 3 of 2009 - 0.47 percentage points, while in foreign currency - 0.08 p.p.



Source: RF Central Bank.

Fig. 7. Housing Mortgages in Rubles against Mortgages in Foreign Currency



Source: AHML data.

Fig. 8. Monthly Volume of Consolidated Debt of JSC "Agency for Housing Mortgage Lending"

The earliest expressed decline in the volume of consolidated debt for mortgage loans provided by the Agency for Housing Mortgage Lending took place in January - February 2008 (*Fig. 8*). At that point, financial and economic crisis has not affected the pace of the continuing growth of housing crediting (see *Fig. 3*). The decline in the volume of AHML refinancing was the result of preventive measures taken by AHML management in view of the expected crises in the mortgage market. The decline in the volume of refinancing in September - October 2008 coincides with the incipient decline in growth rates of loans issued in Quarter III of 2008. The growth in the volume of credits refinancing after the decline in April 2009 demonstrates rather an increased share of AHML credit refinancing in the total mortgage loans, rather than a significant increase of credit volume. Thus, in the first nine months of 2009, such AHML share was 20%, having significantly exceeded the level of 2008. In 2008, the share of mortgages refinanced by the Agency for Housing Mortgage Lending in the total volume of issued credits made 4% - in terms of value and about 6% in terms of number.

An even higher percentage of the Agency was in the total amount of refinanced loans. For the 6 months of 2009, according to the RF Central Bank, 140 agencies were refinancing mortgages for the amount of 33.383 billion rubles. Out of these, further emission of mortgage securities, credits were refinanced for 4.787 billion rubles. During this period, the Agency has refinanced mortgages for 12.9 billion rubles, what made about 40% of the total amount of refinanced credits.

In the crisis situation, 30 thousand borrowers benefited from the current restructuring program, however, the courts received more than 20 thousand claims for mortgages non-payment.

JSC "Agency for Restructuring of Mortgage Housing Loans (ARIMHL) has extended for 2010 the effect of the national assistance program (basic or first level of support) to the mortgage borrowers. Bad debts for credits will be restructured by ARIZHK again. In particular, it is expected to purchase mortgaged apartments from the creditor under a judicial sanction. Such housings will be transferred to municipalities.

Russian citizens have addressed 20.1 billion rubles for housing credits repayment and housing construction from the mother's capital. According to the Pension Fund of Russia since the beginning of 2009 nearly 75 thousand Russian families benefited from this right.

Manifold decrease in the volume of newly issued mortgages is accompanied by active transactions in mortgage securities.

On May 26 Federal Financial Markets Service registered the issue and prospectus of three tranches of mortgage securities of JSC “National Mortgage Agent VTB 001” (SPV-company of bank VTB 24) for the total amount of 14.479 billion rubles with the maturity on February 26, 2039. VTB 24 has attracted about 6 billion rubles for three months through the Central Bank REPO under the pledge of its ruble-denominated mortgage bonds, which were recently included in the mortgage list with the discount of 25% for REPO of more than two weeks.

On November 20, 2009 the Bank of Russia registered the five-year mortgage bonds for 15 billion rubles of Bank VTB 24.

Mortgage Agent of the Moscow Bank for Reconstruction and Development on September 17, 2009 placed its two issues of mortgage securities in the form of housing mortgage bonds grade "A" and "B" totaling to 2.2 billion

On December 15 JSC AHML has acquired from a special-targeted company ETB Mortgage Finance 1 S.A. (Luxembourg) the title for mortgage loans, provided to KB "European Trust Bank" (ZAO), secured by a mortgages for 2 billion rubles. Mortgages comply with the Agency

standards. Transfer of mortgages and credit history files was performed through the depositories of JSC “Gazprombank" and JSC Bank "Revival ".

Vnesheconombank, as a state company that manages the pension savings funds (STMC), in accordance with recently approved by the Government new strategy of investing retirement savings, has obtained the right, starting from November 2009, to acquire AHML bonds and mortgage-backed bonds, if they have the appropriate rating and guarantees.

In November Gazenergoprombank has granted to "Home Credit and Finance Bank" LLC 1.8 billion rubles under the security of mortgage portfolio.

In the absence of demand for retail credits large banks are ready to resume the programs of refinancing of "foreign" loans under more favorable terms. Sberbank of Russia has introduced a new credit product - "Housing mortgage refinancing" for credits redemption (refinancing), issued by other credit institutions for up to 30 years.

VTB 24 has lowered the minimum initial installment for the borrower to 20% on all mortgage programs in the majority of regions of the bank representation.

In December, the State Duma has adopted in the first reading amendments to the Law "On banks and banking activity", which prohibits the banks to unilateral amendments of the interest rates on credits, deposits, commission and contracts validity terms with customers – physical persons.

Also in the first reading the State Duma adopted amendments to Art. 810, Part 2 of the Civil Code, providing for the citizens' right to early repayment of a loan without the consent of the bank.

In June 2009, JSC "Agency for Housing Mortgage Lending" (AHML), in cooperation with the Federal Fund on Promotion to Housing Construction submitted the "Program to encourage lending to developers, implementing housing projects in economy class and for individuals who buy dwellings in the framework of such projects", developed pursuant to the Minutes of the Government Committee on improvement the sustainability of Russian economic development No.12, dated of April 28, 2009. The agency assumes the obligations under the basic conditions of the program in pilot projects on the basis of the approved amount to 1.2 billion rubles.

It is assumed that AHML in accordance with the basic terms of the program will be providing targeted loans to credit agencies for the loans to individuals for dwellings purchase (no more than 30 thousand rubles per sq. m) in a house under construction (equity participation in construction) and/or support of a credit line for construction completion. A forward mortgage contract guarantees to the Agency purchase of the granted housing credits as soon as the construction is completed.

AHML implements the promotion of economy class housing jointly with Vnesheconombank. In the framework of this project, it was agreed in advance that the Bank of Development should provide a credit line to the Agency in the amount of 40 billion rubles for crediting the developers, implementing projects for construction of affordable housing by means of mortgage lending.

5.8. The Military Economy and Military Reform in Russia

The year of 2009 saw an unprecedented acceleration of the genuine military reform. This can be ascribed first to the fact that in the wake of the war with Georgia in August 2008 the tandem of the Russian leaders (the RF President, who also is the Commander-in-Chief, and the Prime- Minister) has *de facto* granted Mr. A. Serdyukov, the RF Defense Minister, *carte*

blanche not only on continuation, but acceleration of the modernization of the Defense Ministry and the Armed Forces; second, this can be explained by the Minister's personal qualities and his commitment to pursue a real reform of the Armed Forces. But the time for the reform implementation has been missed.

5.8.1. New Challenges for the RF Ministry of Defense and the Armed Forces

The annual Report on the RF Ministry of Defense's performance in 2008 and main avenues of its operations for the forthcoming period did not come from press in a due time. But , referencing to a secret document approved by the RF President on September 15, 2008, in his account on results of 2008 Mr. A. Serdyukov enumerated tasks specified therein[1]. It was only on March 17, 2009, when addressing the extended Collegiums of the RF Ministry of Defense[2], Mr. D. Medvedev depicted the 2008 results as "fair, basically" and enunciated, as he put it, "a series of priority tasks". Unfortunately, the President's formulation of the tasks is not consistent with the Minister's, which is bad from all the perspectives - the military administrative culture and the normal civil management's. We are recapping on the tasks below, with citations attributed to their authors marked by the first letter of their names given in brackets (M for Mr. Medvedev and S - for Mr. Serdyukov):

1. "transition of all the units to the permanent combat readiness category" (S); "raising the combat readiness of the armed forces", including "transition of all the combat units to the permanent combat readiness category" (M). Let us note that the adjective "combat" was not further specified in any way – perhaps it was introduced to denominate a major component of the Armed Forces of RF which does not encompass another one, that is "the mobilization component in the form of arms and equipment storage and repair facilities, as well as mobile repair means" (S);
2. "Boosting the efficiency of the Armed Forces command system" (S); "optimization of the structure and quantity of the army" (M);
3. "Giving the Armed Forces modern warfare and military equipment" (S); "equipping the army with cutting-edge warfare" (M);
4. "Improvement of the cadre training system, military education and military science" (S); "a further improvement of the structure of the military education" (M);
5. "Provision of the military with a decent monetary allowance, permanent and departmental housing" (S); "solving the military's social problems" (M);
6. "Social adaptation of retiring officers…. Their retraining and current employment" (M) - notably, this task was specified by the President only.

Let us complement the above with the following statements by the President and the Minister of Defense, "A qualitative implementation of all these complex and large-scale tasks will depend upon a well-orchestrated, everyday, meticulous work, commitment and initiative of the highest rank of the Army and the Navy" (S); "at this juncture, there is the need in a high competence of commanders of all levels, synchronization of our joint effects and, of course, there is an extreme need in the public support of transformations conducted in the army" (M).

[1] *Serdyukov A.* 5 osnovnykh strategicheskikh zadach//Rossiyskoye voennoye obozreniye. 2009. №3. pp. 10-13
[2] *Medvedev D.* na puti k perspektivnomy obliku Vooruzhennykh Sil// Rossiyskoye voennoye obozreniye. 2009. №3. pp. 8-9

As to a more detailed concept of the "new face" of the Armed Forces and the Defense Ministry, a considerable fraction of the characteristics of the former and transformations in the latter constitutes a repetition of the past, non- or under-implemented ideas and programs whose rationale can be traced back to 1992, when the military-political leadership of RF had been making decisions on building the Armed Forces. At the time, the Supreme Soviet of RF developed, adopted and published main provisions of Russia's military policy[1]. Even from the today's perspective, it can be asserted that was a fairly progressive conceptual document that laid out the government's control and managerial functions in the military area:

- legislative approval of the government program of the military building and conversion of the defense sector;
- approval of the structure and the number of the Armed Forces together with the budget;
- control by the legislature over the cadre policy in the Armed Forces and the RF Defense Ministry.

The assertion contained in the Supreme Soviet's declaration that a "decisive transition in Russia's foreign policy to international cooperation and partnership creates a real basis for a substantial cutting of unbearable military expenditures as a necessary premise of a successful implementation of economic programs and elimination of tension in the society" remains vital. In late May 1992, the General Staff Academy held a conference on military building plans[2].

Merging the legislature and military experts' proposals, let us enumerate core elements of the then outlined "new face":

- Cuts in the number of the Armed Forces. In 1992, the troops outnumbered 2.5m, with the cap set in compliance with the act "On defense", that is, 1% of the population. Later, the President cited 1m as a benchmark of the future number of the military, but the cap was lifted by a respective act.
- The primary need to solve the military personnel's (both retiring and on service) all social problems, with a special attention paid to those coming home from the deployed overseas Army Group,.
- Transition of all the regular armed forces from conscription to draft. The provision was stipulated in the resolution by the RF government signed by Pres. Eltsin on November 30, 1992. The document formally retains its force.
- Sufficiency of the strategic nuclear forces whose "structure should be regulated on the basis of agreements with account of the need to keep the means that to the greatest degree meet the requirements of the nuclear security and minimum costs" as a factor precluding world wars.
- The factor of deterrence from "waging large-scale conflicts and local wars against Russia" should become "forces in possession of high-precision arms and means of their delivery", while the factor of neutralization of local military conflicts should become "conventional forces in the composition of a few Army and Navy blocks".

Except for some nuances, these elements match the recently declared concept of the "new face" of the Armed Forces of RF. Equally important is that back in 1992, most of the population and the military were supportive of the declared reform fundamentals. That is why the

[1] Vedomosti Syezda narodnykh deputatov RSFSR i Verkhovnogo Soveta RSFSR. M., 1992. see also: Izvestia. 1992. April 2.
[2] Voennaya mysl. Special edition. 1992.July

general list of characteristics of Russia's military policy that still are topical should be complemented with another two ones, which were declared and explicitly demonstrated then- namely:

- The official openness of the military policy and making the procedures and conditions of military service, the troops' freedoms and rights subject to the parliament and the society's control.
- Openness of the military building plans, as well as a detailed military budget and actual costs in a volume sufficient for the societal control; more specifically, in a full volume, as far as all the socio-economic aspects are concerned; in a volume equivalent to the UN standards on military expenditures - by other aspects, items and kinds of expenditures.

Back in 1992, a considerable fraction of the aforementioned characteristics and parameters meant the rise of a ***de facto*** new system of provision of the country's defense, a new defense ministry, a new armed forces, which have been just partly attained nowadays.

So, the new stage of the military transformation in many ways rests upon the earlier developed and theoretically justified findings of research teams and military experts.

As well, the current transformation is proved by the best overseas practices.

Lastly, the new stage of the reform underway in the Armed Forces and the Defense Ministry is backed by positive results demonstrated by structures within Russia's military organization that were keen to ensure them. It is worth mentioning, first and foremost, the RF Border Service that has succeeded in accomplishing its mission by having professionals engaged in using new technologies, rather than by merely beefing up.

Below, we highlight findings of the analysis of the reform process in the Armed Forces of RF.

5.8.2. Increasing the Combat Readiness of the Armed Forces.

Organizational developments on giving military units a "facelift" mostly concerned the Army. They had been completed as scheduled, that is, by July 1, 2009, some 50 units that did not change their dispositions transited to a new structure, followed by other (30 more units) by December 1.

Considerable changes have also occurred in the Air Force, with other ranches of the Armed Forces experiencing a substantially lesser transformation.

In each of 6 military districts there were formed structural elements of the operative-strategic command capable to run operations of all the forces, except the strategic ones, including the so-called "other" forces located in the territory of the district.

As well, Russia's Armed Forces contributed, with a paratroop division and a paratroop brigade, to the creation of the Collective Rapid Response Forces, which will be acting in the interests of the member nations of the Collective Security Treaty Organization.

There were planned and implemented a string of military exrecises, both individual and collective ones, as well as a number of huge war games that take part in the territory of China, Kazakhstan, as well as the operative-strategic exercise "West-2009" in the territory of Belarus, to name a few.

Thus, the task of creation of military units of *permanent readiness* is being tackled; however, the problem of sustaining their *permanent combat readiness* has remained unsolved, as the Armed Forces are still and will, through 2020, manned with conscripts at 65%. Having served in the army for 1 year, they demobilize to be replaced by rookies, and the cohesiveness between the units vanishes.

By late November, information was published of a comprehensive examination of the military units, including those already transited to the "new face" over the past training year, which, as usual, came to an end on October 30. Following the "normal" pattern, the information was first published by the mass media[1] and only after that - in the official sources[2].

Table 1

Assessment of Combat Readiness of the Army and the Navy by Late 2009

Score	Number of units	Comments
Excellent	4 operative units	All 4 – the Navy vessels (above-water crafts - AWC) and nuclear submarines (NS) equaled to brigade or division
Good	26 divisions of different branches (Air Force, Navy, SRF, paratroops)	A. 50% of units; 46% of the totality of regiments and bases remaining in the Armed Forces 55% of the 1st-class AWCs and NS; 33% of the "new-face" brigades
Fair	23 divisions 105 of the "new-face" brigades 97 separate regiments	47% their total number 60% brigades of the "new-face" > 50%
Poor	4 brigades	From the Siberian military district and the North-Caucasian military district

So, it was slightly over 50% out of nearly 260 units and operative units equaled to them across all the Armed Forces, which can be provisionally called **combat ready**, that displayed just a satisfactory combat readiness. Besides, as by the end of 2009 nearly the half of the conscripts had demobilized from the Armed Forces, to be replaced by rookies, after the New Year many military units would fail to earn satisfactory scores. While their permanent readiness may be close to 100%, the combat readiness would remain pretty low, and such an undulating process in Russia's operative units will be noted until 2020.

From the military and economic perspective, an important fact is that, according to Mr. Serdyukov's article, the financing of the exercises was planned and executed "at the expense of funds allocated for the current maintenance of the Army and the Navy, as well as at the expense of proceeds from sales of military assets". Regretfully, no amount of such funds was specified, but the approach to the organizational problems should be lauded, nonetheless.

But establishment of the Collective Rapid Response Forces in such a fashion that their equipping with "modern warfare and military hardware, specially designed uniforms and equipage" was funded chiefly by Russia raises questions of appropriateness of such costs, as the forces are designated for ensuring Russia as well as all the CSTO member nations' military security.

While forming permanent readiness units, the military have also been tackling the most complex problem of organization of logistics support for the "new-face" army[3]. First, functions in the logistics support system were split, with the military fraction of the Interdepartmental (Unified) Logistics Support System (IULSS) retaining the duty of projecting and planning of the Defense Ministry's needs in certain kinds of works, products and services, while all the logistics business management functions were assigned to JSC Oboronservis. The company is formed by 9 sub-holdings that combined comprise a total of 56 federal public unitary enter-

[1] Sargin A., Telmanov D. Armiya troechnikov//Gazeta. 2009. November 10

[2] Theses of the address of the Head of the Chief Command of Military Training of the Armed Forces of RF before representatives of the Russian mass media. See: http://www.mil.ru/847/852/1154/15977/37805/69116/69115/index.shtml

[3] Nasha konechnaya tsel- obespecheniye voennosluzhaschego (interview nachalnika Tyla VS RF)//Rossiyskoye voennoye obozreniye. 2009. №3. p. 21-23

prises and 19 earlier established JSCs. In the frame of the IULSS, every military unit (both in the Army and in other branches and military agencies) have now become subject to logistics support delivered by the nearest interdepartmental logistics support office.

As well, a very complex organizational work is underway, as far as provision of the logistics support to new military bases created overseas and military units with dispositions in the Far North and remote garrisons in Siberia and the Far East is concerned. This is a consequence of the revision of Russia's vitally important interests and changes in the geopolitical situation.

It is worth noting that the military leadership have focused on developing means and ways of conducting the so-called "information wars". That our info-, or cyber-, space has become a battlefield of invisible wars and Russia's Armed Forces fell behind the leading military nations in developing the respective forces and means and are in need for creation of a system of means of info-engagement – to counter an enemy in an "info-war" - was long discussed by the domestic expert community[1]. They believe these tasks are critical in the times of war as they are in the times of peace. While the information on the matter is brief and fragmentary, the Defense Ministry and the Armed Forces are now preparing to tackle the problem from the organizational perspective.

5.8.3. Optimizing the Structure and the Strength of the Armed Forces, and Increasing the Efficiency of Command and Control

In 2009, the structure of Russia's Armed Forces has seen some improvement, with the transition from the four-link (military district-army-division-regiment) command and control system to the three-link one (military district, which in the peacetime exercises the operational strategic command and control functions, - army, with its operative command and control functions, - brigade aimed at boosting the troops' mobility and flexibility.

The transformation has not stirred much public attention, while chiefly affecting interests of the high echelons of the army.

The public at large were far keener to explore other transformations, including those of the military education and science, and the military-medical service. It is a military staffing policy blueprint, which concerns the voluntary manning of the rank and file, that causes a particular alarm. The influx of young conscripts has recently fallen more than twice, thus making it impossible to ensure a 1mln-strong army, to say nothing of other branches, already in the nearest future. The number of the 18-year-olds will equal the number of university enrollees.

Hence the need in conscribing the bulk of university graduates, which will have an adverse effect on the economy, with the fall in the Armed Forces' combat readiness as a major negative consequence. At this point, it is worth citing the Concept Mr. V. Putin signed on June 15, 2008, "…In the nearest future it is planned to supply the Armed Forces of RF with-the new generation military hardware, which, with its greater efficiency as its distinctive quality, will at the same time be far more sophisticated than the ones currently in use; therefore, qualification (professional training) of the troops using the hardware should be enhanced, which will require additional time costs for their training; the transition to the 1-year-long conscription means that after being trained in rank-and-file centers and having acquired practical skills necessary for using the new-generation military hardware, the personnel will be demobilized due to expira-

[1] *Nikolaev Yu., Pchelyanoy V. Tsymbal. V.* Systema vooruzheniya VS RF – kakoy ey byt?//Vooruzheniye, politika, konversiya. 1997. №2, p. 27-32

tion of the term of conscription as per the law, i.e. the training of the personnel will be carried out permanently, and no fully trained rank-and-file specialists will be in place". So, reads the document, "at this juncture the transition to draft is the only realistic solution". But on August 18, 2008, amid the commotion in the immediate wake of the 5-day war, there was approved another FTP that retains the mixed manning of the permanent-readiness units.

The number of university graduates conscribed into the army is on the rise. Specifically, in the spring 2008 as many as 28,600 of them were enlisted, while in the spring 2009 the number climbed up to 37,900. Today, they have been conscribed for the term of 1 year, but are often forced to sign a contract for a longer term of service.

The state of the conscripts' health poses another problem. With reference to the head of the State Army Mobilization Department[1], in the spring of 2009 as many as 33% of the prospective conscripts was discharged from the military service, while "out of those conscribed over 30% have various kinds of health restrictions".

5.8.4. Equipping the Armed Forces with Arms and Military Hardware

Unfortunately, while pursuing the whole complex of transformations, the core question of coordination between the military-technical policy and the military-manning one has remained unanswered. What should the priority be given to – either mastering a serial production of the cutting-edge weaponry and giving it to the troops, or recruiting and training the troops of all the echelons of the military hierarchy keen to excel in their job in the first place and then fearlessly provide them with the newest military hardware?

Without a bold answer to this question the President's vow "to equip the army with fundamentally new high-tech arms" does not appear convincing, as the troops have to be capable to master them.

After the war with Georgia in August 2008 the need in change the past views has become obvious. Hence the imperative to form the public defense order (PDO) for 2009-2011 not only on the basis of the State Arms Program (SAP) for 2007-2015, but with "account of measures aimed at reequipping the conventional forces"[2], too, i.e. to adjust the PDO.

The government increased spending on arms purchases, albeit without a respective quantitative rise in supplies of a new, cutting-edge warfare, with public orders once again focusing on resource-intensive samples that provide just solitary military combatants.

The Army was supplied with rocket complexes "Iskander" and traditional antiair rocket "Buk-M2" and "Tor-M1" ones, anti-tank complexes "Kornet" , "Khrizantema", self-propelled assult guns "Khosta", "Msta-S", tanks T-90A, making an aggregate of 3,000 units. The problem of equipping the troops with positioning, communication, reconnaissance means has remained unsolved.

Hence a logical question as to whether the deficiencies of the recently approved SAP are to remain untouched, as are the drawbacks of the methodology that underpinned it. This question is even more persisting in the light of the 5-day-long war with Georgia which showed that the PDO needs to be adjusted.

In parallel with that, there is the need to modify the DIC management system. Pres. Medvedev has recently enunciated that "massive investment has been made in the modernization and

[1] O predvaritelnykh itogakh vesennego prizyva 2009 g.// Rossiyskoye voennoye obozreniye. 2009. №7. p 10-12
[2] *Popovkin V.* Novym Vooruzhennym Silam – novoye oruzhiye//Rossiyskoye voennoye obozreniye. 2009. №3. p. 19

development of the DIC…But, in my view, the return has not been high by far. Regretfully, one continues to pursue the "band-aid" policy. And objectives of an advanced technological rearmament of the sector have not been attained, to put it bluntly. All this tells on the quality of the hardware supplied to our Armed Forces and for export"[1]. Concerns that a wrong management of the DIC that implies retaining monopolists and a loose control over their own technological development would yield dire consequences have justified themselves. Pres. Medvedev noted that a new FTP is needed to eradicate the defect, hence new secret budget expenditures on provision of support to beforehand picked DIC corporations. This may turn into a new waste of funds, as it is yet more critical a task to develop "acts, standards and procedures, owing to which it will always be the best developers and producers of military hardware that will find themselves among corporations fulfilling the defense order in the frame of a tight but fair competition". Regretfully, these words sounded just as a wishful thinking.

5.8.5. Improving the Military Education and Research System

As far as the transition plans are concerned, the progress in the military education was only the understood in the frame of the traditional concept of manning, i.e. the officers' training. Despite the presence of the national military education's past success stories and its recognition internationally (Russian military universities still train specialists from 50 more countries), the situation required fundamental changes. With the annual enrollment of 8,000 people necessary for the modified Armed Forces, keeping 64 military universities is an intolerable luxury. The same is true for the military research organizations. Having survived since the Soviet time, they required substantial funding with nearly zero yields. Every tenth officer of the Armed Forces was engaged in the university and MRO system and, what's worse, secrecy hampered cooperation between the institutions advocating polar stances with regard to the problem of current/prospective weaponry.

Hence, ensuring integration between military universities and research institutions is a critical challenge, which might be yet more fruitful from the perspective of the general trends of innovational development.

But another problem raises serious concerns, that is, zero growth in the number of military schools for fresh conscripts in the Army and in the Navy, which means that what then President V. Putin vowed in one of his presidential addresses, that is, upon transition to the 1-year-long conscription young soldiers would be trained for the first half-year and dispatched to regular units for the other one, will remain unfulfilled. Hence the peril that fresh conscripts would be immediately dispatched to the permanent-readiness units and, if need be, further deployed in a zone of military conflict. Hence the question as to whether the pre-conscript training can serve as an adequate substitute for a military training camp.

5.8.6. Solving the Military's Social Problems

The most critical for the military reform avenue was labeled "Improvement of the social well-being of the military". Contrast to the other avenues, the respective measures were publicized in a fairly detailed document "The Strategy of the social development of the Armed Forces of the Russian Federation for the period through 2020". The document was approved

[1] Minutes of the meeting on development of the defense-industrial complex. Reutov, October 26, 2009. http://www.kremlin.ru/transcripts/5825.

at the Collegiums of the Defense Ministry, i.e. on the departmental level, rather than the federal one, on March 23, 2008. According to Mr. N. Makarov, Head of the General Staff, the Ministry will not need to raise any additional funds to implement the Program.

The Strategy encompasses all the social aspects of the military, civil employees with the Armed Forces, retirees, and their family members' lives. The authors of the document believe that solving the core challenge, that is, "meeting the social needs", necessitates completion of seven tasks, of which, as evidenced by the media, the primary ones are pay rises and the housing problem.

In late 2008, the domestic mass media aired vows by the Defense Ministry's leadership to considerably raise monetary allowances for the military. In reality, however, such pay rises were not made available to everyone. In compliance with the Defense Minister's order of August 2, 2008, № 400 "On awarding officers of the Armed Forces of the Russian Federation with money", as many as 34,000 best officers receive monthly bonuses effective as of January 1, 2009 and through December 31, 2009. The bonuses vary from Rb. 35,000 to 150,000, depending on the branch of the Armed Forces, rank and actual position of the grantee. It is planned to increase the number of grantees in 2010. To this effect a special bonus pool worth a total of Rb. 100bn was formed in the 2010 federal budget, with a view that the bonuses are payable in 2010-11.

Even if an officer's merits in 2008 were acknowledged with the "Minister's" bonus in 2009, it does not shield him from the peril of being dismissed due to the organizational-manning measures (to put it boldly, staff cuts) which are underway in the Armed Forces in 2009 due to the military reform. Bonuses for the rank-and-file military are not provided for, though, which is why the military service on these positions has not become more popular on the labor market.

During the whole 2009 the domestic media have been voicing justified doubts regarding the way the "Minister's bonuses" were awarded. In the fall of the year the information appeared that the criticisms had been heard of – following the military's opinions, the order should be amended- namely, since 2010 the bonuses will become payable not to an individual, but to a whole unit, which had demonstrated the best performance in 2009.

The "Strategy" provides for three stages of fulfillment of the tasks. The first stage is 2008-2012. The task with regard to service pays set for this stage reads as follows: "increase of the military's monetary allowance to the level of 90 per cent compared with the average salaries and wages of employees in the national economy". It is further envisaged that by 2020 (the deadline for the Strategy's effect) the monetary allowance would account for 1.25 of the average wages nationwide, which should boost up the military service's attractiveness on the labor market. As stipulated in the "Report on implementation of the Strategy of social development of the Armed Forces in 2008", to fulfill the task the Defense Ministry has designed and approved a "strategic plan of improvement of the monetary allowance through 2020" and drafted a bill on the military's monetary allowance reform. But the launch of the monetary allowance calculation system has been temporized.

The new system shall concern all the military on service and the military pensioners alike. The concept of the bill in question was to be submitted to the RF Government until October 1, 2009, but it still is not there.

Addressing to the State Duma in April 2009 with an account on the RF Government's performance in 2008, Prime-Minister V. Putin vowed that "by 2012 all the military in the Armed

Forces shall have been transited to the new monetary allowance system" and that under new arrangements the platoon commander's salary should be in a region of Rb. 50,000. Addressing the Federal Assembly on November 12, 2009, Pres. D. Medvedev echoed these words by maintaining that, "By 2012 we should also pass a special act on the military's monetary allowance". On November 15, the President issued the following executive order on implementation of the presidential Address to the Federal Assembly: "to submit to the State Duma a bill on the military's monetary allowance[1]". Mr. A. Serdyukov, the RF Defense Minister, argued at the Collegiums of the Ministry that a considerable increase of the monetary allowance will be made only since 2013, "when the new officer and sergeant corps has been formed".

Since August 2009 salaries by the military position and those by the military rank were raised by 8.5% for all the military. As the structure of the monetary allowance has remained unchanged, accordingly, the proportion of the monetary allowance in the salaries has not changed, either. That is to say it has remained at the level of below 40% (with the plans to attain the 40% benchmark only by 2012)[2]. As a consequence, the positive effect of the said pay rise is in decline, while the major drawback is still there, that is, the monetary allowance of the rank-and-file personnel remains low and uncompetitive on the labor market.

Meanwhile, the problem of the new structure of monetary allowance constitutes a core issue for the formation of the draft-based army. Given that the respective decision has been postponed, the draft-based army in Russia will have emerged no earlier than by 2020 and, hopefully, the Strategy of the social development will have be completed by then, too.

The situation with housing for the military leaves much to be desired. While addressing the Federal Assembly, Pres. Medvedev noted, "The set objective- that is, to secure <the military> with constant housing in 2010 and with the departmental one in 2012 shall be completed to the letter". The Defense Ministry's calculations proved the need in 90,000 apartments, and the decision was made to provide them in halves in 2009 and 2010. But in reality, according to Mr. V. Filippov, head of the Defense Ministry Construction and Billeting Service, as of November 2009, as many as some 25,000 apartments had been received and handed over to the military. Thus, the 2009 plans in this regard have failed, but the problem does not lie just in this fact. It goes without saying, 90,000 apartments will not be able to eliminate the shortage of permanent residential housing, as every year quite a number of the military retire and their need in accommodation should be satisfied.

5.8.7. Social Integration of the Retired Military

Regretfully, the problem of the military's social integration is regarded as a temporary one, which should be solved en route the transition towards the "new face". This is evidenced by the name of the Defense Ministry's own departmental program – "Fulfillment of social guarantees for the military dismissed from the military service in the period between 2009 and 2011", which was approved by the Minister's order of February 14, 2009.

The matter of the fact is, social integration of the former military should be included in the list of regularly exercised measures, for the transition of the RF citizens from the civil sphere into the military one and vice versa constitutes a normal process, which will continue further

[1] http://www.president.kremlin.ru/news/6001
[2] http://www.mil.ru/849/11876/37870/index.shtml

on and will be occurring repetitiously. Therefore, the social integration problem should have its own legal and economic-financial rationale and solution.

Currently the following forces have been deployed to cope with the problem: 57 military universities ready to provide a full-scale certified vocational training to officers by 144 civil professions; a handful of civil educational institutions that practice distance tuition; and charity organizations. In contrast to retraining programs of the 1990s, the role of international aid in this respect has become insignificant.

As to job opportunities *per se*, the problem has been passed over to the regional level. Plus, some of retired officers have got a chance to maintain their engagement with their department in a new capacity of a civil servant – there have appeared jobs in the Defense Ministry that can be filled both by officers and civil servants.

5.8.8. Improving the Planning, Programming, Execution and Performance Control System

Even the 5-day war with Georgia resulted in adjustment of the State Armament Program for 2007-2015 in the part of conventional forces. Failures to launch "Bulava" require the same with regard to the strategic forces, and this list can be extended further on. The reality dissuades one from appreciating the viability of the effective development procedures of government arms programs, with their five-year cycle, or the respective methodology. That said, the work on the new state arms program for 2011-2020, which had been ruled by the military commission under the RF Government back in December 20, 2007, started using the same old methodology. Meanwhile for the Armed Forces it is planned to attain the following levels of "the balance between maintenance costs and equipping one": 50:50 - by 2011 and 30:70 – by the end of 2015[1]. This is the backlog to the Soviet time. The civilized nations' experience testifies in favor of rationality of absolutely different proportions - more specifically, the European Defense Agency recommends the EU member nations not to curtail the proportion of the equipping costs in their military budgets below 20%[2], but not to hold them at the level 50 or a formidable 70%.

In parallel with that, there is an array of issues that formally fall beyond the mandate of the RF Defense Ministry and the Armed Forces – one will have to transform the military-technical policy control system, the system of orders and, on top of that, the system of the financial and economic control over these processes and preclude corruption from rising in the military economy, which by far has been notorious for that. Plus, the sphere of military service is equally notorious for numerous abuses and violations of the military's rights.

Those who propone reallocation of budget funds to give a boost to development of weaponry, military and special hardware label the army maintenance costs "a money waste", as if the funds were not spent on retaining our troops' combat readiness. But a sizeable proportion of the funds allocated for R&D and arms supplies is spent on labor compensations to the DIC employees, i.e. "wasted away" by their households. Yet a greater fraction of the funds in question is spent on the bureaucrats' labor compensations and, most appallingly, on kickbacks, quasi-bonuses and other illicit kinds of "money waste". That is the black hole consuming a

[1] *Popovkin V.* Novym Vooruzhennym Silam – novoye oruzhiye//Rossiyskoye voennoye obozreniye. 2009. №3. p. 20

[2] *Korobov I.* Voenno-promyshlennnaya integratsia straan Evropeyskogo soyuza//Zarubezhnoye voyennoye obozreniye. 2010.№ 1, p. 27

sizeable proportion of funds tagged as "development costs". While the public spending on the military aircraft and weaponry has been on the rise over recent years, in reality, the Air Force received only 3 new aircraft. The tendency was reversed only in 2009, but many experts ascribe this fact not so much to the growing attention to the army's needs, but to Algeria's refusal to buy originally agreed upon MIGs-29.

The discussion on proportions of "money waste" and "development" forms a smokescreen for the bureaucracy reluctant to offer the military (let us note, mostly scions of the needy families) a decent compensation for the hard and dangerous soldier labor, as such costs do not yield any kickback. It is far simpler to bite a piece from a huge public order, even more so as the respective procedures are typically closed ones. The closeness of the DIC from the rest of the economy likewise fuels corruption.

The methodology of the works needs to be revised, too. It is imperative to transit to a national analogue of a well-justified US system of budgeting as a core public administration vehicle. In so doing, it is equally necessary a task to identify causes that have utterly delayed the current reform and, accordingly made it hardly implementable.

5.8.9. The Military-Budget Policy and the Problem of Openness

In the conditions of the current financial and economic crisis the flexibility of the nation's annual financial plan hit an unprecedented level – while in 2008, in the first year of the crisis, the federal budget was modified just four times upon its approval, in 2009 there were seven such modifications, ie once in every six weeks. Between the RF President's signing into act the first version[1] of the federal budget and the moment of approval of the eighth one[2] allocations by section 02 "The National Defense" shrank for the first time over many years – from Rb. 1,336trln to 1,193trln, or by 10.7%, against an overall 9.1% increase in the federal budget expenditures over the same period. Compared with the 2008, the increase in allocations on the said section ultimately accounted for 12.6% in real terms[3] concomitant with a 0.56 p. p. increase in its proportion in GDP.

The level of secrecy of the 2009 federal budget expenditures slid insignificantly (*Table 2*) resulting from Rb. 96, 344bln in direct cuts in secret appropriations made in the course of the budget modification in April 2009 and increase in budget expenditures due to the government's anti-crisis measures. However, all that has had no effect on transparency of the budget *per se*. Secret allocations have survived to date in such expenditure sub-items as 0701 "Preschool education", 0801 "Culture" and 0908 "Physical culture", their presence therein impossible to explain in rational terms. The proportion of secret expenditures has been on the rise across Section 05 "The housing and public utilities" (up by 62%) and 'The national economy" (+92%), with just "Environmental policy" continuing to be the one and only Section in the federal budget immune to the secrecy fever.

[1] On the 2009 federal budget and the planned period 2010 and 2011: federal act №204-FZ; passed by the State Duma on October 31, 2008

[2] On introducing amendments to federal act "On the 2009 federal budget and the planned period 2010 and 2011": federal act №309-FZ; passed by the State Duma on November 20, 2009

[3] With the use of the GDP deflator index (Rosstat's initial estimate for 2009 is 102.7%). Given the crisis conditions, earlier being conservative, this estimate has grown into an optimistic one, as the average annual values of indices of both consumer prices and industrial producer prices have remained in double digits.

Table 2

Proportion of Secret Appropriations in the Federal Budget Expenditures in 2003–2009, in %

Code and name of the Section (sub-section) that comprises secret expenditures	2003	2004	2005	2006	2007	2008.	2009
The federal budget expenditures, total	9.73	9.83	11.33	11.80	10.33	11.92	10.01
0100 GENERAL PUBLIC ADMINISTRATION ISSUES	n/a [1]	n/a	3.67	6.28	5.52	8.66	5.05
0108 International relations and international cooperation	31.88	18.04	–	0.01	< 0.01	3.66	–
0109 The state material reserve	97.73	93.33	82.86	89.23	92.18	90.17	85.01
0110 Fundamental research	–	–	2.13	1.22	1.12	0.97	0.78
0114 Other general public administration issues	n/a	n/a	0.05	0.72	0.28	4.42	1.56
0200 NATIONAL DEFENSE	37.22	38.40	42.06	42.77	45.33	46.14	48.09
0201 The Armed Forces of RF	35.39	36.11	33.07	35.59	37.11	39.04	40.21
0204 Mobilization preparation of the economy	100.0	100.0	100.0	100.0	100.0	100.0	100.0
0205 Preparation for and participation in provision of the collective security and peacekeeping activities	–	–	100.0	100.0	100.0	–	–
0206 Nuclear arms complex	100.0	100.0	100.0	100.0	100.0	100.0	100.0
0207 Implementation of international obligations in the sphere of military-technical cooperation	100.0	41.05	45.22	46.90	50.65	100.0	100.0
0208 Applied research in the area of national defense	n/a	n/a	98.37	93.94	93.69	93.20	92.85
0209 Other issues in the national defense area	n/a	n/a	2.49	8.79	24.38	29.21	34.64
0300 NATIONAL SECURITY AND LAW ENFORCEMENT	23.33	20.79	28.52	31.64	31.07	31.84	30.82
0302 Interior Ministry bodies	3.40	3.01	4.76	6.31	5.16	4.97	3.70
0303 Interior Ministry troops	13.21	11.10	11.76	10.31	9.80	10.25	8.19
0306 Security bodies	100.00	98.91	97.80	95.49	97.31	99.05	99.61
0307 Border Guard bodies	19.73	22.88	100.00	98.97	97.62	100.00	99.47
0309 Population and territory protection from emergency situations of natural and technogenetics situation, civil defense	43.69	41.74	59.02	62.39	50.65	51.39	51.00
0313 Applied research in the area of national security and law enforcement activity	n/a	n/a	73.95	66.41	64.43	75.49	79.35
0314 Other matters in the area of national security and law enforcement activity	n/a	n/a	8.26	50.71	39.95	56.32	68.37
0400 NATIONAL ECONOMY	n/a	n/a	0.05	0.02	0.44	0.64	0.55
0411 Applied economic research	n/a	n/a	–	–	5.23	5.84	4.49
0412 Other matters in the national economy area	n/a	n/a	0.12	0.06	< 0.01	0.31	0.72
0500 HOUSING AND UTILITIES SECTOR	n/a	n/a	–	3.42	0.85	6.96	10.09
0501 Housing	n/a	n/a	–	4.22	5.69	15.97	12.91
0700 EDUCATION	–	–	2.76	2.69	2.39	2.55	3.06
0701 Preschool education	–	–	2.03	2.17	2.44	2.48	2.45
0702 General education	–	–	1.51	1.91	2.14	2.00	2.75
0704 Secondary vocational training	–	–	1.06	1.03	1.02	0.86	0.99
0705 Professional training and retraining	–	–	16.85	15.78	17.22	1.80	2.54
0706 University and post-graduate professional education	–	–	3.15	2.93	2.53	3.08	3.64
0709 Other matters in the sphere of education	–	–	0.30	0.33	0.28	0.29	0.48
0800 CULTURE, MOTION PICTURE INDUSTRY, MASS MEDIA	–	–	0.17	0.17	0.21	0.17	0.18
0801 Culture	–	–	0.14	0.10	0.16	0.10	0.14
0804 Periodical media and publishing	–	–	13.46	7.45	2.57	2.62	3.14
0806 Other matters in the sphere of culture, motion picture industry and mass media	–	–	0.02	0.15	–	–	–
0900 HEALTH CARE, PHYSICAL CULTURE AND SPORTS	–	–	4.30	3.99	2.57	4.14	3.54
0901 Stationary medical assistance	–	–	5.61	4.66	2.94	3.24	2.77
0902 Outpatient medical assistance	n/a	n/a	n/a	n/a	n/a	13.94	4.34
0905 Rehabilitation	n/a	n/a	n/a	n/a	n/a	14.07	15.88
0907 Sanatorium-epidemiological well-being	n/a	n/a	n/a	n/a	n/a	2.09	0.63
0908 Physical culture and sports	–	–	0.28	0.26	0.24	0.42	0.32
0910 Other matters in the sphere of health care, physical culture and sports	–	–	–	–	–	1.74	1.07
1000 SOCIAL POLICY	–	–	–	–	–	0.01	0.01
1003 Social security of the population	–	–	–	–	–	0.02	0.02
1100 INTERBUDGETARY TTRANSFERS	–	–	–	–	0.16	–	–
1101 Subsidies to budgets of the RF Subjects and municipal entities	–	–	–	–	0.50	–	–

Source: the IET calculations by the 2003-2009 federal budget data (the 2003-2007 data have been adjusted to the respective sections and subsections of the budget classification that took effect as of January 2008)

So what constituted the genuine cause behind making programs, such as, for instance, the FTP "Development of the defense-industrial complex over the period 2007-2010 and through

[1] Non-applicable due to the modifications in the structure of the budget classification.

2015" classified information? The program in question was adopted back in 2006 and has been middling well ever since with no sufficient, albeit secret financing. According to Mr. V. Khristenko[1], the RF Minister of Trade and Industry, in all likelihood the state secret merely shields from bureaucrats and heads of the DIC enterprises from criticism and control.

Absolute and relative values of main components of direct military appropriations in the federal budget and their change relative to 2008 according to the final version of the 2009 federal budget are given in ***Table 3*** (recalculation into the 2008 prices was made with the use of the Rosstat's initial estimate of the 2009 GDP deflator index[2]).

Table 3

Direct Military Appropriations in the Federal Budget on Section 02 "National Defense"

Section and subsections	2009, as Rb mln / the same in the 2008 prices	Change 2009/2008 as Rb. mln./ increase as %	Allocated proportion, as % / change vs. 2008, as p.p.	
			In the 2009 federal budget	In GDP
1	2	3	4	5
NATIONAL DEFENSE	1 192 867	129 948	12.12	3.06
	1 161 506	12.60	–2.57	0.56
The Armed Forces of the Russian Federation	887 916	115 639	9.02	2.28
	864 573	15.44	–1.65	0.46
Mobilization and out-base training	3 623	–1 517	0.04	0.01
	3 528	–30.07	–0.04	–
Mobilization preparation of the economy	3 381	–208	0.03	0.01
	3 292	–5.95	–0.02	–
Preparation for and contribution to provision of collective security and peacekeeping operations	264	–303	<0.01	<0.01
	257	–54.11	–0.01	–
Nuclear weapons complex	19 081	1 495	0.19	0.05
	18 579	8.75	–0.05	–
Implementation of international obligations in the military-technical cooperation area	4 455	427	0.05	0.01
	4 338	10.92	-0.01	–
Applied research in the national defense area	162 896	25 271	1.65	0.42
	158 614	18.95	–0.24	0.09
Other issues in the national defense area	111 251	–10 857	1.13	0.29
	108 326	–9.11	–0.57	–

Source: the IET calculations.

As a year ago, subsection 0202 "Modernization of the Armed Forces of the Russian Federation and Military Formations" appears missing in the open part of the federal budget and, judging by the match between the amount of allocations by subsections and the aggregate amount of allocations on Section 02[3], it is still missing in the secret appendices, either.

Military allocations by other sections of the federal budget are presented in ***Table 4***.

[1] Minutes of the meeting on development of the defense-industrial complex. Reutov, October 26, 2009. http://www.kremlin.ru/transcripts/5825.

[2] Osnovnye ekonomicheskiye i sotsialnye pokazateli Rossii v 2009 ujdu: M.: Rosstat, February 9, 2009. http://www.gks.ru/rufree_doc/2009/b09_01/1-o.htm

[3] See the Federal Treasury data on execution of the consolidated budget

Table 4

Direct and Indirect Military Expenditures across Other Sections of the Federal Budget

The name of the section or *the nature of appropriations*	2009, as Rb. mln / the same in the 2008 prices	Change2009 to 2008, as Rb mln. / increase, as %	Proportion of the appropriation, as % / change relative to 2008, p.p.	
			in the 2009 federal budget	in GDP
In Section 03 «National security and law enforcement activity»				
Law enforcement forces	57 652	1 893	0.59	0.15
	56 136	3.49	–0.19	0.02
Security agencies	179 755	28 816	1.83	0.46
	175 029	19.71	–0.261	0.11
The border guard structures	80 134	10 164	0.81	0.21
	78 027	14.98	–0.15	0.04
The RF MES forces and civil defense	41 152	3 289	0.42	0.11
	40 070	8.94	–0.11	0.02
In Section «National economy»				
The presidential program "Liquidation of the chemical weapons inventory in RF"	1 081	–1 551	0.01	<0.01
	1 053	–59.57	–0.03	–
Subsidies to transportation organizations that exercise procurements of motor vehicles for completion of the mobile component of motor columns.	80	–16	<0.01	<0.01
	78	–17.15	–	–
Subsidies to the functioning of the Russia-NATO coordination center	21	–3	<0.01	<0.01
	20	–13.10	–	–
Construction of special and military objects	4 317	–2 075	0.04	0.01
	4 204	–33.04	–0.05	–
FTP «Industrial utilization of weaponry and military hardware (2005–2010)»	45	–45	<0.01	<0.01
	44	–50.78	–	–
Subsidies to "Rostekhnologii" public corporation	4 408	2 792	0.04	0.01
	4 292	186.11	–0.03	–
Contribution to authorized capital of, and subsidies to organizations of the defense-industrial complex	37 014	27 810	0.38	0.09
	36 041	337.87	0.26	0.07
Classified expenditures	10 655	4 967	0.11	0.03
	10 375	91.85	0.03	0.01
In Section 05 «Housing and Utilities Sector»				
FTP «Industrial utilization of weaponry and military hardware (2005–2010)»	2 165	316	0.02	0.01
	2 108	17.62	–	–
Provision of the military with the departmental and permanent housing	84 627	47 494	0.86	0.22
	82 402	136.06	0.36	0.13
Classified expenditures	14 346	5 358	0.15	0.04
	13 968	62.22	0.02	0.02
In Section 07 «Education»				
The RF Defense Ministry's expenditures	42 315	6 111	0.43	0.11
	41 203	17.42	–0.07	0.02
Classified expenditures	12 263	3 318	0.12	0.03
	11 940	38.47	–	0.01
In Section 08 «Culture, motion picture industry, mass media»				
The RF Defense Ministry's expenditures	3 533	726	0.04	0.01
	3 440	26.74	–	–
Classified expenditures	201	37	<0.01	<0.01
	196	23.11	–	–
In Section 09 «Health Care, Physical Culture and Sports»				
The RF Defense Ministry's expenditures	31 063	5 061	0.32	0.08
	30 247	20.09	–0.04	0.02
Classified expenditures	11 890	2 164	0.12	0.03
	11 578	22.99	–0.01	0.01
In Section 10 «Social Policy»				
The RF Defense Ministry's pension plans	115 638	16 549	1.17	0.30
	112 598	17.23	–0.19	0.06
The FSB pension plans	17 554	1 458	0.18	0.04
	17 092	9.33	–0.04	0.01
Procurement of housing for the retired and designated for retirement military	10 598	–1 737	0.11	0.03
	10 320	–14.41	–0.06	–

The name of the section or *the nature of appropriations*	2009, as Rb. mln / the same in the 2008 prices	Change2009 to 2008, as Rb mln. / increase, as %	Proportion of the appropriation, as % / change relative to 2008, p.p.	
			in the 2009 federal budget	in GDP
Complementary monthly material allowance to the disabled due to the military injures	373 363	57 18.79	<0.01 –	<0.01 –
Provision for conduct of refurbishment of individual housing owned by the families of military that have lost the breadwinner	317 308	18 6.36	<0.01 –	<0.01 –
Compensations to family members of the deceased military	1 481 1 442	–11 –0.78	0.02 –0.01	<0.01 –
Relief and compensations to the military, individuals equaled to them, and those dismissed from their ranks	12 353 12 028	3 941 48.72	0.13 0.01	0.03 0.01
Classified expenditures	17 17	2 10.03	<0.00 –	<0.00 –
In Section 11 «Interbudgetary transfers»				
Subsidies to CATEs' budgets	10 442 10 168	390 3.99	0.11 –0.03	0.03 –
Support of measures on ensuring the CATEs' budget equilibrium	1 095 1 066	–68 –6.03	0.01 –0.01	<0.01 –
Development of, and support to the CATEs' social and engineering infrastructure	5 412 5 270	–546 –9.39	0.05 –0.03	0.01 –
Running the primary military and conscription records in territories with no military commissariats in place	2 066 2 012	387 23.82	0.02 –	0.01 –
One-time allowance to a conscript's pregnant wife and the monthly allowance for a conscript's child	1 077 1 049	– –	0.01 0.01	<0.01 –
Residents relocation from CATE	1 318 1 283	49 3.99	0.01 –	<0.01 –
Material security for specialists of the nuclear-arms complex of RF	3 303 3 216	1 010 45.78	0.01 –	<0.01 –
Complementary monthly material security for disabled due to the military injury	655 638	–32 –4.82	0.01 –	<0.01 –

Source: the IET calculations.

The 2009 RF Defense Ministry's allocations on housing construction by Section 02 ("National defense") dwindled by 77% in real terms vs. the prior year's figures; however, that was overwhelmingly compensated for by a 136% increase in allocations to the military in the frame of Section 05 ("Housing and utilities"). Despite the moves, the objective set a few years ago, that is, provision of the military with housing by 2010 (i.e. by the end of 2009) was not attained. The federal budget appropriations on the housing certificates have remained practically unchanged since 2008 (see ***Table 4***), while the military mortgage certificates posted a triple-plus growth (up to Rb. 3. 217bln), which should be ascribed to the low-base effect, as due to reasons nobody bothered to explain the 2008 appropriations were curtailed more than twice, down to Rb. 4,063bln.

While the annual appropriations on the Defense Ministry military personnel rose by 35% (24.4% in real terms[1]), in August 2009 the military's monetary allowance and pensions were increased just by 8.5%. That is to say, with account of the consumer price rise from the moment of the prior pay rise, the military's incomes in real terms had dropped by some 8% by the end of the year. The aforementioned bonuses granted to some 10% of the officer corps cannot fully explain the noted surplus by the item "Military personnel" estimated at a level of not less than Rb. 20 to 30bln. It might well happen that one of the reasons behind creation such a pool

[1] With the 2009 average annual CPI (11.7%) factored in.

has been its spending on readjustment pays in the course of the planned considerable cuts in the number of officers and warrant officers.

In 2009, allocations on military training were axed at 29% in real terms vs. the prior year, as in April the Defense Ministry opted for sequestration chiefly at the expense of the current expenditures. Allocations for the material and logistical supplies were curtailed by 15%, with the major cuts falling on fuel and lubricants (29% down); allocations for food supplies remained unchanged, while those on material support were cut once again, for another 9%, which further aggravated the situation with shortages of uniform, bed sheets and laundry services in the Armed Forces. It should be assumed that while the effect of noted fall in procurements of fuel and lubricants was mitigated by the price fall for oil products on the domestic market, it anyway has not contributed to a notable progress in terms of military readiness in the Air Force and the Navy compared with 2008, nonetheless.

The Defense Ministry's pension allocations were increased by 20% compared with the year 2008, thus, they sufficed to ensure a nominal 8.5% pensions rise since August 2009 and the respective payments in favor of the military dismissed in the process of the started reduction of the Armed Forces.

Calculated according to the UN military expenditure standards, the 2009 federal budget direct military appropriations (*Table 5*) accounted for 4.7% of GDP, while inclusive of allocations associated with the past military activities (military pensions, destruction of chemical weapons, etc.), they stood at 5.1% of GDP.

Table 5

Aggregate Indicators of the Federal Budget Military Expenditures and Other Associated Expenditures

Expenditure	Amount of appropriations, as Rb. mln	Proportion of appropriations, as % / its change vs 2008 г., as p.p.	
		In the 2009 federal budget	In GDP
Overall direct military appropriations	1 828 385	18.57	4.69
		–2.83	1.04
Aggregate direct and indirect military appropriations related to the current and past military activity	1 995 388	20.27	5.11
		–3.16	1.13
Aggregate appropriations across sections "National defense" and "National security and law enforcement activity"	2 215 322	22.50	5.68
		–4.00	1.17

Source: the IET calculations.

As far as the issue of aggregate military expenditures is concerned, the execution of the 2009 federal budget displays no striking difference vis-à-vis the 2008 figures. Specifically, the Federal Treasury reports a Rb. 7,875bln-worth excess of the expenditure limit by the aggregate budget estimate of the federal budget over the respective appropriations by Section 02 "National defense" already since January of the year. The gap has been widening since and hit its peak value of Rb. 19,471bln. in July, but subsequently slid to 10,845bln in the fall 2009. To benchmark the executive power's discretionary powers, it should be noted that sections 9, 11 and 13 of Art. 25 of the 2009 federal budget act have capped increase in military appropriations at the expense of extra budget revenues in the frame of the specified budget estimate with Rb. 13,549bln; plus, by 2008 results this particular expenditure section posted a Rb. 9, 283bln overspending of budgetary funds.

The data on the monthly execution of the military expenditures and other associated expenditures of the 2009 federal budget are presented in *Table 6* and *Figs 1-3*. The year 2009 saw

some progress in execution of military expenditures – specifically, the period for effecting up-front payments, the 1st quarter, appeared far clearly squared, the December overhang reduced, but that formed a backdrop for the problem of the practical absence of federal budget expenditure in January.

Table 6

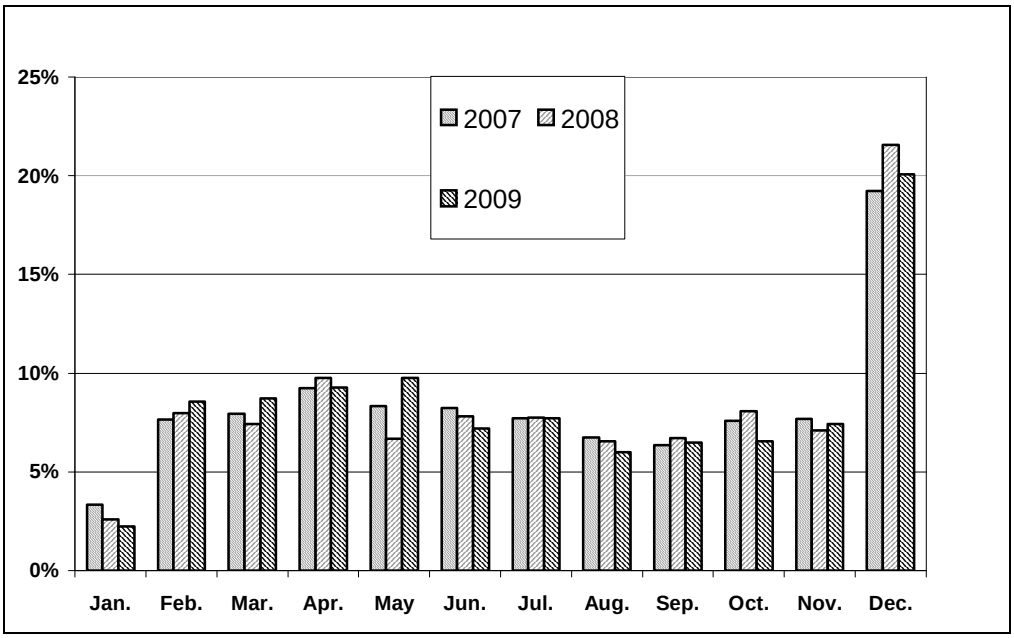
Monthly Execution of the Federal Budget Military Expenditures and Other Associated Expenditures in 2009, as Rb. Bn.

Expenditures	As per the FB 2009[1]	FB-2009 , as amended[2]	January	February	March	April	May	June	July	August	September	October	November	December	Saved (over-spent)
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16
NATIONAL DEFENSE	**1 336.4**	**1 192.9**	**22.5**	**96.4**	**96.6**	**116.6**	**107.4**	**81.9**	**85.2**	**72.1**	**72.4**	**75.0**	**78.6**	**89.8**	**4.7**
Armed forces of RF	962.6	887.9	20.0	76.8	78.0	83.1	87.4	64.4	69.2	53.6	58.2	58.8	66.5	179.9	(1.8)
Mobilization and out-of-army training	6.7	3.6	0.0	0.0	0.0	0.2	0.3	0.5	0.1	0.1	0.3	0.3	0.4	1.2	0.1
Mobilization preparation of the economy	3.5	3.4	0.0	0.1	0.2	0.2	0.3	0.8	0.6	0.6	0.5	0.3	0.3	0.6	(1.2)
Preparation for and participation in provision of the collective security and peace-keeping activities	0.1	0.3	–	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.0	0.0	0.0	0.2	(0.2)
Nuclear arms complex	22.4	19.1	0.8	2.0	1.3	0.3	2.5	1.3	0.1	0.1	0.3	0.0	0.2	0.5	–
Implementation of international obligations in the sphere of military-technical cooperation	2.9	4.5	0.8	0.5	0.1	0.0	0.0	0.6	0.4	0.2	0.2	0.0	1.0	0.9	0.4
Applied research in the area of national defense	174.2	162.9	0.6	16.0	12.7	19.5	7.8	8.2	7.1	9.3	5.2	8.4	13.1	53.0	(0.3)
Other issues in the national defense area	164.0	111.3	0.2	1.1	4.2	13.2	9.1	6.0	7.6	8.2	7.6	7.1	8.3	31.4	7.6
NATIONAL SECURITY AND LAW ENFORCEMENT	**1 093.2**	**1 022.5**	**27.9**	**80.8**	**81.9**	**73.9**	**69.7**	**84.6**	**77.8**	**64.2**	**92.0**	**79.1**	**94.3**	**153.8**	**18.0**
Interior Ministry bodies	65.0	57.7	1.3	2.7	6.7	4.3	4.2	4.8	4.3	4.5	4.5	4.5	5.2	10.7	(0.3)
Interior Ministry troops	185.1	179.8	5.1	14.0	13.9	13.3	11.8	13.4	14.0	12.2	13.1	14.4	15.1	30.4	0.5
Security bodies	92.4	80.1	1.7	5.7	5.9	5.4	6.2	5.7	7.7	5.6	5.6	6.1	7.6	13.0	1.3
Border Guard bodies	56.8	54.5	1.6	3.6	7.3	3.5	3.0	4.5	3.8	4.9	7.4	3.8	4.4	11.1	(4.2)
Population and territory protection from emergency situations of natural and technogenetics situations, civil defense	10.4	9.4	0.2	0.7	0.5	0.4	0.5	0.6	0.5	0.6	0.7	0.5	0.9	1.7	1.4
Applied research in the area of national security and law enforcement activity	7.6	9.4	0.2	0.3	0.4	0.3	0.2	0.9	0.2	0.3	0.3	1.5	0.5	1.3	2.6

Source: the IET calculations basing on the data of the Federal Treasury.

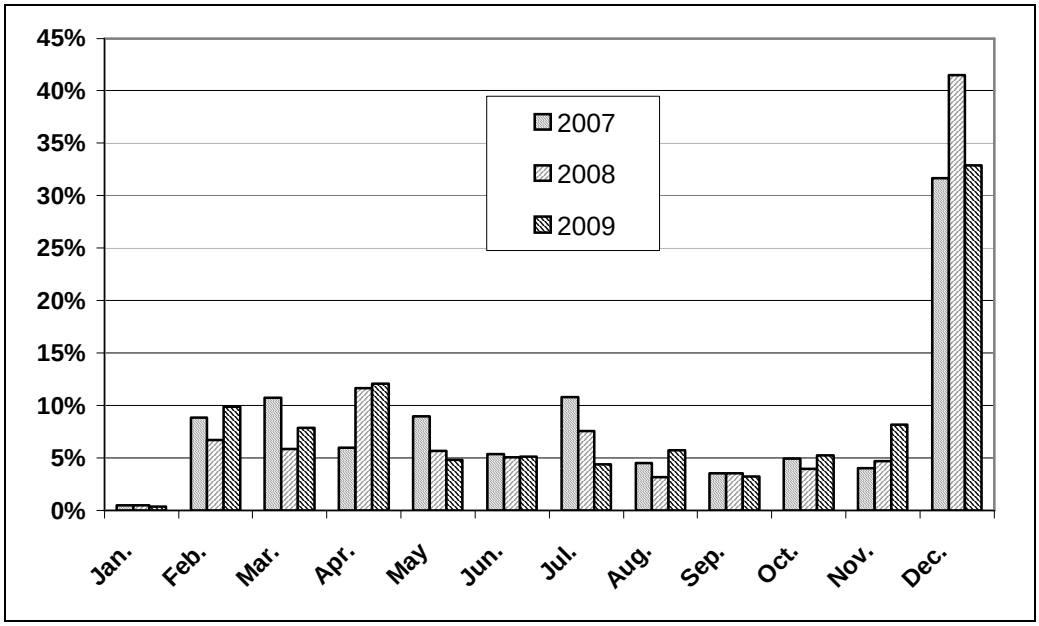
[1] On the 2009 federal budget and the planned period 2010 and 2011: federal act №204-FZ; passed by the State Duma on October 31, 2008

[2] On introducing amendments to federal act "On the 2009 federal budget and the planned period 2010 and 2011": federal act №309-FZ; passed by the State Duma on November 20, 2009



Source: the IET calculations basing on the data of the Federal Treasury.

Fig. 1. Execution of the Federal Budget Expenditures by Sub-Section 0201 «The Armed Forces of the Russian Federation » in 2007–2009



Source: the IET calculations basing on the data of the Federal Treasury.

Fig. 2. Execution of the Federal Budget Expenditures by Sub-Section 0207 "Applied research in the area of national defense" in 2007–2009

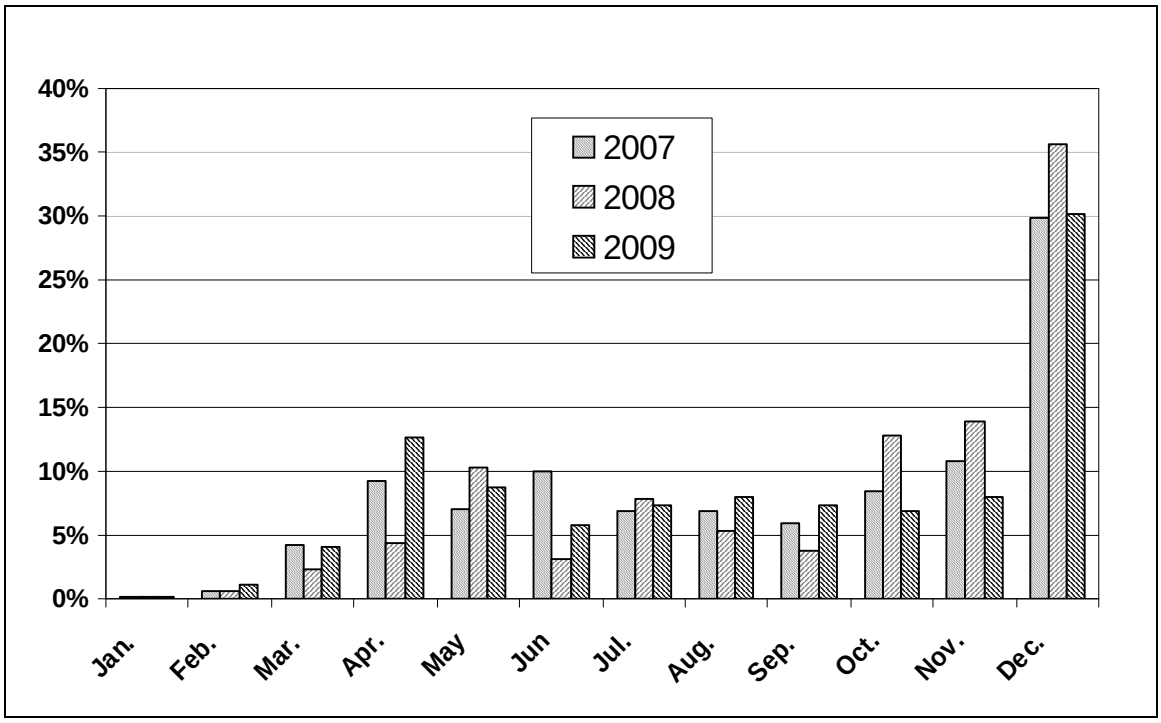


Fig. 3. Execution of the Federal Budget Expenditures by Section 0208 "Other Matters in the Area of National Defense" in 2007–2009

Table 7 evidences that long-standing trends continue to persist in the Federation Subjects' military expenditures – the ones on mobilization and out-of-army training generally do not exceed the amount of transfers from the federal budget on exercising the primary military registration.

Table 7

Military Expenditures of the Consolidated Budgets of the Federation Subjects in 2003–2009, as Rb. mln*

Name of the sub-section of the expenditure classification	2003	2004	2005	2006	2007	2008	2009
	–	–	–	3.5	0.5	0.3	–
The Armed Forces of the Russian Federation	–	–	–	0.1	0.3	0.3	–
Modernization of the Armed Forces of the Russian Federation and military establishments	–	–	–	–	–	1.0	–
	–	–	–	–	–	0.5	–
Mobilization and out-of-army training	13.1	–	65.6	899.3	1 351.9	1 797.9	2 116.0
	13.2	–	65.6	808.6	1 245.6	1 702.2	2 021.6
Mobilization preparation of the economy**	449.7	532.4	485.4	708.3	861.2	1 137.2	1 045.4
	405.6	500.6	468.6	692.8	840.9	1 063.9	989.7
Other matters in the national defense area	–	–	109.6	32.8	5.5	0.7	4.4
	–	–	97.5	32.1	5.7	0.5	4.4
Ministry of Interior forces	14.6	12.4	9.9	3.5	1.0	0.3	–
	12.7	12.2	9.9	1.4	1.0	0.3	–
Security agencies	3.7	6.7	0.3	16.5	0.1	0.0	60.0
	2.1	6.5	0.3	16.5	0.1	0.0	60.0
Border Guard bodies	–	–	0.1	–	–	–	–
	–	–	0.1	–	–	–	–
Population and territory protection from emergency situations of natural and technogenetics situations, civil defense	6 511.0	7 968.2	11 184.6	15 636.4	19 118.4	23 895.8	23 865.0
	6 244.1	7 281.3	10 958.9	14 367.0	18 292.6	21 456.7	21 712.6

*numerator – as allocated, common denominator – as earmarked.
** had not been included in the section "National defense" until 2005

Table 8 presents results of the 11-year-long statistical monitoring of Russia's military expenditures over the period of 1999–2009. To avoid double count, the data do not comprise the ones presented in *Table 7*.

Table 8

Main Indicators of Military Expenditures of the Russian Federation in 1999–2009

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
1. In nominal terms (in current prices), as Rb.bn											
Execution of the federal budget expenditures by Section "National Defense" in the current budget classification [a]	115.6	191.7	247.7	295.4	355.7	430.0	581.1	681.8	831.9	1 040.8	1 188.2
The federal budget appropriations by Section "National Defense":	93.7	209.4	214.7	284.2	354.9	427.4	578.4	686.1	839.1	1 031.6	1 192.9
in the current budget classification placed into other sections of the budget classification [b]	–	–	–	–	–	–	44.3	77.7	91.3	126.5	202.4
In a comparable budget classification	93.7	209.4	214.7	284.2	354.9	427.4	622.6	763.9	930.4	1 158.1	1 395.3
Military expenditures, the UN data [c]	–	202.6	294.4	325.9	447.0	499.0	665.0	822.1	850.2	1 127.2	–
Overall direct military appropriations [d]	128.9	270.4	283.4	357.7	464.2	552.7	770.3	1 003.9	1 214.4	1 502.8	1 828.4
Direct and indirect military appropriations associated with the current and past military activity, combined [e]	144.0	304.6	329.6	460.1	602.3	638.8	855.1	1 090.4	1 375.6	1 645.4	1 995.4
2. In real terms (in the 2009 prices) [f], as Rb. bn											
Execution of the federal budget expenditures by Section "National Defense" in the current budget classification	1 159.2	1 251.8	1 203.3	1 130.8	1 142.3	1 153.6	1 252.3	1 182.0	1 190.9	1 249.0	1 188.2
The federal budget appropriations by Section "National Defense":	939.7	1 367.4	1 042.9	1 087.8	1 139.8	1 146.6	1 246.3	1 189.6	1 201.3	1 237.9	1 192.9
in the current budget classification placed into other sections of the budget classification	–	–	–	–	–	–	95.4	134.7	130.7	151.8	202.4
In a comparable budget classification	939.7	1 367.4	1 042.9	1 087.8	1 139.8	1 146.6	1 341.7	1 324.3	1 332.0	1 389.7	1 395.3
Military expenditures, the UN data	–	1 323.1	1 430.3	1 247.6	1 435.6	1 338.7	1 433.0	1 425.2	1 217.2	1 352.6	–
Overall direct military appropriations	1 292.7	1 765.6	1 376.7	1 369.1	1 490.8	1 482.7	1 659.9	1 740.5	1 738.5	1 803.4	1 828.4
Direct and indirect military appropriations associated with the current and past military activity, combined	1 444.2	1 939.0	1 601.0	1 761.5	1 934.2	1 713.9	1 842.8	1 890.4	1 969.2	1 974.4	1 995.4
3. In real terms (in the 1999 prices) [f], as Rb. bn											
Execution of the federal budget expenditures by Section "National Defense" in the current budget classification	115.6	124.8	120.0	112.8	113.9	115.0	124.9	117.9	118.8	124.5	118.5
The federal budget appropriations by Section "National Defense":	93.7	136.4	104.0	108.5	113.7	114.3	124.3	118.6	119.8	123.4	118.9
in the current budget classification placed into other sections of the budget classification	–	–	–	–	–	–	9.5	13.4	13.0	15.1	20.2
In a comparable budget classification	93.7	136.4	104.0	108.5	113.7	114.3	133.8	132.1	132.8	138.6	139.1
Military expenditures, the UN data	–	131.9	142.6	124.4	143.1	133.5	142.9	142.1	121.4	134.9	–
Overall direct military appropriations	128.9	176.1	137.3	136.5	148.7	147.9	165.5	173.6	173.4	179.8	182.3
Direct and indirect military appropriations associated with the current and past military activity, combined	144.0	198.3	159.6	175.6	192.9	170.9	183.8	188.5	196.4	196.9	199.0
4. Military burden on the economy, in % of GDP											
Execution of the federal budget expenditures by Section "National Defense" in the current budget classification	2.40	2.62	2.77	2.73	2.69	2.52	2.69	2.53	2.51	2.52	3.05

	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
The federal budget appropriations by Section "National Defense":	1.94	2.87	2.40	2.62	2.68	2.51	2.67	2.55	2.53	2. 50	3.06
in the current budget classification placed into other sections of the budget classification	–	–	–	–	–	–	0.20	0.29	0.28	0.31	0.52
In a comparable budget classification	1.94	2.87	2.40	2.62	2.68	2.51	2.88	2.84	2.81	2.81	3.58
Military expenditures, the UN data	–	2.77	3.29	3.01	3.38	2.93	3.07	3.06	2.57	2.73	–
Overall direct military appropriations	2.67	3.70	3.17	3.30	3.51	3.24	3.56	3.73	3.67	3.64	4.69
Direct and indirect military appropriations associated with the current and past military activity, combined	2.99	4.17	3.69	4.25	4.55	3.75	3.95	4.05	4.16	3.99	5.11
5. By purchasing power parity (in current prices), in USD bn											
Execution of the federal budget expenditures by Section "National Defense" in the current budget classification	21.9	26.8	30.2	31.9	34.2	36.2	45.6	48.2	54.2	62.8	66.8
The federal budget appropriations by Section "National Defense":	17.7	29.3	26.2	30.7	34.1	35.9	45.4	48.5	54.6	62.3	67.1
in the current budget classification placed into other sections of the budget classification	–	–	–	–	–	–	3.5	5.5	5.9	7.6	11.4
In a comparable budget classification	17.7	29.3	26.2	30.7	34.1	35.9	48.9	54.0	60.6	69.9	78.4
Military expenditures, the UN data	–	28.3	35.9	35.2	42.9	42.0	52.2	58.1	55.4	68.0	–
Overall direct military appropriations	24.4	37.8	34.6	38.6	44.6	46.5	60.5	71.0	79.1	90.7	102.8
Direct and indirect military appropriations associated with the current and past military activity, combined	27.2	42.6	40.2	49.6	57.9	53.7	67.1	77.1	89.6	99.3	112.2
For reference:											
GDP deflator, as % to the prior year	172.5	137.6	116.5	115.5	114.0	120.1	119.2	115.8	113.5	118.0	102.7
Public administration final consumption expenditure deflator [g], as % to the prior year	138.5	153.6	134.4	126.9	119.2	119.7	124.5	124.3	121.1	119.3	*120.0*
Purchasing power parity[h], as Rb/USD	5.29	7.15	8.19	9.27	10.41	11.89	12.74	*14.14*	*15.36*	*16.57*	*17.79*

[a] For 2009 – the Federal Treasury preliminary data on execution of the federal budget.

[b] The Defense Ministry's expenditures and secret expenditures by sections 04–09 and 11 of the federal budget in 2005–2009

[c] The RF Government did not submit the 1999 data to the UN; the 2009 data will be submitted in 2010, inclusive of expenditures on the Ministry of Interior forces, the Board Guard and civil defense, among others

[d] Including on the Ministry of Interior forces, the Board Guard, civil defense, and other elements of the military organization

[e] Inclusive of pensions due to the military.

[f] Deflated by means of the public administration final consumption expenditure deflator.

[g] On 2009 - as estimated by the IET.

h For the period of 2006–2009 – the linear trade of past years' values (as estimated by the IET).

Sources: the 1999–2009 federal acts on federal budget and its execution; Natsionalnye scheta Rossii v 1997–2007 godakh: Stat. sb./ Rosstat. M., 2005–2009; Obyektivnayay informatsiya po voennym voprosam, vklyuchaya transparentnost voennykh raskhodov. Doklady Generalnogo Sekretarya OON 2001–2009; Rosstat; the Federal Treasury.

5.9. 2009 as a year of municipal counter-reform

In accordance with Russian municipal legislation, the year 2009 was to be the first year of full-scale implementation of municipal reform throughout the whole territory of this country, except the Republic of Ingushetia and the Chechen Republic where this process is to be launched from early 2010. The so-called transition period lasted from 2006 through 2008, During that period, the authorities of the Federation's subjects were able to regulate, on their own

and on a rather broad scale, the rate of development and directions of the implementation of the transformations envisaged by reform.

Formally, by 1 January 2009 the transition period was over in all subjects of the Federation (with the exception of the two mentioned earlier), and municipal reform began to be implemented on a full scale all throughout Russia. In the Republic of Ingushetia and the Chechen Republic the territorial base for local self-government was created, and 11 October 2009 municipal elections were held there. In the Republic of Ingushetia, 46 municipal formations were created: 4 urban okrugs, 4 municipal raions, and 38 rural settlements. All municipal formations have adopted a model whereby heads of municipal formations are to be elected by representative bodies from among their deputies. In the Chechen Republic, 2 urban okrugs, 15 municipal raions, 2 urban and 219 rural settlements were created. Heads of municipal formations were elected by universal direct suffrage.

In this connection, it would have been an exaggeration to state that all the problems pertaining to the implementation of municipal reform in these regions have been adequately solved. For example, one of the biggest towns in the Chechen Republic – Gudermes – received no municipal status at all, and so remained a mere settlement, the administrative center of Gudermes Raion. All the powers of bodies of local self-government within the boundaries of the town of Gudermes are exercised by the raion authority[1]. Besides, there remains uncertainty with regard to the lack of proper delimitation of the borders of these RF subjects. Thus, legislation of the Chechen Republic on the creation of the Sunja Raion municipal formation and the municipal formations of which this raion is to consist, as well as on the establishment of their borders and the endowment of them with the status of a municipal raion and a rural settlement respectively[2] has been indeed adopted, but with the stipulation of the condition that the final delimitation of the borders of Sunja municipal raion will be achieved only after an agreement is concluded between the Chechen Republic and the Republic of Ingushetia concerning the establishment of their administrative borders in accordance with the RF Constitution.

At the same time, just as it happened in previous years, the formal indices of municipal reform's implementation and the real processes going on in that sphere were not only in discord, but sometimes their dynamics were even differently vectored. This fact became particularly obvious in 2009. In actual practice, that year was by no means a period of the most complete revelation of the potential hidden in the transformations envisaged by the ongoing reform – instead, it became a period of curbing municipal reform and an active infringement on the autonomy of local self-government, which began to be incorporated into the vertical of authority. In a situation when it was legally impossible to switch over – by analogy with the appointment of governors – to direct appointment of mayors (in accordance with the Constitution of the Russian Federation, bodies of local self-government are not part of the system of bodies of state authority), some other methods for establishing control over local self-governments were found. This control was by no means exercised by the population – whose rights relating to organizing local life were significantly reduced – it was imposed from above by superior levels

[1] The Law of the Chechen Republic, of 27 February 2009, No 19-RZ 'On the creation of the municipal formation of Gudermes Raion and the municipal formations of which it is to consist, the establishment of their borders and the endowment of them with the corresponding status of a municipal raion or rural settlement'.

[2] The Law of the Chechen Republic, of 13 February 2009,. No 6-RZ 'On the creation of the municipal formation of Sunja Raion and the municipal formations of which it is to consist, the establishment of their borders and the endowment of them with the corresponding status of a municipal raion or rural settlement'.

of authority. Early last year, a presidential draft law was submitted to the State Duma, whereby it was envisaged that a special institution for removing from office heads of municipal formations was to be established; the law was finally approved on 7 May 2009. This legislative act envisages an extrajudicial dismissal of heads of municipalities on the initiative of deputies of the representative body of a municipal formation or of the supreme official of a given subject of the Federation. The decision concerning the dismissal of the head of a municipal formation is to be made by the representative body's qualified majority, and in this connection the region's head must voice his opinion on this issue. The grounds for dismissal can be a substantial volume of outstanding accounts payable accumulated through the fault of the head of a municipal formation, or non-targeted spending of budget resources; a failure to fulfill, for three or more months, his obligation with regards to issues of local importance or the execution of state powers; and the results of the activity of the head of a municipal formation (as stated in his annual report) being estimated twice (in a row) as unsatisfactory by the representative body of a municipal formation. The head of a municipal formation enjoys the right to receive complete information concerning the date and place of conducting a meeting of the representative body and the content of documents relating to his own dismissal, as well as explanations concerning the circumstances referred to as the grounds for the dismissal.

In spite of the 'presidential' character of the innovations, the response to them on the part of society was by no means uniform. This issue was actively discussed at the meetings of the State Duma, by the experts' community, and in the press. The draft law was spoken against by some political parties, such as the CPRF and *Yabloko*; the deputies from the CPRF refused to vote for its approval in the first reading. The All-Russian Council on Local Self-Government received more than 300 comments from municipal formations suggesting some serious amendments to the draft law. This issue attracted the attention of the Congress of Local and Regional Authorities of Europe, which requested all the documents and set up an expert commission to examine them.

The opponents of the amendment noted that its introduction would result in creating a special institution for removing 'inconvenient' heads of local self-government who might be disliked by the governor for some or other reason, as well as in increasing the dependence of municipalities on the party in power. Thereby the independence of local self-government and its position outside of the system of bodies of state authority, which is guaranteed by RF Constitution, will be severely violated. Thus, in the appeal to the RF President from the Russian Association of the Democratic Yabloko Party it was noted that the vagueness of the procedure of enforced dismissal, the lack of guarantees of judicial protection and the lack of an arbiter in estimating the grounds for putting forth the initiative concerning an enforced dismissal would inevitably give rise to intriguing and punishments motivated by personal dislike, political ideology, or vested economic interest[1].

Out of all the arguments against the draft law, only two significant points were indeed taken into consideration: the list of grounds for dismissing heads of municipal formations was made closed and more precise; and the interval before a repeated proposal of a head's dismissal was lengthened to two month. The issues relating to the governor's role in initiating the dismissal

[1] Appeal to President of the Russian Federation D. A. Medvedev 'On introducing amendments to the draft of a Federal Law designed to allow dismissal of city mayors on the initiative of governors'. The Bureau's Decision No 788 was adopted on 28 March 2009. See http://www.yabloko.ru/resheniya_byuro/2009/04/06

procedure, the absence of judicial protection of heads of municipalities, and the passive role assigned to the population in this process remained unchanged.

In late 2009, a law was adopted whereby the procedure for merging settlements was altered. Instead of obtaining the population's consent to this (locally very important) type of territorial transformation expressed by voting or a general meeting of residents, it became sufficient to obtain the consent thereto of the representative body of a given municipal formation. As a result, regional authorities now had at their disposal a rather simple and easily controllable mechanism for carrying out territorial transformations, whereas a local referendum on this issue had by no means always yielded desirable results[1]. This decision – of fundamental importance for local self-government – was actually made without any preliminary discussion with the participation of the municipal and experts' community or any serious analysis of its potential consequences. As the Chairman of the State Duma Committee for Local Self-Government noted in this connection, 'merging of small settlements is necessary, it is already under way; we are only eliminating red tape and procrastination'[2].

It cannot unequivocally be stated that the period that elapsed between these two events – which have irreversibly eliminated the positive potential of municipal reform – was indeed full of energetic activity in the sphere of local self-government. Rather, one may speak of the interest in this particular issue gradually dwindling. Thus, the problems of local self-government remained practically unnoticed in RF President Dmitry Medvedev's Message to the RF Federal Assembly; besides, no strategic tasks have been formulated with regard to that particular sphere. Only current issues – although indeed important for the functioning of municipal authorities – were dealt with within the framework of the activity aimed at improving the institutional mechanisms of local self-government; and the solutions that were offered were by means always the best ones.

Some alterations were introduced in legislation on local self-government. Among the most important of these, the following can be noted:

- The list of interbudgetary transfers to be taken into account when determining the level of a municipal formation's reliance on donation was revised and abridged by the exclusion of subventions and the subsidies and interbudgetary transfers granted to municipal formations for funding their execution of part of their powers relating to issues of local importance in accordance with concluded agreements, which were covered from the Investment Fund of the Russian Federation [3];

[1] While in some regions the necessity of obtaining the population's consent was no obstacle to enlargement of population units (for example, in Vologda Oblast where the current crisis has brought about a significant reduction in the number of settlements), in others the local population was rather unanimous in their rejection of the suggested reform. Thus, in Cheliabinsk Oblast the large-scale plans developed by the regional authorities with regard to merging settlements ended up in an almost total fiasco – the referendums in a vast majority of cases yielded negative results. A similar situation was also typical of Amur Oblast.

[2] Gorodetskaia N. Ob"ediniat' poseleniia nachnut bez lishnikh skhodov [They will begin to merge settlements without too many resident meetings] // Kommersant. 11 December 2009.
http://www.kommersant.ru/doc-y.aspx?DocsID=1290191

[3] The amendment was introduced by Federal Law, of 28 November 2009, No 283-FZ 'On the Introduction of Alterations into Some Legislative Acts of the Russian Federation'.

- the procedure for a switchover from a direct election to the representative body of a municipal raion to its forming by delegates from settlements was defined more specifically[1];
- the list of rights enjoyed by bodies of local self-government was augmented by the right to create a municipal fire service[2].

In September 2009, two commissions of the RF Public Chamber – for regional development, and for local self-government and housing policy – in cooperation with the European Club of Experts on Local Self-Government – held experts' hearings on the theme 'The current status and prospects for local self-government in the Russian Federation'. At that meeting, the community of independent experts expressed their concern in connection with the increasingly negative trends observed in the sphere of Russian local self-government and the inadequacy of measures resorted to by the federal center in its attempts to achieved the declared goals of municipal reform. In the Recommendations issued as result if the hearing, it is noted that an analysis of the situation in Russian regions has confirmed the fact that the negative processes associated with the implementation of Federal Law FZ-131 and repeatedly pointed to by all related public organizations and the experts' community continued to develop throughout the year 2009[3]. In addition to proposals for adjusting the current policy of reforms and strengthening control over the implementation of the most disputable decisions adopted recently in this sphere, the Recommendations also contain some strategic proposals, in particular:

- to consider the possibility of separating from local self-government the raion level, with reestablishing the status of an administrative raion as the lowest fundamental level of state authority bearing full responsibility for fulfilling state obligations;
- to return to the issue of dividing big cities into districts and determining the status of urban districts.

As both these recommendations appear to be disputable, it is advisable that further discussion in the framework of the experts' and municipal communities should take place.

In December 2009, the Council for Local Self-Government under the Chairman of the State Duma met in order to discuss issues pertaining to the development of inter-municipal economic cooperation. In the resolution adopted by the Council it was stated that there existed some obstacles in the way of developing this form of interaction between municipal formations that had to do both with the specific features of its legal regulation and the widespread practice of transferring certain powers of settlements to municipal raions. The former issue became especially prominent in the course of the Council's meeting. Thus, Viacheslav Glazychev said that 'in our conditions, the scheme of inter-municipal interaction decisively contradicts the tradition of "packaging" the settlement-type municipal formations inside another municipal formation'[4]. He was opposed by Viktor Pankrashchenko who noted that 'the "packaging" of settlements

[1] The amendment is introduced by Federal Law, of 27 December 2009, No 365-FZ 'On the Introduction of Alterations into Some Legislative Acts of the Russian Federation in Connection with Improving the Performance of the Bodies of State Authority of Subjects of the Russian Federation and Local Self-Government Bodies'.

[2] This amendment is also introduced by Federal Law, of 27 December 2009, No 365-FZ.

[3] Information letter of the RF Public Chamber's commissions for local self-government and housing policy No 83/AOB of 13 November 2009 to Chairman of the RF Council of the Federation's Committee on Local Self-Government Issues, President of the All-Russian Congress of Municipal Formations S. M. Kirichuk.

[4] Transcript of the meeting of the Council for local self-government under the Chairman of the State Duma devoted to the issues of developing inter-municipal economic cooperation. http://www.komitet4.km.duma.gov.ru/site.xp/050056054124051048052.html

inside a municipal raion is contrary to the letter of the law but is absolutely compatible with its spirit and, most importantly, with the existing economic system of the Russian Federation. So, whatever is adopted by way of the laws, this process will go on in actual life'[1]. In this connection, a number of different proposals were voiced as to what the further evolution of municipal raions was to be like, including the option of turning them into the territorial bodies of state authority.

However, this issue – just as some other among the most interesting issues that had been discussed (for example, the necessity of introducing changes in legislation in order to promote inter-municipal cooperation in the sphere of urban development, or the necessity of legislative regulation of inter-municipal cooperation in the framework of urban agglomerations as a whole, with regard to which the participants of the discussion expressed their personal points of view) – have not so far been reflected in the Council's decision. Instead, it was recommended – and this was perhaps the only concrete proposal – 'to investigate the issue of introducing in legislation and subsequently in actual practice such organizational-legal forms of inter-municipal cooperation as an inter-municipal enterprise and an inter-municipal institution, and for this purpose to adapt the existing legal structures of municipal institutions and municipal unitary enterprises to the stated goals'[2]. In fact, this means that some already discredited organizational-legal forms – of which bodies of state authority and local self-government alike have gradually been getting rid of - will once again be implemented in inter-municipal cooperation, which has been demonstrated, for example, in Nadezhda Kosareva's speech at the Council's meeting.

As for the practice of executing the functions of local self-government in 2009, it was increasingly characterized by anti-reforming trends, some of which had been given rise to by the introduction of new legislation, while others were a continuation of the processes that had already been going on for a few years. The most evident trends were associated with the following phenomena:

- practical implementation of the norms allowing dismissals of heads of municipal formations;
- a continuing practice of judicial prosecution of heads of municipal formations;
- further restrictions on applying the general election procedure to heads of municipal formations;
- an intensifying struggle of United Russia for 'suitable' outcomes of municipal elections by applying, among other things, certain forms whose legitimacy was questionable.

Some attempts to dismiss heads of municipal formations had been made even prior to the official entry into force of the amendments introduced with regard to this issue. The first precedent in this vein occurred in early June 2009 in Oziorsk, a town in Cheliabinsk Oblast. The initiative that Mayor Sergey Chernyshov should be dismissed was put forth by *Fair Russia'*s faction that held a majority in the City Council of Deputies. According to the faction's leader, 'the issue as to the mayor's dismissal has been 'ripe' for a long time already: he has completely neglected the town, and even litter is now collected and disposed of very negligently in Oziorsk.' The opinion of the governor of Cheliabinsk Oblast that he would not object to the dismissal of the head of that municipal formation was related (orally) by Vice Governor

[1] See ibid.
[2] See ibid.

N. Riazanov who then arrived at Oziorsk. As regards the grounds for their decision the deputies cited two reasons who actually gave rise to many questions. The first one was the mayor's report for the year 2008 that had been estimated by the deputies as unsatisfactory (usually in cases like this a special commissions with the participation of deputies is created, and the report is then elaborated further). The second reason was that the report for the year 2007 had also been unsatisfactory. Mr. Chernyshov argued that last year's report had already been accepted by deputies, but they nevertheless black-balled him retrospectively.

Besides, the expression of lack of confidence in the mayor was legally disputable from the point of view of the decision-making procedure established for settling such cases, of which the deputies had been warned beforehand by a representative of the city prosecutor's office. Firstly, the doubly negative assessment of the mayor's report took place before 24 May, when the new Law had not yet come into force. Secondly, the mayor's explanations were not heard, as it was required by the law (because he was at that time on a leave). As a result, on 16 June the Oziorsk City Court of Justice deemed the dismissal of the head of Oziorsk City Okrug to be unlawful and passed a ruling that the suit filed by the acting Okrug's head be satisfied, and then on 21 June the Cheliabinsk Oblast Court of Justice declined the cassational appeal filed by the deputy.

One more attempt to dismiss the head of Oziorsk was made in early September, but this time the number of deputies' votes necessary for passing the resolution could not be collected. Representatives of law enforcement agencies once again warned the deputy corpse that this decision would be unlawful. This time it was pointed out that the violations of which the mayor was being accused of had not been proved. Besides, no official opinion of the governor concerning this issue was available. Thus, this new attempt to implement the dismissal procedure also failed.

At the same time, the town's deputies altered the procedure for forming the bodies of local self-government – the town's head was, from then on, to be elected from among the members of the town council, while the town administration was to be headed by a hired manager. Thus, at the municipal election in March 2010 the population will no longer be able to decide who is to be the head of their municipal formation.

The second incident involving a head's dismissal happened on 16 June 2009 in Suzdal, where the town deputies decided to terminate early the powers of the Suzdal mayor, S. Godunin, because of his failure to act properly. According to chairman of the Suzdal Town Council V. Malashkin, 'During the past year Godunin did not sign and did not publish the decisions of the town council. The deputies have failed to find any answer to the question as to why he has been sabotaging the town council's decisions'. Malashkin added that this was by no means the only one reason why Godunin had to be dismissed early: 'The problems have kept arising throughout all the three-and-a-half years after was elected the town's head'[1]. Meanwhile, such a situation is also rather controversial. Legislation lacks sufficient regulation of the issue as to what the head of a municipal formation must do when he considers the decision made by the representative body to be incompatible with the law, and what responsibility he must bear if he signs the adopted decisions. The fact of conflict between a town's head and the

[1] Cited from the news archive of the newspaper 'Mestnoe samoupravlenie' [Local Self-Government], http://emsu.ru/lg/default.asp?item=12

deputies' corpse in such a situation does not mean in itself that the mayor is always in the wrong.

The only case when a head of a municipal formation was dismissed on a governor's initiative was the dismissal of Yu. Vostriakov, mayor of the town of Tchaikovsky in Perm Krai. The decision to this effect was made by the town's deputies on 30 July 2009. The Krai governor, O. Chirkuniv, had come forth with this initiative because of the systematical failures of the urban settlement's head to properly perform his duties with regard to settling issues of local importance. Specifically, the mayor was blamed for having failed to properly deal with the following two issues:

- the organization of the service of hot water supply to citizens;
- resettling of citizens from hazardous buildings.

As the Krai governor was informed, hot water supply in Tchaikovsky had been non-existent from February through July 2009, which was regarded as the most blatant instance of the mayor's neglect in properly performing his duties. In all probability, in this particular case the reason for applying such a radical measure as a mayor's dismissal was that, in case of filing an appeal to a court of justice (which would have entailed a much lengthier procedure), there was a danger of the town entering the heating season next autumn not only without hot water supply but also without heating. The head of the town of Tchaikovsky, just as the mayor of Oziorsk had dome, tried to dispute this decision in a court of justice, but without success. At the same time, the town residents, in spite of the evidently existing problems with the organization of the town's economy, took controversial views towards the decision concerning their mayor's dismissal. Anyway, at the subsequent municipal election it was another candidate, and not the one supported by the regional authority, who became the winner.

When analyzing the newly introduced provisions of legislation and the emerging law enforcement practice, experts note that 'the mechanism of dismissing heads of municipal formations as stipulated in Article 74.1 of Federal Law No 131-FZ, is riddled with many gaps and contradictions. The legal technicalities applied in the Article give rise to many questions and create many problems when they are being actually implemented … An analysis of the emerging law enforcement practice demonstrates attempts to apply the dismissal mechanism in settling the score with an independent and self-sufficient head of a municipal formation'[1]. At the same time, after the first precedents that revealed both the legal and political drawbacks of this process, the practice of dismissals so far has not become widespread. And it is not clear just how actively this mechanism is going to be applied in the future.

In this connection, it should be noted that introduction of the amendment concerning a dismissal of a municipal formation's head did not put a stop to new 'loud cases' involving criminal prosecution of mayors – contrary to the hopes that had been nursed by the experts' community. The latest case – the initiation of two criminal suits against Nikolai Krasnikov, mayor of the 'science city' of Koltsovo, who was renowned for his achievements in the town's development. The governor of Novosibirsk Oblast publicly spoke in the mayor's defense, as did the

[1] Shugrina E. Udalenie glavy munitsipal'nogo obrazovania v otstavku: problemy zakonodatel'nogo regulirovania i pravoprimenitel'naia praktika. [Dismissal of a municipal formation's head: the problems of legislative regulation and the law enforcement practice.] // Aktual'nye voprosy razvitia mestnogo samoupravlenia v Rossii I za rubezhom. [The outstanding issues of the development of local self-government in Russia and abroad.] A collection of articles / Ed. A. V. Madiarova. E. Marquart, N. M. Mironov, L. V. Shapiro. M., 2009. Pp. 349, 359.

Town Council deputies. Over a thousand of the town's residents signed an appeal to President of the Russian Federation to take under his personal control the investigation of this case. In the appeal, it was stated directly that the mayor's prosecution was linked to the political struggle going on in their town: 'Perhaps someone wants to destroy the creative, development-oriented atmosphere in the settlement that has taken years to be developed, under the leadership of N. G. Krasnikov, by the personnel of the scientific and industrial enterprises and budget-funded organizations of Koltsovo. It seems that someone is beginning an election campaign in this way – by discrediting our head. Probably someone is excited by the prospects of Koltsovo's development as a RF 'science city', by its biotechnopark and social projects'[1]. At the same time, the mass media noted the peculiar methods applied in collecting the incriminating evidence against the town's head: 'Trains are being blown up in this country while the state security staff roam through a small town in search of compromising evidence and urge the residents and the personnel of enterprises to provide information against their mayor'[2]. It is difficult to forecast the outcome of this situation. So far it is known that a Novosibirsk raion court of justice rejected the petition filed by the mayor of Koltsovo in connection with the initiation of a second criminal case against him[3].

The year 2009 also saw the continuation of the other trends (that had emerged in the preceding period) towards limiting the autonomy of local self-government and making it part of the vertical of authority. One of the most significant processes going on in that sphere is the more limited application of direct elections of heads of municipal formations. This is especially obvious in big cities. Thus, in 2009 direct elections were abolished in Samara, Stavropol, Riazan, Nizhniy Novgorod, Tumen, Perm, Kazan, Ufa, and Tver. In a majority of these cities, a model was adopted instead that most strongly restricted the ability of the population to influence the process of forming the bodies of local self-government: the city heads are elected from among the city council deputies, and a manager is hired under a contract to perform the functions of the head of the administration; the choice of a candidate for this latter post can be strongly influenced by regional authorities.

The trend of merging the system of local self-government with the vertical of authority also takes shape of the alterations being introduced in electoral legislation. As early as 2005, municipal formations were granted the right to introduce not only the majoritarian electoral system, but also mixed or purely proportional systems of municipal elections[4]. In April 2009, federal lawmakers went even further, by establishing a new procedure in accordance with which the lists of candidates during a municipal election applying a proportional system could be

[1] The appeal of more than 1,000 of Koltsovo's residents to the RF President was posted to Koltsovo's official website and published in the newspaper 'Kompas' of 26 November 2009; copies were sent to the governor of Novosibirsk Oblast, speaker of the Novosibirsk Oblast Council of Deputies and the regional prosecutor. *Source:* 1 December 2009, Taiga,info. http://tayga.info/documents/2009/12/01/~94580

[2] Samakhova I. Grazhdanskaia kazn' mera naukograda (Irina Samakhova otpravliaet "SOS" iz Sibiri.) ['Civil execution' of the mayor of a 'science sity'(Irina Samakhova sends "SOS" from Siberia). *Source:* 7 December 2009, Polit. Ru. http://www.polit.ru/analytics/2009/12/07/sos.html

[3] *Source*: 20 January 2010, TASS - Siberia
http://www.itartass-sib.ru/index.php?option=com_content&view=article&id=15907-302.html

[4] The wording as of 21 July 2005, of Item 3 of Article 32 of Federal Law of 12 June 2002, No 67-FZ 'On the Basic Guarantees of the Electoral Rights and the Right to Participate in a Referendum of Citizens of the Russian Federation'. It should be noted that, in the initial wording of this Law, candidates cold be entered onto the electoral lists could be entered by electoral associations or electoral blocs.

drawn only by the local sections of those political party that, in accordance with the federal law, had the right to participate in the election[1]. Previously, this right had been also enjoyed by the electoral blocs created during elections to local self-government institutions by public associations (public organizations or movements). Now those public associations that did not have the status of a political party can only suggest candidates to be placed on one or other party list, which should be done in the procedure established by the Federal Law 'On Political Parties'. As for the guarantees for those citizens who are not members of political parties or electoral associations to exercise their passive electoral rights, this issue has been transferred to the regional level[2].

The policy adopted by subjects of the Federation with regard to this issue was by no means uniform. Some regions altogether eliminated the possibility of organizing municipal elections on the basis of party lists, which is, in fact, quite compatible with the essential meaning of local self-government's activity – to deal with the economic (and not political) issues of local life. However, some subjects of the Federation granted to the bodies of local self-government the right to set one of the three available electoral systems, including the proportional one, thus failing to comply with the requirements stipulated in federal legislation concerning the guarantees for citizens of exercising their passive electoral right. Thus there emerged possibilities for violating the constitutional rights of those citizens who were not members of political parties or electoral associations[3].

In the autumn electoral campaign 2009, party elections began to be held both in big municipal formations and in small rural settlements. One example of the latter was the election held on 11 October 2009 in the rural settlement of Khomutinino in Cheliabinsk Oblast, whose regional legislation did not envisage the relevant guarantees for independent candidates. The settlement's population numbers only 1,400 (or 1,262 voters), and there had not been any active party cells for 20 years. Nevertheless, four parties – *Fair Russia*, the CPRF, *United Russia* and the LDPR – officially put forth their candidates there. Interestingly, the candidates from three out of the four parties worked at the sanatorium 'Ural'. Although the population of Khomutinino is far from numerous, since the onset of municipal reform the settlement had been plagued by conflicts between different groups of interests. One sign of this situation, among other things, was the voluntary election model that envisaged appointing a hired manager to the post of head of the local administration, which made it possible to achieve a compromise by inviting a candidate that suited all. Although with difficulty, the balance of interests could somehow be achieved also with regard to other issues. The adoption of the model of elections based on party lists resulted in the situation actually exploding, because thus a mechanism for a takeover of power by one of the local groups was created. This was the management of the sanatorium 'Ural' (which provides employment to the majority of the village's adult popula-

[1] The new wording as of 5 April 2009 of Item 3 of Article 32 of Federal Law of 12 June 2002, No 67-FZ 'On the Basic Guarantees of the Electoral Rights and the Right to Participate in a Referendum of Citizens of the Russian Federation' .

[2] In accordance with Item 3.1 of Article 32 of the Federal Law 'On the basic Guarantees …' (as amended 21 July 2005), if it envisaged by the RF Constitution, charter or law of subject of the Federation that within the representative body of a municipal formation all deputy mandates are to be distributed between the lists of candidates in proportion to the number of votes, then the Law of a RF subject must envisage guarantees for the execution of their passive electoral right by those citizens who are not members of any political parties or electoral blocs and associations.

[3] As stipulated in Article 18 and 19 of the RF Constitution.

tion), who thus acquired a monopoly over its entire territory. The preparations for the election in Khomutinino were associated with many scandals (for example, CPRF veterans wrote an open letter to their leader asking him to remove the list of 'pseudo-Communists'). As proved by the available information, the process of forming that rural settlement's representative body on the basis of party lists was too protracted, so that the residents of Khomutinino are not yet acquainted with all the deputies who are representing their interests in the reputedly elected body of local self-government.

The situation in Khomutinino actually mirrored the general atmosphere typical of the municipal elections held on 11 October 2009. The press referred to numerous facts of the results of elections being distorted, from placing insurmountable administrative barriers in the way of the registration of candidates who did not belong to United Russia to the rigging of the results of voting. A number of criminal proceedings were initiated. However, at present we know only one instance when the results of municipal elections were annulled. On 4 December 2009, the Derbent City Court of Justice annulled the ballot results obtained during the election of the city mayor where, according to the official results, the winner was the current head of the municipal formation. The list of violations committed there includes an unlawful refusal to register candidates; pressure on candidates in order to make them remove their names from the electoral lists; the inclusion in the election commissions of persons affiliated with the city head; unlawful issuance of ballots for early voting; computation of votes in absence of the members of electoral commissions with decisive votes and observers, etc. On the election day, 13 polling stations were closed, and another 12 operated intermittently.

Even after the 11 October elections, electoral legislation underwent some new changes that envisaged further centralization of municipal elections. In late December 2009, *United Russia*'s initiative that the role of parties in regional electoral commissions during the setting-up of municipal electoral commission should be made more prominent was supported by the State Duma. Previously, the electoral commissions of a municipal formation were formed by its representative body on the basis of proposals submitted by those political parties that had put forth federal lists of candidates with deputy mandates; the proposals submitted by voter meetings held at their places of residence, employment, studying; and the proposals submitted by the previous electoral commission of the municipal formation or the electoral commission of subject of the Russian Federation. The settlement's electoral commission was formed on the basis of proposals submitted by the electoral commission of the municipal raion. Now, one half of the municipal electoral commission is formed by the Oblast electoral commission, while the other half – by those parties that have been granted access to the distribution of mandates to representative bodies of authority. The number of members constituting the municipal electoral commissions has been increased approximately by one-and-a-half. Thus, the electoral commission of a municipal raion, a city okrug, or an urban territorial unit within a city of federal importance now consists of eight, ten or twelve members with the right of decisive votes. The electoral commission of a settlement consists of six, eight or ten members with decisive votes.

An analysis of the current development of the situation in the sphere of local self-government in 2009 has led to the following conclusions. Over that year, the trend of municipal 'counter-reform' was becoming stronger, aiming towards a deeper merger of local self-government with the 'vertical of authority', further restrictions of citizens' opportunities to influence the performance of bodies of local self-government and to exercise control over their activity. Over 2009, one could observe both the continuation of the anti-reforming trends that

had emerged in the previous years and also new steps in that direction. The main developments were the introduction of a new amendment to municipal legislation concerning the dismissal of heads of municipal formations and the abolition of referendums as a mandatory requirement when making a decision concerning mergers of settlements. At the same time, the toughening of the legislative provisions aimed at liquidating all autonomy of local self-government did not result in diminishing the pressure on local authorities exerted in the form of force methods: criminal persecution, ballot rigging during elections, etc.

Annex 1

A Review of Significant Changes in the Sphere of Fiscal Regulation and Civil Legislation in 2009[1]

Year 2009 has become no exception from the perspective of continuation of the reform of the tax legislation. Annually, the tax legislation undergoes some changes: throughout the year there were introduced amendments to all articles of the second part of the Tax Code of the Russian Federation. In this survey we will review only the most significant changes related to the switching from the unified social tax (UST) to insurance contributions to the Pension Fund, Social Insurance Fund, Federal and Territorial Compulsory Medical Insurance Funds.

Besides, there will be also noted the significant changes in the civil legislation.

1. Major Changes Introduced to the RF Tax Code (second part)

1.1. Value added tax (VAT)

Article 21 of the RF Tax Code was supplemented with the provisions envisaging the use of an application based procedure as concerned the VAT refund[2].

According to the newly introduced rule set forth by article 176.1 of the RF Tax Code, the amount of tax claimed to be refunded in a tax declaration (the positive difference between the amount of tax deductions and the amount of the assessed tax) can be refunded to the taxpayer prior to the completion of an in-office tax audit.

The right to use such a procedure governing the refund of the tax was granted to the corporate taxpayers, whose aggregate amount of VAT, excise taxes, corporate profit tax, and mineral extraction tax (with the exception of certain amounts of taxes) paid over last three calendar years made not less than Rb 10 billion and also the taxpayers, who provided bankers' bonds (envisaging the bank's obligation to pay to the budget the excess of the amount of tax refunded (credited) to the taxpayer in the case it was required by the tax authorities) together with the tax declarations indicating the amounts of VAT to be refunded. Such bonds could be provided by the banks the RF Finance Ministry had included in the list of the banks meeting the applicable requirements.

The right to refund the VAT can be exercised via the submission of an application, where there should be indicated the particulars of the bank account for the transfer of the respective funds. Within 5 days since the date the application was submitted, the respective tax authority should check if the taxpayer complied with the applicable requirements and take a decision either to refund the amount of the tax or reject the application.

Provisions of article 176.1 of the RF Tax Code thoroughly regulate the procedures governing the refund of the amount of tax to a taxpayer, offsets against taxpayers' arrears related to mandatory payments, and the return of the excessive amounts of tax refund received by the

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[1] This section has been prepared with the use of the legal system KonsultantPlus.

[2] See Federal law No. 318 FZ of December 17, 2009, "On the introduction of amendments to the first and second parts of the Tax Code of the Russian Federation in relation to the introduction of the application based procedure as concerns the value added tax refund".

taxpayer under the application based procedures. The new rules governing the refund of VAT amounts should be applied to tax declarations, which cover tax periods starting from the first quarter of 2010.

Changes have been also introduced in a number of other articles of the RF Tax Code. Thus, there was developed a new version of item 2 of article 169 of the RF Tax Code; according to this provision errors occurring in commercial invoices should be used as a reason for rejection of applications for VAT refund only in the case such errors prevent tax authorities to identify the seller, the buyer, the description and cost of goods (works, services), property rights, the rate and the amount of the tax.

There have been introduced new VAT allowances granted to management companies, condominium partnerships, and housing construction cooperatives[1].

Thus, according to sub-item 29 of item 3 of article 149 of the RF Tax Code, the provision of communal services should be exempted from VAT, whereas according to sub-item 30 of item 3 of article 149 of the RF Tax Code the services related to the maintenance of common property in apartment buildings and repairs of such property should be not subjected to VAT. Earlier, the RF Supreme Arbitration Court has stated the same position with respect to condominium partnerships. According to the newly introduced amendments, the use of this tax privilege is granted to management companies, condominium partnerships, housing construction, housing, or other specialized consumer cooperatives founded to meet the housing needs of citizens and responsible for the maintenance of internal utility systems used to provide communal services.

It should be noted that this tax allowance[2] can be used on two conditions:

- only the organizations listed in this provision of the RF Tax Code should provide the indicated services, i.e. in the case the communal services are directly provided to residents by a supply or operating entity, such entity should have no right to use this tax allowance;
- these services should be purchased by the companies indicated above directly from the organizations of the public utilities complex, electrical power suppliers, organizations engaged in supply of natural gas, and the companies and businesspersons directly providing services related to the maintenance of common property in apartment buildings and carrying out repair works.

There has been also introduced new item 3 of article 162 of the RF Tax Code, in accordance to which the funds received by the organizations indicated above for the purposes of formation of a reserve for carrying out the running and major repairs of the common property in apartment buildings should not be included in the VAT base.

An important amendment is related to the VAT taxation of property received by noncommercial organizations on the gratis basis to be used for the purposes of conduct of the activities listed in their charters[3]. Thus, no VAT should be imposed on the services related to the transfer of public or municipal assets not assigned to public or municipal enterprises and agencies and comprising the state treasury of the Russian Federation, a RF subject, or municipal treasury to

[1] See Federal law No. 287 FZ of November 28, 2009, "On the introduction of amendments to articles 149 and 162 of the second part of the Tax Code of the Russian Federation".

[2] Taxpayers have the right to waive the use of these privileges under a procedure envisaged by item 5 of article 149 of the RF Tax Code.

[3] See Federal law No. 281 FZ of November 25, 2009, "On the introduction of amendments to the first and second parts of the Tax Code of the Russian Federation and certain legislative acts of the Russian Federation".

noncommercial organizations on conditions of gratis use for the purposes of conduct of the activities listed in their charters (see sub-item 10 of item 2 of article 146 of the RF Tax Code).

1.2. Profit tax

From now on, payments for medical services provided to insured employees should be singled out in the composition of expenditures for remuneration of labor similarly to the contributions made on the basis of contracts for voluntary personal insurance. Agreements with medical organizations should be made for a period not less than a year, whereas such organizations should have licenses for provision of medical services. In order to be recognized, the general cap on such expenditures (contributions related to insurance contracts and direct payments to medical organizations) has been left at the same level and makes no more than 6 per cent of the total amount of expenditures for remuneration of labor (paragraph 9, item 16 of article 255 of the RF Tax Code).

The changes introduced in item 2 of article 254 and sub-item 2 of item 1 of article 268 of the RF Tax Code have conferred on the companies the right to reduce their incomes derived from the sales of property discovered in the course of inventory, which is not subject to depreciation, by the cost of such property. Prior to January 1, 2010, according to the rules set forth in sub-item 2 of item 1 of article 268 of the RF Tax Code, the income derived from the sales of "other" (not subject for depreciation) property could be reduced by its purchasing price or creation, which was absent in the case of property discovered in the course of inventory. Now, this provision is formulated more precisely: the income should be also reduced by the amount of expenditures indicated in paragraph 2 of item 2 of article 254 of the RF Tax Code.

An important amendment is related to the taxation of profits derived by noncommercial organizations as concerns the receipt of property on condition of gratis use for the purposes of conduct of the activities listed in their charters[1]. In the case the governmental or municipal bodies take decisions to transfer state or municipal property to noncommercial organizations to enable them to conduct the activities listed in their charters, such noncommercial organizations derive no profits in terms of ownership rights received on gratis basis (see sub-item 16 of item 2 of article 251 of the RF Tax Code).

The RF Ministry of Economic Development[2] also plans to introduce other changes in article 251 of the RF Tax Code in 2010: to expand the notion of grants; include voluntary asset contributions received by foundations and autonomous noncommercial organizations from the founders at the moment of creation of such organizations; incomes in the form of works carried out for, services provided to, and ownership rights transferred to noncommercial organizations on the gratis basis for the purposes of conduct of the activities listed in the charters of such organizations engaged in science, culture, arts, physical culture and sports with the exception of professional sports, education, public health, protection of human and civil rights and freedoms, social and legal support and protection of citizens provided on the gratis and preferential basis, assistance to protection of citizens in emergency situations, environment and wild life protection, as well as organizations engaged in other types of charitable activities, alongside with a number of other changes.

[1] See Federal law No. 281 FZ of November 25, 2009, "On the introduction of amendments to the first and second parts of the Tax Code of the Russian Federation and certain legislative acts of the Russian Federation".
[2] http://www.economy.gov.ru/

Turning back to the already adopted amendments, it should be noted that there has been changed the procedure of taxation of securities trading.

Thus, there have been more precisely formulated the conditions, on which securities should be recognized as those circulating in the organized securities market (hereinafter referred to as the OSM). One of these conditions is that for these securities there should be calculated market quotations in the cases it is required by the respective national legislation (sub-item 3 of item 3 of article 280 of the RF Tax Code). Now, paragraph 5 of item 3 of article 280 of the RF Tax Code envisages that in the case it is impossible to determine in what country's territory the securities transaction was made outside the OSM (including the transactions made via electronic communications networks), an organization should have the right to choose such a state at its own discretion depending on the location of the seller or buyer of securities. The mechanism of such choice should be a part of the accounting policy for the purposes of taxation.

There has been also more precisely formulated the notion of the market quotation of securities. It should be the volume weighted average price of the transactions made within one trade day via a Russian trade organizer in the securities market (hereinafter referred to as SM), including stock exchanges, as concerns the securities admitted to trade by such a trade organizer in the SM and such stock exchanges. In the case securities are admitted to trade at a foreign stock exchange, the market quotation should be defined as the closing price of the security calculated by the foreign stock exchange with relation to transactions made within a trading day via such a stock exchange (item 4 of article 280 of the RF Tax Code).

There have been amplified the rules governing the determination of the market price as concerns the securities traded in the OSM. Now, it is directly envisaged that in the case securities are sold at a price above the maximum price in the OSM, the financial performance is determined exactly on the basis of the maximum price of a transaction made in the OSM (see paragraph 5, item 5, article 280 of the RF Tax Code). Earlier, article 280 of the RF Tax Code contained no such a provision; therefore, the RF Finance Ministry had an opportunity to put forward a requirement to include in the incomes not the maximum, but the actual price, at which securities were sold[1].

There were somewhat streamlined and changed the rules governing the determination of the selling price of the securities circulating outside the OSM (see item 6 of article 280 of the RF Tax Code). For taxation purposes, there is recognized the actual price of a transaction in the case it is within the range between the minimum and maximum prices determined proceeding from the estimated price of a security and the extreme deviation of prices (which is set at 20 per cent above or below the estimated price). In the case the selling price of a security is below the minimal price or above the maximum price, there is taken into account either the maximum or minimum price (set as proceeding from the estimated price and the extreme deviation of prices).

The procedure governing the determination of the estimated prices of securities not traded in the OSM should be set forth by the Russia's Federal Financial Markets Service (FFMS) as approved by the RF Finance Ministry (see paragraph 4 of item 6, article 280 of the RF Tax Code).

[1] See, for instance, letters issued by the RF Finance Ministry: No. 03-02-07/1-452 of November 23, 2007, No. 03-03-06/2/74 of April 17, 2007, and No. 03-03-04/1/269 of March 21, 2006.

1.3. Unified social tax (UST)[1]

Since January 1, 2010, Federal law No. 212 FZ of July 24, 2009, is in force (with the exception of its certain provisions). This law regulates the relations concerning the calculation and payment of insurance contributions[2], whereas article 24 of the RF Tax Code "Unified Social Tax" ceased to be in force (see part 2 of article 24 of Federal law No. 213 FZ of July 24, 2009). Thus, the law envisaged the replacement of UST by insurance contributions to the RF Pension Fund (hereinafter referred to as the RF PF), the RF Social Insurance Fund (hereinafter referred to as the RF SIF), and compulsory medical insurance funds (hereinafter referred to as the FCMIF and TCMIF). In other words, we see the situation existing prior to the adoption of article 24 of the RF Tax Code. Essentially, the provisions of the Law on insurance contribution repeat the provisions contained in the first part of the RF Tax Code and peculiarly article 24 of the RF Tax Code.

In sum, since year 2010 the UST is replaced with insurance contributions to public social funds. Tax authorities will have no control over the payment of contributions, since this control over the calculation and payment of contributions to the RF PF and medical insurance funds is passed to the RF Pension Fund; at the same time, the RF Social Insurance Fund should control the social insurance contributions as before.

Self-employed entrepreneurs, notaries, and lawyers should pay not only defined contributions to the RF PF, but also contributions to medical funds.

As concerns the payment of contributions, taxpayers should have the same amounts of rights and obligations, as those set by the RF Tax Code. Since the beginning of the year, all payers of insurance contributions will have to register with the RF Pension Fund. At present, the procedure governing the registration is not determined yet and should be approved by the RF government.

Since 2010, reporting forms should be submitted to each fund separately, what is obviously inconvenient for taxpayers. The payers of insurance contributions should, alongside with the previously existing submission of their calculations to the RF SIF, also every quarter of the year present to the territorial agencies of the RF Pension Fund estimates of the charged and made compulsory pension insurance payments due to the RF Pension Fund and compulsory medical insurance contributions to the Federal Compulsory Medical Insurance Fund in accordance with a reporting form approved by the respective federal executive authority performing the functions related to the development of state policy and normative regulation in the sphere of social insurance, which also has not been approved yet. The terms of submission of calculations to the RF SIF remain as before – prior to the 15th day of the month following the quarter

[1] See Federal laws No. 212 FZ of July 24, 2009, "On insurance contributions to the Pension Fund of the Russian Federation, the Social Insurance Fund of the Russian Federation, the Federal Compulsory Medical Insurance Fund, and territorial compulsory medical insurance funds" and No. 213 FZ of July 24, 2009, "On the introduction of amendments to certain legislative acts of the Russian Federation and on repealing of certain legislative acts (provisions of legislative acts) of the Russian Federation in relation to the adoption of the Federal law "On insurance contributions to the Pension Fund of the Russian Federation, the Social Insurance Fund of the Russian Federation, the Federal Compulsory Medical Insurance Fund, and territorial compulsory medical insurance funds".

[2] The new law does not concern the contributions related to the compulsory industrial injury insurance and occupational diseases, as well as compulsory medical insurance of the economically inactive population, since special federal laws regulate the respective contributions.

under review; whereas the RF Pension Fund and the CMIF should receive such reports prior to the 1st day of the second calendar month of the respective year.

The payers of contributions do not have to submit annual reports. In the first quarter of the year they should present reports related only to the data for the fourth quarter of the preceding year.

Prior to March 30, 2010, the payers should present declarations concerning compulsory pension insurance contributions for year 2009 in accordance with the form approved by the RF Finance Ministry. After a comparative check, the tax authorities should pass these reports to the agencies of the RF Pension Fund.

Nothing is reported about a transition period as concerns the payment of the UST for year 2009. Since January 1, 2010, article 24 of the RF Tax Code, which set forth the obligation to pay the UST, is not in force; at the same time, Federal law No. 212 FZ of July 7, 2009, which entered into force on January 1, 2010, also envisages no respective obligation.

As before, the objects of insurance contributions differ depending on the payer. The payers making payments to the benefit of individuals should make contributions on the basis of payments and other remunerations awarded in relation to labor and civil law contracts, which concern the delivery of works and provision of services, as well as the commissioning agreements, agreements on the alienation of the exclusive rights in works of science, literature and arts, publishing license contracts, license contracts concerning the rights to use works of science, literature and arts. The notion of the "insurance contributions objects" was somewhat expanded: authors' contracts were replaced with commissioning agreements.

In 2010, the rates for employers remained at the level set in 2009: 20 per cent are due to the RF PF, 2.9 per cent – to the RF SIF, 1.1 per cent – to the FCMIF, and 2.0 per cent – to the TCMIF. However, there has been changed the amount of contributions transferred to the RF PF for financing of the insurance and funded components: as concerns persons born in 1966 and earlier, the financing of the insurance component makes 20 per cent, and as concerns persons born in 1967 and later, the financing of the insurance component makes 14 per cent, whereas the financing of the funded component makes 6 per cent.

There was significantly changed the system of calculation of contributions (a regressive scale of calculation of contributions). There was set forth a limit as concerned the charging of insurance contributions: no insurance contributions should be charged on the payments and other remunerations to the benefit of individuals[1] after the progressive total of such payments and remunerations exceeds Rb 415 thousand after the beginning of the period under review. Since 2010, the marginal amount of the base used for the charging of insurance contributions will be annually indexed as determined by the RF government in accordance with the growth in the average wage.

The new law on the payment of insurance contributions also concerns both self-employed entrepreneurs, and taxpayers operating under the simplified taxation system (STS) and using the unified tax on imputed income (UTII). It should be noted that the option to pay no UST was among the advantages related to the use of special taxation regimes. Although no insurance payments to the RF SIF should be made in 2010, there should be paid not only fixed con-

[1] Contributions should be charged on payments made to individuals not depending on the fact if these payments should be used for a reduction of the profit tax or not.

tributions to the RF Pension Fund, but also contributions to the compulsory medical insurance funds.

As concerns the organizations and self-employed entrepreneurs engaged in agriculture production or having the status of residents of technology development special economic zones, the respective insurance contributions tariffs should remain at the level registered in 2009, a lower tariff should be used as concerns the organizations and self-employed entrepreneurs operating under the STS or paying the UTII, as well as the persons using labor of invalids. Such persons should pay insurance contributions to the RF Pension Fund at the rate of 14 per cent dividing the contributions into the insurance and funded components: as concerns the persons born in 1966 and earlier 14 per cent are paid for the financing of the insurance component of the work pension, whereas for the persons born in 1967 and later 8 per cent are transferred for the financing of the insurance component and 6 per cent for the financing of the funded component.

Organizations and self-employed entrepreneurs using the unified agricultural tax (UAT) should pay 10.3 per cent to the RF PF dividing the contributions into the insurance and funded components: as concerns the persons born in 1966 and earlier 10.3 per cent are paid for the financing of the insurance component of the work pension, whereas for the persons born in 1967 and later 4.3 per cent are transferred for the financing of the insurance component and 6 per cent for the financing of the funded component.

Tariffs for self-employed entrepreneurs, lawyers, and notaries, engaged in private practices (the payers not making payments to the benefit of individuals) should be determined as the product of the minimum wage, as set for the beginning of a financial year, on the tariff due to the respective fund, i.e.: for the RF PF – minimum wage x 20 per cent x 12; the FCMIF – the minimum wage x 1.1 per cent x 12; the TCMIF – the minimum wage x 2 per cent x 12. Basing on the resulting sum and not the actual profit, self-employed entrepreneurs should pay monthly insurance contributions. This category of taxpayers is not required to make contributions to the RF SIF.

The payments made to the benefit of foreigners employed abroad or temporarily staying in Russia should be excluded from contributions. Some incomes, earlier not subject to insurance contributions payments, i.e. compensations for carry-over vacations at the time of dismissal, compensations for hard work, harmful and (or) hazardous working conditions (without milk compensation, etc.) have been excluded form the provision governing the non-taxable payments related to insurance contributions. These incomes should be subject to the payment of contributions similarly to other incomes. However, the financial benefits related to child birth (up to Rb 50 thousand) is excluded from the payment of insurance contributions, but only in the case these benefits are provided during the first year after the birth of a child.

From 2010, the enterprises should be not concerned with the fact, if their profit tax base is diminishing or increasing as relates to the social benefits granted to their employees. The provision of item 3 of article 236 of the RF Tax Code permitting the organization to choose between the reduction of the profit tax or the UST was repealed since January 1, 2010.

Besides, certain payments should be excluded from insurance contributions, for instance:

– financial aid in the amounts up to Rb 4 thousand (earlier, this amount made up to Rb 3 thousand) should be excluded from the payment of insurance contributions;

- payment for education as concerns basic and additional professional educational programs, including professional training and retraining of employees, as well as the compensations of such expenses to employees;
- financial aid in the amounts up to Rb 50 thousand paid in relation with the birth (adoption) of a child within the first year after the birth (adoption);
- payments for the medical treatment of employees under voluntary personal insurance contracts made with the insurers and under the contracts for provision of medical services to employees made for the periods exceeding 1 year;
- payment of insurance contributions by employers made in accordance with Federal law No. 56 FZ of April 30, 2008, "On the additional insurance contributions to the funded component of the labor pensions and the state support of the formation of pension savings" not exceeding Rb 12 thousand a year;
- compensations of expenses borne in relation to loans (credits) for the purchase and (or) construction of residential premises.

There has changed the amount of benefits in case of temporary incapacity to work and maternity pay. The respective calculation should be made proceeding from the newly set maximum of the daily pay. In 2010, the maximum average daily pay should make Rb 415 000[1] / 365 = Rb 1 136.99. However, in the case an organization wishes to pay an allowance taking into account the real average wage received by an employee, which may exceed the amount indicated above, the said additional payments should not be included in the composition of expenditures reducing the profit tax paid by such an organization (item 15, article 255 of the RF Tax Code). As concerns the nursing allowances, the maximum amount of such payments will also be changed; in 2010 it will make Rb 415 000 / 12 x 40 per cent = Rb 13 833.33.

It should be noted that the situation of taxpayers will deteriorate because of the introduction of the provision envisaging that in the case an error relating to the transfer of contributions is made as concerns the budgetary classification code (BCC), such contribution is considered as not paid even in the case it is transferred to the correct fund.

As concerns inspections, the RF PF is granted the right to carry out field inspections, in the course of which it can check not only the accuracy of the calculation of contributions and promptness of payments thereof, but the provision of identifying data[2]. Field inspections should be carried not more often than once in 3 years[3].

A positive development is that there were repealed inadequate penalties for the failure to submit calculations to the RF SIF. From year 2010, the penalties are set in the terms of the percentage of the contributions to be paid, but in the amounts not less than Rb 100 for up to 180 days delay and Rb 1000 after 180 days delay. Therefore, there will be no more payments of Rb 1000 to the RF SIF in the case the delay makes just several days.

Below, there are discussed some changes the payers should expect in year 2011.

Thus, to the quarterly report on the charged and paid insurance contributions there will be added the quarterly identifying report submitted to the RF PF. It should be noted that the in-

[1] In 2010, the marginal size of the base subject to insurance contributions makes Rb 415 thousand (see item 4 of article 8 of Federal law No. 212 FZ of July 24, 2009).

[2] As concerns the identifying data, in 2010 the reporting periods for the provision of such information should be 6 months and a calendar year. Accordingly, the insurers should present the respective data prior to August 1, 2010 and prior to February 1, 2011.

[3] A repeat inspection may be carried out only in the case the payer is liquidated or reorganized.

surers employing on the average more than 50 persons in the preceding calendar year are obliged to submit their reports only in the electronic format and with electronic digital signature.

In 2011, it is planned to increase contribution rates up to 34 per cent with the exception of certain categories of insurers. There will also be increased the rates of fixed payments as concerns self-employed entrepreneurs.

As concerns employers, operating under the general taxation system, the insurance contributions tariffs will be as follows (see *Table 1*):

Table 1

Insurance contributions tariffs, in %

Fund	2010	2011 and beyond
RF PF	20	26
SIF	2.9	2.9
FCMIF	1.1	2.1
TCMIF	2	3
Total:	26	34

The taxpayers, operating under the STS or using the unified tax on imputed income (UTII), since year 2011 should be granted the same status as the taxpayers operating under the general taxation system. Accordingly, the rate of taxation for such payers will make 34 per cent.

In 2011 through 2014, reduced insurance contributions tariffs (see *Table 2*) should be in force only for agricultural producers, payers of the UAT, communities of indigenous peoples, residents of technology development special economic zones, organizations of handicapped persons and the enterprises using labor of handicapped persons.

Table 2

Reduced insurance contributions tariffs, in %

Fund	2011–2012	2013–2014
RF PF	16	21
SIF	1.9	2.4
FCMIF	1.1	1.6
TCMIF	2.1	2.1
Total:	20.2	27.1

Therefore, this category of taxpayers should transfer to the RF PF 16 per cent in 2001 and 2012, and 21 per cent in 2013 and 2014, dividing the contributions into the insurance and funded components: as concerns persons born in 1966 and earlier, the financing of the insurance component makes 16 per cent and 21 per cent respectively for the periods indicated above, and as concerns persons born in 1967 and later, the financing of the insurance component makes 10 per cent and 15 per cent respectively, whereas the financing of the funded component makes 6 per cent (up to year 2014).

Since year 2015, no reduced rates will remain. All insurers will pay contributions at the unified rate of 34 per cent.

1.4. Excise duties[1]

Since January 1, 2010, there entered into force the amendments to article 193 of the RF Tax Code envisaging an increase in excise duties on certain types of excisable goods.

Thus, for instance, the rate of excise duty on ethyl alcohol produced from all types of raw materials (including crude ethyl alcohol produced from all types of raw materials) made Rb 30.5 per one liter of anhydrous ethyl alcohol (earlier this rate made Rb 27.7). On the average, the rates of excise duties on the alcoholic beverages, where alcohol by volume makes up to 9 per cent inclusively, grew by 20 per cent. There were significantly raised rates of excise duties on beer containing volume concentration of alcohol from 0.5 per cent to 8.6 per cent (almost by 3 times). There were also increased the rates of excise duties on tobacco products, cars, motor oils and directly distilled gasoline. In particular, the rates of excise duties on tobacco, cigars and cigarillos grew by 40 per cent. There has been also changed the fixed part of the tax rate on cigarettes and mouthpiece cigarettes.

There was also set a more precise procedure governing the calculation of the amount of the excise duty on alcoholic beverages, where alcohol by volume exceeds 9 per cent.

There was introduced an amendment to item 2 of article 200 of the RF Tax Code, which limited the deduction of the excise duty on the production of alcoholic beverages containing more than 9 per cent of ethyl alcohol: the deduction should be calculated within the amount of the excise duty on ethyl alcohol (notwithstanding what type of raw materials was used to produce strong alcoholic beverages).

According to item 3 of article 204 of the RF Tax Code, the excise duty on the sale (transfer) of produced excisable goods should be paid in equal installments not later than on the 25th day of the first month and not later than on the 15th day of the second month following the tax period to date. Since January 1, 2010, the excise duty should be paid in full not later than on the 25th day of the month following the tax period up to date.

1.5. Personal income tax (PIT)[2]

Since January 1, 2010, taxpayers should have the right to use the property related tax deduction envisaged by sub-item 2 of item 1 of article 220 of the RF Tax Code as concerns the purchase of a residential building (or a share therein) with a plot of land, or a plot of land to be used for the construction of such a building. In this case, the deduction is granted only on the condition the respective individual has the documents confirming that person's title to the plot of land or a share therein, as well as a certificate of ownership of a building (see paragraphs 5 and 23 of sub-item 2 of item 1 of article 220 of the RF Tax Code). It should be noted that prior to the date indicated above, the property related tax deduction could be granted only in the case there were purchased apartments, houses, rooms (and shares therein)[3].

[1] See Federal law No. 282 FZ of November 28, 2009, "On the introduction of amendments to articles 22 and 28 of the second part of the Tax Code of the Russian Federation."

[2] See Federal law No. 202 FZ of July 19, 2009, Federal law No. 281 FZ of November 25, 2009, and Federal law No. 368 FZ of December 27, 2009.

[3] The commentaries presented by the supervisory authorities it has been noted that the list of objects entitled for deduction for purchase (construction) is a closed list, and the expenditures related to the purchase of a plot of land are not included in this list; therefore, in the case of such purchase, there arises no right for deduction. See, for instance, letters by the RF Finance Ministry No. 03-05-01-04/243 of August 8, 2006, by the Admini-

From year 2010, the property related tax deduction should be also used as concerns the expenditures borne in relation to targeted loans (credits) received and spent for the purchase of the plots of land with houses (or shares therein). Since January 1, 2010, the respective amendment to sub-item 2 of item 1 of article 220 of the RF Tax Code has entered into force. In the case the taxpayer has used the targeted loan (credit) for the purposes of new construction or purchase of a plot of land with a house (or a share therein), the amount of the tax related to the repayment of the interest on such loans should not be included in the total amount of the property related tax deduction, which is limited to Rb 2 million, but should be totally refunded (see paragraph 18 of sub-item 2 of item 1 of article 220 of the RF Tax Code).

Paragraph 19 was included in sub-item 2 of item 1 of article 220 of the RF Tax Code. In accordance to this paragraph, the total amount of the property related tax reduction may be used in the case of the interest on bank credits provided for the purposes of refinancing of the loans used for construction of purchase of new residential buildings, apartments, rooms or shares therein, plots of land to be used for the construction of such buildings and plots of land with houses (or shares therein). Prior to January 1, 2010, the expenditures for the development of the design and estimate documentation have been taken into account as concerned the property related tax deductions only if a residential building (share therein) was constructed or purchased, whereas no such right was envisaged as concerned the finishing of purchased apartments (rooms).

The property related tax deduction related to the amounts obtained due to the sale of property (with the exception of residential buildings, apartments, country houses, garden cottages or plots of land and shares in the said property), which had been in ownership of the taxpayer for not less than 3 years, was increased exactly by two times (see sub-item 1 of item 1 of article 220 of the RF Tax Code).

There was expanded the list of incomes exempt from the PIT taxation (article 217 of the RF Tax Code). Thus, in this list there were included the financial aid to the members of families paid in relation to the death of the former employee, who retired. Besides, former employers should withhold no PIT from the financial aid provided to the former employee, who retired, in the case a member of the family of such an employee dies (see paragraph 3 of item 8 of article 217 of the RF Tax Code). Prior to January 1, 2010, the court practice related to such cases more often than not supported the tax authorities as courts ruled that the amounts of financial aid provided to the members of families in relation to the deaths of former employees should be subject to the PIT.

Prior to the introduction of changes concerning the sale of residential premises, country houses, garden cottages and plots of land (shares in the said properties), other properties (with the exception of securities and the property used for business purposes), being in the ownership of the taxpayer for more than 3 years, the individuals being tax residents of the Russian Federation had the right to use the property related tax deduction envisaged in sub-item 1 of item 1 of article 220 of the RF Tax Code as concerned the amount of incomes. From 2010, the said incomes are included in the list of incomes exempt from the PIT (item 17.1 of article 217 and sub-item 1 of item 1 of article 220 of the RF Tax Code); therefore, in this case taxpayers do not have to submit the PIT declaration to the tax authorities[1].

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stration of the Federal Tax Service for the city of Moscow No. 28-10/076950 of August 13, 2008, and No. 28-10/172132 of March 6, 2006.

[1] These changes concern the legal relations arising since January 1, 2009.

Since January of year 2010, individuals have been granted the right to turn to their employees in order to obtain social deductions as concerns agreements on non-state retirement benefits or voluntary pension insurance contracts (item 2 of article 219 of the RF Tax Code). The following conditions should be met:

– it is necessary to present documents confirming the actual expenditures borne by taxpayers in accordance with sub-item 4 of item 1 of article 219 of the RF Tax Code;
– contributions pertaining to such agreement should be withheld by employers and transferred to the respective funds[1].

There are also expected other changes: within this year the RF Ministry of Economic Development and Trade is planning to introduce amendments to article 219 of the RF Tax Code covering social tax deductions. For instance, at present in accordance to item 3 of article 210 of the RF Tax Code as concerns the determination of the size of the tax base taxpayers are entitled to social tax deductions amounting to the incomes transferred by such taxpayers for charity purposes in the form of financial aid provided to the organizations operating in the spheres of science, culture, education, health care and social security, *partially or in full financed from the funds of the respective budgets*, as well as the organizations engaged in physical culture and sports, educational and preschool institutions as concerns the needs related to the physical training of citizens and maintenance of teams, and also in the amount of donations transferred (made) by taxpayers to religious organizations to be used for the purposes of conduct of the activities listed in their charters. The deductions should amount to the actual sums of the respective expenditures; however, the total amount of deductions should not exceed 25 per cent of the amount of incomes gained over the respective tax period.

It is planned to eliminate the connection with the partial or full financing of the said organizations from budgets and additionally include in this provision other incomes subject to the deductions indicated above, i.e.: taxpayers should be entitled to social tax deductions "in the amount of incomes transferred by the taxpayer in the form of financial aid to charity organizations for charity purposes; incomes amounting to donations transferred by the taxpayer in the form of financial aid to noncommercial organizations operating in the sphere of science, culture, physical culture and sports, with the exception of professional sports, education, enlightenment, health care, protection of human and civil rights and liberties, social and legal support and protection of citizens provided on gratuitous and favorable terms, assistance in the protection of citizens against emergencies, protection of the environment and wildlife, as well as in the amount of donations transferred (made) by taxpayers to religious organizations to be used for the purposes of conduct of the activities listed in their charters and to noncommercial organizations for the purposes of formation and replenishment of endowments carried out in accordance with the procedures established by the Federal law "On the procedures governing the formation and utilization of endowments of noncommercial organizations". The deductions should amount to the actual sums of the respective expenditures; however, the total amount of deductions should not exceed 25 per cent of the amount of incomes gained over the respective tax period[2].

[1] This provision concerns the legal relations arising since January 1, 2009. Therefore, the employees being parties of agreements on non-state retirement benefits and (or) voluntary pension insurance contracts, have the right to obtain social deductions from their employers as concerns such expenditures borne in 2009, or submit the PIT declaration and the respective confirming documents to the tax inspections they are registered with.

[2] See http://www.economy.gov.ru/

Turning back to the already adopted amendments, it should be noted that there has been also introduced amendments to a number of other articles; as a result, submitting the PIT declarations to tax authorities after the end of respective tax periods taxpayers are not obliged to supplement such declarations with separate written applications in order to receive:

– standard deductions, which were not granted to taxpayers, or granted in the insufficient amounts (a change in item 4 of article 218 of the RF Tax Code);
– social tax deductions (a change in item 2 of article 219 of the RF Tax Code);
– property related tax deductions (a change in item 2 of article 220 of the RF Tax Code);
– professional tax deductions. However, in order to be granted these deductions by fiscal agents, taxpayers need to submit written applications (item 3 of article 221 of the RF Tax Code).

Besides, in the PIT declarations taxpayers may indicate no incomes exempt from taxation, as well as the incomes, the full amounts of tax on which were withheld by fiscal agents (item 4 of article 229 of the RF Tax Code).

Since January 1, 2010, there has entered into force a new version of article 214.1 of the RF Tax Code, which regulates the specifics of taxation of securities and financial futures (FF) trading. These rules were expanded and presented in more detail. The major development was the introduction of an option to carry losses borne in the course of trading with securities and financial futures traded in the organized securities market forward. The procedure governing the carry forward of losses was set in item 16 of article 214.1 and article 220.1 of the RF Tax Code. In particular, the amounts of losses carried forward to future periods may reduce the tax base only as concerns similar operations. This carry forward is conducted within 10 years following the year the loss was borne. Losses borne over past years reduce the tax base via the granting of tax deductions (see article 220.1 of the RF Tax Code). In order to be granted the respective tax deductions, there should be submitted documents confirming the amount of the loss for the whole period the tax base of the current period was reduced by the amount of losses borne earlier (item 4 of article 220.1 of the RF Tax Code). The deductions are granted on the basis of a written application submitted by the taxpayer together with the tax declaration related to the respective year (item 5 of article 220.1 of the RF Tax Code). The carry forward concerns only the losses borne since year 2010.

1.6. Transport tax[1]

There have been introduced amendments to the procedure governing the determination of the transport tax. In accordance to article 361 of the RF Tax Code currently in force, the rates of the transport tax should be approved by the laws adopted by the RF subjects within the interval envisaged by the RF Tax Code. At the same time, the regional authorities should have the right to increase of reduce the rates set by the RF Tax Code, but by no more than 5 times[2].

[1] See Federal law No. 282 FZ of November 28, 2009, "On the introduction of amendments to articles 22 and 28 of the second part of the Tax Code of the Russian Federation."

[2] In letter of the RF Finance Ministry No. 03-05-06-04/401 of December 3, 2009, it was explained that the amendments introduced to article 361 of the RF Tax Code by Federal law No. 282 FZ of November 28, 2009, did not automatically entail an increase in the tax rates, but expanded the range of options available to RF subjects authorities in the process of making the decisions concerning the determination of transport tax rates. Indeed, the introduced amendments did not change the rates indicated in item 1 of article 361 of the RF Tax

It should be noted that the draft law envisaged an increase in the rates of the tax indicated in item 1 of article 361 of the RF Tax Code; whereas the regions were granted the right to raise the rates by no more than 5 times and reduce the rates by no more than 10 times. However, the RF Federation Council defeated that version of the draft law. The Conciliatory Commission of the RF State Duma and the Federation Council adopted a decision concerning the law "On the introduction of amendments to articles 22 and 28 of the second part of the Tax Code of the Russian Federation": as concerned the transport tax, it was decided to return the previous base rate, whereas the corridor of possible changes in this rate the regions could make was expanded allowing changes by 10 times as concerned both the increase in and reduction of the rates.

In accordance with item 3 of article 361 of the RF Tax Code, the transport tax rate may be differentiated depending on the category and the useful service life of vehicles. Such a basis of differentiation of the rates as the useful service life of vehicles should be excluded. However, since January 1, 2010, the RF subjects should have the right to adopt the laws setting different rates of the tax on vehicles depending on the year of production and emission class thereof.

According to item 4 of article 57 of the RF Tax Code, in the case the calculation of the transport tax base is carried out by the inspection, the obligation to pay this tax should not arise prior to the date the respective notification is received. Basing on the changes introduced to item 3 of article 363 of the RF Tax Code, the inspection may send to the taxpayer notifications concerning the payment of the transport tax only for three tax periods preceding the calendar year, in which such notifications are sent. There was also set the obligation of such individuals to pay the transport tax for no more than three tax periods preceding the year, in which the notifications were sent. It should be noted that as concerns the transport tax the tax period is a calendar year.

1.7. State duty

The amounts of almost all types of state duties have been increased by more than two times (see article 25.3 of the RF Tax Code). The increased tariffs are in force since January 30, 2010[1].

There have been introduced new benefits related to the payment of the state duty. From now on, the state duty should not be paid:

- for the state registration of the right of the permanent (indefinite) use of land plots being in the state or municipal ownership (see sub-item 4.3 of item 3 of article 333.35 of the RF Tax Code);
- for the introduction of changes in the Unified State Register of Rights in Immovable Property and Transactions Involving Such Property in the case the RF legislation is amended (sub-item 4.4. of item 3 of article 333.35 of the RF Tax Code);
- for the introduction of changes in the Unified State Register of Rights in Immovable Property and Transactions Involving Such Property in the case of submission of verified data concerning the items of immovable property (see sub-item 4.5 of item 3 of article 333.35 of the RF Tax Code);

Code; since that time, the regions may use their new right to raise rates within the interval approved by the RF Tax Code.

[1] See item 1 of article 28 of Federal law No. 374 FZ of December 27, 2009.

- for the state registration of the cancellation of the seizure of immovable property (the new version of sub-item 5 of item 3 of article 333.35 of the RF Tax Code);
- for the state registration of the termination of rights in relation to the liquidation of the item of immovable property, renunciation of the right in an item of immovable property, transfer of ownership to a new possessor of rights, transformation (reconstruction) of an item of immovable property (see sub-item 8.1 of item 3 of article 333.35 of the RF Tax Code);
- for the state registration of the cancellation of limitations (encumbrances) related to immovable property (sub-item 8.2 of item 3 of article 333.35 of the RF Tax Code);
- for the attachment of apostil to the documents concerning the registration of the acts of civil status and certificates issued by the archive agencies in answer to requests of individuals residing outside Russia in the case it was required by diplomatic missions and consular offices of the Russian Federation (sub-item 12 of item 3 of article 333.35 of the RF Tax Code).

As concerns foreign citizens and persons without citizenship, the state duty for the issuance, extension of the validity, and renewal of visas may be paid in foreign currency (item 5 of article 333.29 of the RF Tax Code).

The issuance of copies of documents is not recognized as a legally significant act requiring the payment of the state duty (item 1, article 333.16, sub-item 4, item 1, article 333.18 of the RF Tax Code).

1.8. Simplified taxation system (STS) and Unified tax on imputed income (UTII)

One of the conditions of the use of the simplified taxation system is the compliance with the marginal amount of income received as a result of 9 months of the year, in which an organization submits the application to switch to the said special taxation regime. Since January 1, 2010, this cap should make not Rb 15 million, but Rb 45 million (see item 2.1 of article 346.12 of the RF Tax Code). Exactly this amount indicated above needs to be used as the guide as concerns the submission of the applications for switching to the STS after October 1, 2009. This cap should be used until October 1, 20121. Also, there was increased the amount of incomes, exceeding which the taxpayer ceases to be entitled for the use of the STS (from Rb 20 million to Rb 60 million) (see item 4.1 of article 346.13 of the RF Tax Code). This new cap should be used from January 1, 2010, to December 31, 20122. At the same time, since July 22, 2009, and until January 1, 2013, there is suspended paragraph 2 of item 2 of article 346.12 of the RF Tax Code, in accordance to which the marginal amounts of incomes should be multiplied by deflator coefficients.

Since year 2011, organizations and self-employed entrepreneurs operating under the STS should make contributions pertaining to compulsory pension insurance, compulsory insurance in relation to temporary incapacity to work and maternity, compulsory medical insurance, compulsory insurance of industrial injury and occupational diseases.

Since the beginning of 2010, there are in force the changes introduced in the RF Tax Code, which concern the taking into account the said contributions in the course of the calculation of

[1] See item 1 of article 2, item 3 of article 4 of Federal law No. 204 FZ of July 19, 2009.
[2] See item 3 of article 2, item 4 of article 4 of Federal law No. 204 FZ of July 19, 2009.

the unified tax as relates to the use of the STS. In the case the taxpayer uses the STS in relation to the object of taxation "incomes minus expenditures", such a taxpayer should have the right to include the amounts of insurance contributions in the composition of expenditures (sub-item 7 of item 1 of article 346.16 of the RF Tax Code). The taxpayers using the STS in relation to the object of taxation "incomes" may also reduce the amount of the unified tax (advance payments) on both amounts of pension contributions and temporary incapacity to work allowances, and other insurance contributions indicated above. However, the cap on reduction remains the same and makes no more than 5 per cent (see paragraph 2 of item 3 of article 346.21 of the RF Tax Code). These amounts may also be used to reduce the remaining cost of the patent in the case the STS is used on the basis of patents (item 10, article 346.25.1 of the RF Tax Code).

Nevertheless, in 2010 the payers of insurance contributions operating under the STS should have a privilege – they transfer only a contribution to the RF PF and have the right to take this contribution into account as concerns the calculation of the unified tax paid under the STS.

The payers of the UTII should also have the right to reduce the amount of the unified tax (advance payments) by the contributions made for the compulsory pension insurance, compulsory social insurance in relation to temporary incapacity to work and maternity, compulsory medical insurance, compulsory insurance of industrial injury and occupational diseases. The cap on such a reduction remains the same and makes no more than 50 per cent (item 2 of article 346.32 of the RF Tax Code).

2. Certain Changes in the Sphere of Civil Legislation

2.1. Changes in the legislation concerning the activities of limited liability companies[1]

The changes concerning the regulation of the activities carried out by limited liability companies have been introduced in the RF Tax Code and a number of legislative acts.

The major change related to the fact that before January 1, 2010, all limited liability companies needed to bring their foundation documents in accordance with the RF Tax Code and the law on limited liability companies. In other words, it is envisaged that the charters of companies founded prior to July 1, 2009, (i.e. prior to date the Federal law of December 30, 2008, entered into force) should be harmonized with the version of the first part of the RF Tax Code and the Federal law on limited liability companies currently in force before January 1, 2010. The substance of the issue will be discussed below.

Charters and articles of incorporation of the companies created prior to the date the said law entered into force should be used as far as they agree with the said legislative acts. From this provision, it follows that the failure to harmonize charters of limited liability companies with the Federal law of December 30, 2008, should not result in the invalidity of the charters

[1] Federal law No. 312 FZ of December 30, 2008, "On the introduction of amendments to the first part of the Tax Code of the Russian Federation and certain legislative acts of the Russian Federation", Federal law No. 205 FZ of July 19, 2009, "On the introduction of amendments to certain legislative acts of the Russian Federation". The majority of amendments introduced by Federal law No. 312 of December 30, 2008, entered into force on July 1, 2009. Some provisions introduced by Federal law No. 205 of July 19, 2009, entered into force since the date of promulgation (on July 22, 2009), other provisions entered into force after 90 days since the date of its promulgation.

after January 1, 2010. In the case a charter is not reregistered, its provisions not contradicting the new requirements set by the legislation should remain valid[1].

The RF Ministry of Economic Development adheres to the same position as concerns this problem: "the failure to harmonize the charter of a limited liability company with the Federal law of December 30, 2008, should not result in the invalidation of the charter and should not be the basis of the liquidation of the company by a court ruling (item 2 of article 61 of the RF Civil Code) on the condition that the company did not commit other major or repeated violations of normative legislative acts. In the case an authorized governmental authority or a local government turns to a court requesting the liquidation of a limited liability company, the court should be provided with the specific evidence relating to such major or repeated violations of the RF legislation." [2]

So, it does not follow from the provisions of Federal law No. 312 FZ of December 30, 2008, that after the indicated deadline limited liability companies should have no right to continue their activities or introduce necessary changes in their charters. In the case the charter is not harmonized with the said Federal law, it will not result in the withdrawal of the company from the Unified State Register of Legal Entities (USRLE). The registering authorities will carry out registration of changes in limited liability companies' charters for the purpose of harmonization thereof with this law even after January 1, 2010.

At the same time, there has been developed a draft law[3] aimed at the abolition of the requirement concerning the compulsory re-registration of limited liability companies. It was planned that the draft law should envisage that limited liability companies needed to re-register in the case they change their charters without setting any deadlines. Federal law No. 310 FZ of December 17, 2009, abolished this deadline. Now, limited liability companies have the right to harmonize their charters with the current requirements at the moment any changes are introduced in their charters.

As concerns the changes in the civil legislation as such (due to which the companies will have to introduce amendments to their charters in the case they contravene the new provisions[4]), the following developments should be noted:

There were partially changed the terms used in article 4 of the RF Civil Code and the law on limited liability companies. Earlier, as concerned limited liability companies, alongside with the notion of the "share in the authorized capital" there was used the notion of "contributions of

[1] The Federal law of December 30, 2008, sets a cap on the time limited liability companies' charters should be harmonized with the new legislation; however, no penalties for the failure to meet this requirement is envisaged.

[2] See Letter No. D06-2639 of September 11, 2009.

[3] Draft Federal law No. 280513-5 "On the introduction of amendments to article 5 of the Federal law "On the introduction of amendments to the first part of the Civil Code of the Russian Federation and certain legislative acts of the Russian Federation" (as concerns the extension of the time of re-registration of foundation documents of limited liability companies). It is planned that this draft law should be approved in three readings at once. The Chamber of Commerce and Industry, "Opora Rossii", a non-governmental organization of small and medium sized businesses, the State Legal Directorate (SLD), and the RF Ministry of Finance positively assessed this draft law.

[4] First of all, it concerns such new rules as the new procedure governing the alienation of shares in favor of other participants and third parties; the new procedure governing the retirement of participants; the new obligation of the company to keep a register of participants; the new procedure governing the management of the company.

the participants". From now on, in accordance with the amendments made to the said acts, the term "contributions of the participants" was excluded from the provisions concerning the creation of limited liability companies.

A new provision is the exclusion of the articles of incorporation from the composition of the foundation documents of limited liability companies. Thus, according to article 89 of the RF Civil Code, the only foundation document of a limited liability company should be a charter. A similar provision is contained in item 5 of article 11 of the law on limited liability companies. Surely, the exclusion of articles of incorporation from the composition of foundation documents does not mean that the founders should not sign the articles of incorporation (see item 1 of article 89 of the RF Civil Code). It means only that from now on this is not an obligation, but a right of founders of limited liability companies. At present, it is not required any more to indicate the composition of participants, the procedures governing the distribution of profits among the participants, and the procedure governing the retirement from the company.

Earlier, the provisions of the law on limited liability companies concerning the contents of the articles of incorporation envisaged an option to indicate in the articles the responsibility for the violation of the founders' obligation to make their contributions. However, these provisions failed to explain the specific of such a responsibility. Changes introduced in article 16 of the law on limited liability companies set forth that the articles of incorporation may include a clause envisaging the recovery of damages (fine, penalty) for the failure to pay shares in the authorized capital of a limited liability company.

As concerns charters, this provision has also undergone some changes. Thus, from now on the requirement that the charter should contain information on the amount and face value of the shares of each participant of the company is only an option. Earlier, the limited liability company has been required to introduce the respective amendments to its charter and articles of incorporation and consequently into the register (USRLE) each time the amounts of the shares of participants changed; now it is not necessary in the case the limited liability company's carter contains no information on shares.

Besides, the data on the procedure and consequences of the retirement of participants from the company are reflected by the charter only in the case the right to leave the company is envisaged by the charter.

Since July 1, 2009, in accordance with item 3 of article 8 of the law on limited liability companies the founders (participants) of limited liability companies should have the right to make agreements on the exercise of rights of participants of the company; according to such an agreement the participants undertake to exercise their rights in a certain way and (or) abstain from exercise thereof. According to item 3 of article 8 of the law on limited liability companies, the participants thereof should have the right to regulate the exercise of their rights, in particular:

- to determine the voting procedure as concerns the general meetings of the participants of such companies;
- to agree their voting with other participants of companies;
- to agree the terms of the sale of their shares and set the selling prices of shares among the participants of companies.

The list indicated in item 3 of article 8 of the law on limited liability companies is not an exhaustive one, what permits the participants of limited liability companies to independently regulate the exercise of their rights.

There is envisaged a new procedure governing the alienation of shares in favor of other participants or third parties.

From now on, the sale of alienation of shares in favor of third parties is permitted only on the condition that the following requirements set forth by the law and companies' charters are met: participants of companies and companies as such should have the preferential right to purchase shares alienated in favor of third parties. The previous version of article 93 of the RF Civil Code and article 21 of the law on limited liability companies it was indicated that the sale or other transfer of shares (parts of shares) owned by participants was permitted in the case it was not prohibited by the company's charter. The term "transfer" was replaced with the term "alienate".

There were set forth additional requirements concerning the form of transactions aimed at the alienation of shares. Whereas earlier such transactions were made in a simple written form, since July 1, 2009, they should be subject of certification by a notary. Therefore, the failure to comply with this requirement should result in the invalidity of such a transaction. As concerns shares, the moment of transfer of ownership was defined differently: ownership is considered to be transferred to the buyer after the purchase transaction is certified by a notary[1], and not after the company is notified about the fact of transfer.

There were also expanded the provisions of article 22 of the law on limited liability companies concerning the issues of pledge of shares in the authorized capitals of limited liability companies. In particular, the agreements on the pledge of shares in the authorized capitals of limited liability companies or parts thereof are also subject to the certification by a notary[2]. The USRLE record about an encumbrance with a pledge of a share in the authorized capital of a

[1] Notaries are required to check if the person alienating a share has the power to dispose of such shares. Notaries should have the right to request the seller to present the documents pertaining to the purchase of the respective share by the seller, as well as a statement from the USRLE. Notaries' responsibilities also include the submission to the registering authority of an application for the introduction of the respective changes in the state register signed by the participant of a limited liability company alienating the share and supplemented with the documents certifying the grounds of transfer of ownership of a share of a part thereof within three days since the certification of the transaction aimed at the alienation of the share. Alongside with forwarding the documents to the registering authority, notaries are required to send copies of such documents to the company within three days since the certification of the transaction in the case they are vested with such a function. Otherwise, according to the agreement between the parties of the transaction they on their own account notify the company, what, in turn, releases notaries from responsibility for the failure to notify the limited liability company.

[2] In this case, notaries certifying such transactions should also be responsible to submit within three days since the date of the certification of the agreement on the pledge of a share in the authorized capital of a company or a part thereof to the authority carrying out the registration of legal entities an application for the introduction of the respective changes in the USRLE, signed by the participant of a limited liability company making the pledge, indicating the type of the encumbrance (pledge) of a share or a part thereof and the term, for which such an encumbrance exists, or the procedure governing the determination of such a term. Besides, the initial version of the law established that in accordance with paragraph 2 of item 3 of article 22 of the law on limited liability companies the notary should be responsible to forward to the company, a share in the authorized capital of which or a part thereof was pledged, a copy of such an application supplemented with a copy of the pledge agreement concerning this share of a part thereof. Later, Federal law No. 205 FZ of July 19, 2009, introduced an amendment, which excluded the responsibility of notaries to forward to the limited liability companies copies of agreements on pledge of shares or parts thereof (these changes came into force on July 22, 2009). Therefore, at present notaries are responsible only for the notification of the registering authority about the pledge of shares or parts thereof.

limited liability company or a part thereof should be cancelled on the basis of a mutual statement of the person making the pledge and the pledge holder, or the final judgment of a court.

As concerns the retirement of participants from a company, certain amendments were made to the respective provisions too. A participant of a company should have the right to retire only in the case it is envisaged by the charter (see article 26 of the law on limited liability companies). The preceding version of this article stipulated that a participant of a company should have the right to retire at any time not depending on the consent on the part of other participants or the company as such. This right could not be restricted by provisions of the charter. Besides, the new version of the article does not permit the retirement of a participant (participants) from the company in the case it results in the fact than no participants remain in the company.

The amendments (paragraph 2 of item 6.1 of article 23 of the law on limited liability companies) also stipulate that the company should pay the actual value of the share owned by the retiring participant; the respective value should be determined on the basis of the company's financial statements covering the last reporting period preceding the date, on which such a participant submitted the application for the retirement from the company, or, with consent of this participant, to transfer to this participant property in kind of the same value, or, in the case this participant failed to pay the share in the authorized capital of the company in full, to transfer to such a participant the actual value of the paid part of the share. The previous version of the law on limited liability companies the real value of the share should be paid within 6 months since the end of the financial year, in which the participant applied for the retirement from the company. Now, the term of payment makes 3 months since the date the respective responsibility arose (unless otherwise stipulated by the charter).

Article 31.1, which set forth the responsibility of companies to keep a list of their participants, was added to the law on limited liability companies. This provision is similar to the respective requirement to joint stock companies[1]. It should be noted that the list of participants of companies has no such a legal significance as a register of shareholders, an extract from which confirms the right for shares. As concerns extracts from the lists of company's participants may be a document not confirming the rights for shares, since according to item 5 of article 31.1 of the law on limited liability companies in the case the data indicated in the list of participants in the company disagrees with the information contained in the USRLE, the right to own the share is established on the basis of the data provided by the USRLE.

The provisions determining the limited liability companies' management procedures have been also significantly changed.

Prior to the introduction of amendments to article 33 of the law on limited liability companies, the issues pertaining to the transfer of powers from the sole executive body of a company to a commercial organization or a self-employed entrepreneur (hereinafter referred to as the manager), approval of such a manager, and the terms of the contract concluded with such a manager were classified as the reserved matters of the general meeting of participants. However, earlier item 3 of article 91 of the RF Civil Code had not classified the settlement of such issues to the reserved matters of the general meeting of participants. After the amendments had been made to sub-item 2 of item 3 of article 91 of the RF Civil Code and sub-item 4 of item 2 of article 33 of the law on limited liability companies, the differences between the provisions

[1] See article 44 of Federal law No. 208 FZ of December 26, 1995, "On joint stock companies".

were accommodated; now the provisions contain a stipulation, in accordance to which the formation of the executive bodies of companies and early termination of their powers, as well as the taking of decisions on transfer of powers of the sole executive bodies of companies to managers, approval of such managers and terms of contracts concluded with such managers should fall within the terms of reference of the general meetings of participants in the case the settlement of the said issues does not come within the terms of reference of the boards of directors (supervisory councils) of companies.

Sub-item 13 of item 2 of article 33 of the law on limited liability companies was amended; according to the respective changes, alongside with the issues set forth in item 2 of article 33 of the law on limited liability companies, other issues may also come within the terms of reference of the general meetings of participants in the case it is envisaged not only by the law on limited liability companies, but also by charters of companies.

It should be noted that according to paragraph 2 of item 2 of article 33 of the law on limited liability companies, there are listed the issues, which charters of companies can not set within the terms of reference of other managing bodies of limited liability companies, i.e. [1]:

- introduction of changes in charters of companies, including those changing the amount of authorized capitals thereof;
- election and early termination of powers of audit commissions (auditors) of companies;
- approval of annual reports and annual accounting balance sheets;
- adoption of decisions concerning the distribution of net profits earned by companies among their participants;
- adoption of decisions on reorganization or liquidation of companies;
- appointment of liquidation commissions and approval of liquidation balance sheets.

Item 2.1 of article 32 of the law on limited liability companies sets a list of issues the charters may set within the terms of reference of the boards of directors: the issues relating to the formation of executive bodies of companies, early termination of their powers, make major transactions and related party transactions, issues related to the preparation, calling, and holding of general meetings of companies' participants. Charters may also set within the terms of reference of the boards of directors other issues not pertaining to the terms of reference of general meetings of participants of companies or executive bodies of companies.

The previous version of the law on limited liability companies contained an option to set within the terms of reference of the boards of directors (supervisory councils) the issue of formation of executive bodies of companies. At the same time, the formation of executive bodies and early termination of powers thereof was a reserved matter of the general meetings of participants. Besides, item 1 of article 40 of the law on limited liability companies stipulated that the sole executive body of a company (the general director, the president and others) should be elected by the general meeting of participants of the company.

At present, these provisions are amended. According to the amendments, the sole executive body of the company (the general director, the president, and so on) should be elected by the general meeting of participants of the company for a term determined by the charter in the case the charter does not set these issues within the terms of reference of the board of directors (supervisory council). In other words, the election of the company's sole executive body may be

[1] The said changes entered into force on July 22, 2009.

carried out by the board of directors (supervisory council) in the case the carter sets the settlement of this issue within the terms of reference of these bodies.

In a similar way there was settled the issue concerning the formation of collegial executive bodies of companies and early termination of the powers thereof. Thus, according to item 1 of article 41 of the law on limited liability companies the formation of the collegial executive body and early termination of its powers may fall within the terms of reference of the board of directors (supervisory council) of a company.

Article 42 of the law on limited liability companies envisaging the transfer of powers of the sole executive body of a company to a manager was amended. According to the respective amendments, such a transfer does not require any more a direct provision of the charter concerning this issue. Besides, there was determined the person, who should sign the contract with the manager on behalf of the company in the case this issue falls within the terms of reference of the board of directors (supervisory council) of the company. In this case the contract should be signed by the Chairman of the board of directors (supervisory council), or a person authorized to sign such contracts by a decision of the board of directors (supervisory council).

New provisions concerning the appeal against decisions taken by managing bodies of limited liability companies were added to the law on limited liability companies.

In particular, for the contesting of decisions taken by all managing bodies of companies there was set a two months period starting on the date such a decision and the circumstances providing the grounds to hold it invalid came, or should come to the knowledge of a participant in the company. This period should not be extended if expired, with the exception of the cases, where participants failed to submit appeals because of possible violence or threats.

It was also stipulated that the declaration of decisions taken by general meetings of participants of companies, or boards of directors (supervisory councils) with respect to the approval of major transactions and related party transactions invalid, in the case such decisions are appealed against separately from the contesting such transactions, should not result in the holding of the respective transactions invalid.

Besides, there is envisaged a new procedure, which governs the making and contesting of the transactions on the part of companies. The new provisions of the law on limited liability companies concerning related party transactions and major transactions are practically similar to the provisions regulating related party transactions and major transactions relating to joint stock companies.

There were also changed the stipulations concerning the record management and provision of access to the records for participants of companies, as well as the provisions regulating reorganization of limited liability companies.

2.2. Planned changes of the legislation concerning the activities of organizations engaged in the noncommercial sphere

The RF Ministry of Economic Development is preparing massive changes in the sphere of activities of the noncommercial sector. The expert community has taken part in the discussion of the planned changes[1]. First of all, there should be noted the amendments made to the law on charity[1]. It is planned to expand the purposes of charitable work at the expense of:

[1] Lawyers and experts in the sphere of noncommercial activities working with the Commission on charity, beneficence, and volunteering of the RF Public Chamber, the International Center for noncommercial law, the noncommercial partnership “Lawyers for Civil Society”, “Donors’ Forum”, CAF Russia (Charities and Founda-

- social rehabilitation of street children, orphans, and children without parental support;
- provision of gratuitous legal assistance to citizens and noncommercial organizations, and legal education of the population;
- assistance to voluntary activities;
- prevention of socially dangerous forms of behavior of the population;
- assistance to the development of scientific, technological, and artistic creativity of children and young people;
- assistance to the patriotic upbringing, spiritual and moral education of children and young people, as well as support of youth initiatives, projects, children and youth movements and organizations;
- independent activities carried out on the gratuitous basis in the spheres of education, science, culture, arts, enlightenment, personal spiritual advancement, protective treatment and health care, encouragement of health lifestyle, improvement of the moral and psychological state of the citizens, physical culture and mass sports, production and dissimilation of public service advertising.

There will be determined the legal grounds needed for the volunteers to carry out charitable activities. Volunteers carry out charitable activities on the basis of civil law contracts made by them in their own names; the scope of such contracts may be the work carried out for and services provided to the benefit recipients by volunteers on the gratuitous basis. There will be determined the terms of such contracts, introduced the option to receive compensation of expenditures borne in the process of carrying out such activities.

It is planned to significantly expand the law on endowments[2]. It is envisaged that endowments could be formed not only at the expense of financial resources, but immovable property and securities transferred to endowments as donations. It is planned to expand the list of activities presented above, which could be financed from endowments, and include in this list the activities relating to the protection of environment. Changes should be also introduced in other provisions of the law, such as the notion of endowment, the rights of donors, the requirements to noncommercial organizations being the owners of endowments, the reporting of noncommercial organizations being the owners of endowments, the procedures governing the utilization of incomes from endowments and so on[3].

tion, office in Russia), the Institute for the Economy in Transition, and so on took part in this discussion. The RF Ministry of Economic Development presented the results of the work on this issue and a draft document on changes at the 4th All-Russian Conference "Social Partnership and Development of Civil Society Institutions. Experience of Regions and Municipalities", which took place on December 11, 2009.

[1] Draft Federal law "On the introduction of amendments to the Federal law "On charitable work and charity organizations" and the Federal law "On insurance contributions to the Pension Fund of the Russian Federation, the Social Insurance Fund of the Russian Federation, the Federal Compulsory Medical Insurance Fund, and territorial compulsory medical insurance funds" published at the web site of the RF Ministry of Economic Development and Trade http://www.economy.gov.ru/

[2] See draft law No. 306882-5 "On the introduction of amendments to the Federal law "On the procedures governing the formation and utilization of endowments of noncommercial organizations" and the second part of the Tax Code of the Russian Federation" (as concerns the issue of formation and replenishment of endowments of noncommercial organizations) introduced by the RF government to the RF State Duma in December of 2009.

[3] In more detail, see http://www.iet.ru/

Annex 2

Major Trends of Amendments to Legislation Applicable to the Procedure of Tax Abuse Investigations in 2008–2009

During 2008-2009 a number of measures aimed at streamlining the tax administration were taken. Although not all "problematic" provisions of the RF Tax Code and the Administrative Code of Russia were covered by the legislators, there were many changes in relations between the taxpayers and the state.

In particular, in 2009, there came into force on the Federal Law No.293-FZ of December 26, 2008 "On Amendments to some Legislative Acts of the Russian Federation in terms of cancelling the procedural rights of the Russian Federal agencies of internal affairs, involved in tax audits of business entities", as well as the Federal Law No.294-FZ of December 26, 2008 "On protection of rights of legal entities and individual entrepreneurs in the exercising the state control (supervision) and municipal control."

Federal law No. 293-FZ has introduced a number of amendments aimed at limiting the administrative burden on business, namely:

– It deprived law enforcement agencies of the right to conduct independent tax audit (canceled Subitem 35 Art. 11 of the Law "On militia");
– the law obliged enforcement agencies to participate in joint audits carried out at the request of tax authorities and with their participation, solely in the manner prescribed by the tax law (amended in Sub-Item 33 of Art. 11 of the Law "On militia"). This means that the audits carried out with the police, from 2009 is applicable to all restrictions imposed on the frequency, duration and recurrence of tax control measures. Due to this amendment, the functions of law enforcement agencies involved in joint audits are largely limited to ensure safety of tax authorities and ensure their access to the territory of the taxpayer;
– it prohibited the law enforcement agencies, even when there is suspicion that a legal entity has committed an administrative or a criminal offense, to conduct audits of business activities or demand such audit performance, as well as to inspect the premises and vehicles belonging to the organization, to examine its documents, to seize samples of raw materials, products and goods for examination (for this purpose Sub-Item 25 of Art. 11 of the Law "On militia" was removed);
– the Law clarified that police staff should use their rights not for the purpose of "performance their duties, but only "in the process" of implementation thereof" (Article 11 of the Law "On militia"). Thus the legislator has stressed that the actions of the law enforcement officers non-complying with the procedural order, can not be recognized as legal.

These restrictions were largely designed to help to protect businesses during tax audits. However, in practice, those restrictions were not as effective as originally anticipated by the legislators. To the effective restrictions one can attribute primarily prohibition for the law enforcement agencies to conduct independent field audits of the taxpayers. Until 2008 they had the right to carry out the repeated audits for unlimited number of times. Herewith, while the provisions of the Tax Code (Article 89 of the RF Tax Code) clearly indicate that the taxpayer can not be held responsible if the violations are identified by the tax authorities on the basis of

repeated audit, the criminal law does not impose such restrictions. Thus, the violations identified by law enforcement agencies in repeated audit could be used as evidence against the taxpayer.

However, the prohibition to conduct audits (inspections) of organizations as such, including the inspection of premises, vehicles and to seize documents was virtually useless. The fact that law enforcement authorities retained the right to "enter freely into residential and other premises of citizens, to belonging to their land areas, sites and premises occupied by the organizations, and examining them with the aim of prosecution of persons suspected in crimes, or if there is sufficient information for believing that there is a committed or a planned a crime, accident, and also to protect the personal safety of citizens and public safety during natural disasters, catastrophes, accidents, epidemics, epizootics and mass disorders." The condition of the legality of such an access for the law-enforcement authorities is a notification to the Prosecutor, issued within 24 hours (Su-item 18 of Art.. 11 of the Law "On Militia").

In addition, law enforcement agencies were not deprived of a number of "other than procedural" rights under the RF Administrative Code and the RF Code of Criminal Procedure. For example, under the RF Administrative Code and the Code of Criminal Procedure, the law enforcement agencies have the right to:

- seize the items and documents that are the evidence in the case of administrative violation, as well as objects and documents, “discovered in carrying out the inspection of the entity owned territories, premises and the goods, vehicles and other property, as well as the relevant documents" (Article 27.10 of the RF Code of Administrative Offenses);
- seize the goods, vehicles and other items (Article 27.14 of the RF Administrative Code);
- inspect premises (Art. 176 of the RF Administrative Code);
- seize any property items (Article 176 and Art. 183 of the RF Criminal Code), etc.

In both of the above amendments to the Code, symmetrical changes made to the Law "On militia" have not been introduced. Moreover, the possibility of restrictions listed in those acts on militia is not obvious, since all the listed in regard to the RF Code of Administrative Offenses, and particularly those made to the RF Code of Criminal Procedure can be used by law enforcement agencies during the exercising of the powers provided to them under the already quoted by us above Sub-Item 18 of Art. 11 of the Law "On militia".

Therefore, a comprehensive interpretation of the new version of the Law "On militia», provisions of the RF Administrative Code and the RF Code of Criminal Procedure allow us to conclude that:

1. Prohibition of business entities audit is applied only to cases of suspicion of committing "administrative" offense. Herewith, police retains the right to exercise control in respect of organizations suspected of having committed "crimes".

2. It is impossible totally to prohibit law enforcement agencies an access to the organizations, because such a prohibition would impede the performance of their duties. However, the opportunity to conduct field audits of the organization can ultimately bring it to administrative liability. An examination can be motivated by the presence of information about the threat of a crime. If in the course of its conduct a crime will not be revealed, but an administrative offense will be identified, the law enforcement agencies will be able to bring the entity to legal responsibility. The probability of such spontaneous inspection is even higher, since many of the administrative violations and crimes in the economic sphere differ only by the harm to the State, organizations and citizens.

3. The practice of the new edition of the Law "On militia" application in 2009 showed that there was no real decline in the administrative burden on taxpayers. This was directly noted by deputies B.V. Gryzlov, U.V. Vasilyev, E.A.Fedorov, P.V. Krasheninnikov, V.N. Pligin, V.M. Resnick, G.Ya. Chorus, A.M. Makarov, in a memorandum to the draft Federal Law "On Amendments to Part One of the RF Tax Code and some legislative acts of the Russian Federation (on amendments to the terms of criminal prosecution for tax offenses)" No. 224549-5.

4. Limiting law enforcement powers, in practice, did not result in the need to harmonize the operational-search activities undertaken by the authorities of the Ministry of Internal Affairs in respect the taxpayer, with the tax authorities conducting the audit. During 2009, like before, the vast majority of criminal cases brought against the taxpayers were initiated by the police without the participation of tax offices. According to the law firm of "Pepeliaev, Goltsblat and Partners", according to the results of tax audits, i.e., as per result of interaction of the FTS and the Ministry of Internal Affairs of Russia, only 5% of proceedings were initiated, while the remaining 95% of criminal prosecution of taxpayers cases are not related to tax audits[1].

In June 2007, a draft Federal Law "On Amendments to Part One of the RF Tax Code and some legislative acts of Russia was submitted to the State Duma of Russia of the RF Federal Assembly (to modify the terms of criminal prosecution for tax crimes), basing on which the Federal Law No. 383-FZ of December 29, 2009 was adopted.

Relevance of the new act was motivated by its authors as follows:

"legislation regulating tax relations, as well as law enforcement historically have a significant bias towards the criminal suppression, and the threat of criminal prosecution is regarded as perhaps the most effective way of the government "dialogue" with a taxpayer ...";

"complexity of legal structures used by the legislators, cross-references to Articles from various chapters of the Tax Code make the task of establishing the will of the legislator is extremely difficult ..." (and hence complicate the process of proving the guilt of the offender);

"solving the issue of legal responsibility, the state is not interested in more taxpayers to be subject to criminal liability and be imprisoned, but in as many taxpayers as possible to be compliant and fulfill their liabilities conscientiously, and where tax law violation still occurred, the taxpayer should recover the losses to the government... ";

"the state is interested in systematically generating revenue in the form of tax payments from taxpayers, and not in one-time receipt of fines or other sanctions, which often involve the cessation of the taxpayer business."

At the stage of the law discussion it did not meet strong objections neither from the RF Government nor from the RF Supreme Court, which gave the overall approval on the draft law, and as a result, it was accepted with minor amendments.

The purpose of the law adoption was designated as "decriminalization of tax relations and establishment of the legislative level, the legal milestones of the tax system, which were repeatedly designated by country leadership - namely, to stop "tax terror" and to stop " to threaten the business"", etc.[2]

However, it should be immediately mentioned that the law does not imply full decriminalization of tax offenses and does not mean complete renunciation of the practice of bringing to justice the taxpayers. In fact, it implies the change in the terms and conditions of its occurrence.

[1] http://www.vedomosti.ru/newspaper/article/2009/11/20/219356
[2] See Explanatory Note to the draft law http://asozd.duma.gov.ru/

In particular, the new law has introduced the following amendments to the Tax Code, to the Criminal and Procedural Codes:

1. Refinement of the procedure of the information transfer on tax offenses containing elements of the crime, from the tax authorities to law enforcement bodies. To this end, amendments were made to Item 3, Article 32 of the Tax Code. Before the new law adoption, the tax authority was supposed to pass information on all major tax arrears, which are not repaid by the taxpayer within two months from the date of expiry of the deadline for complying with the requirement to pay taxes and fees. This is a 10-days term from the moment of the requirements (Article 69 of the Tax Code).

The new version of Item 3, Article. 32 of the Tax Code is presented in the following wording: "If, within two months from the date of expiry of the execution term of tax (duty) requirement sent to the taxpayer (payer of the duty) as a result of the tax audit, the taxpayer (the payer of the duty) has not redeemed the arrears, the amount of which, as well as the amount of fines and penalties in full implies the criminal breach of legislation on taxes and levies, the tax authorities shall, within 10 days of identifying those circumstances, to send the materials to the bodies of the Internal affairs to make a decision in initiation of criminal proceedings."

A new point in comparison with the current version is the requirement that the arrears should be identified during the audit, whereas previously allowed to inform law enforcement of arrears identified without audit activities. For example, such arrears can arise when the taxpayer has declared, but failed to pay tax on time.

The authors of the law proceeded from the implication that the very fact of large arrears existence (formal indicator of a crime) to pass information to law enforcement agencies is not enough. In their view, in case of detection of large arrears, tax authority should perform tax audit, and only on its results make a decision about the presence or absence of the taxpayer incompliance and therefore evidence of crime in his actions. That is, the tax authorities are supposed to assess the taxpayer's actions on the basis of evidence collected during the tax audit. Unfortunately, their ability to gather evidence is limited, because the tax authorities are not empowered to implement the operational-investigative activity. They practically do not work with the testimony, they do not perform test purchases, not explore the personal correspondence and records of the taxpayer (drafts, records of mobile phones, notebooks, etc.). This means that the conclusions of the tax authority of the presence / absence of direct intent in the actions of the audited entity are likely to be very rough and it is hardly reasonable to neglect tax investigation on the basis thereof.

In general, one should agree with the amendments to Item 3, Article 32 of the Tax Code. However, the question arises of how to deal with those taxpayers who is not available at the site of their residence and not actually carrying out any activities. It is impossible to conduct a full-scale tax audit in regard to this category of persons, but initiation of criminal procedures against their business leaders may be necessary.

Furthermore, the proposed refinement in general does not imply the development of new procedural guarantees for taxpayers. Since the evaluation of presence / absence of the intent in the actions of the taxpayer by the tax authorities can only be very rough, there are still ample opportunities for free discretion on whether to pass the information about the offense to the law enforcement authorities, and hence, for corruption.

2. The amendments proposed in the Art. 108 of the RF Tax Code, in fact repeat the logic of the amendments made by the authors of the law to Items 3, Article 32 of the RF Tax Code. It

is stated in Art. 108 of the RF Tax Code that the reason for holding a person responsible for the violation of legislation on taxes and levies is the fact of the violation established by the tax authority and confirmed by the decision, which came into force.

In this case, however, Art. 101 of the RF Tax Code is supplemented by Item 15.1, according to which the transfer of materials to law enforcement agencies the Head of the tax authority should suspend the initiation of proceedings against physical entity. At the same time the limitation period is suspended in respect of this decision.

One should agree with this amendment, because it allows excluding the dual prosecution of the same person.

3. Item 15.1 of Art. 101 of the RF Tax Code has stipulated the obligation for law enforcement authorities to sent to the tax authorities notifications of the results investigation of materials submitted by the tax authorities no later than the day following the day of decision. Copies of the decision are also sent to the entity or its representative, against whom the relevant decision, with the receipt confirmation.

4. The Law has non-recurrently enlarged the rate of "large" and "very large" amount of tax arrears, which gives grounds for criminal prosecution. If earlier the "threshold", which allowed to distinguish between the criminal offense of administrative offenses was Rb 100 thousand for individual entrepreneurs and Rb 500 thousand - for legal entities (provided that the amount of arrears accumulated over 3 years in a row on all types of taxes, is not less than 10% of the total obligations of the taxpayer), the new law, this amount is increased to Rb 1.8 million and Rb 2 million, respectively.

Since the value of debts, established in Art. 198-199.2 of the RF Criminal Code was not adjusted according to index in the past six years, this step is considered to be feasible. Herewith, the law, unfortunately, does not establish the order of further indexing the "threshold" values. This means that the solution to their gradual decline is temporary, and after 2-3 years due to inflation the issue of unreasonably low threshold of criminal responsibility will once again be relevant. It should be noted that there is a number of ways of regular indexation of the "threshold" values to be estimated by the tax, administrative and criminal legislation. This is the application of a rate-deflator, annually adjusted by the Ministry of Economic Development (applied to the "threshold" values, giving grounds to the simplified taxation system) and the establishment of a "threshold" values in the annually indexed conventional tax units (there is no such practice in Russia until now), and their annual revision in the budget law, and other methods. It seems that simultaneously with a one-time increase in "large" and "very large" amount of arrears there would also be appropriate to establish procedures for its further adjustment for inflation.

5. Article 108 of the Criminal Procedural Code of the Russian Federation has been supplemented by Item 1.1, which indicated that according to the general rule in regard to the entities, suspected or accused of committing crimes, responsibility for which is provided under the Art. 198-199.2 of the RF Criminal Code, a confinement under guard is not applied a preventive measure.

Exceptions are defined in Art. 108 of the RF Criminal Procedural Code, where:

1) the suspect or the accused has no permanent place of residence in the territory of Russia;
2) the suspect is not unidentified;
3) the suspect violated the previously chosen a preventive measure;
4) He escaped from the preliminary investigation or the court.

This amendment is of major importance, since it is the detention is often used by corrupt law enforcement officers for unlawful pressure on employers.

6. Criminal law finally secured the notion of the taxpayers' as "active repentance", for which purpose it was proposed to amend Art. 198-199.1 of the Criminal Code, as well as in the Criminal Procedural Code. The new law has supplemented Art. 198 and 199.1 of the RF Criminal Code with the notes, which stated: "the person who first called to criminal responsibility for crimes under this article shall be exempt from criminal liability if that person or organization, which is called for tax evasion and (or) fees charged with this person, until the end of the preliminary investigation of the case is fully paid the amount of the arrears and penalties, as well as the amount of penalty in the amount determined in accordance with the RF Tax Code."

This change, in our opinion, is essential. It also represents the greatest difficulty as from a practical point of view and from the standpoint of the theory of law.

From the standpoint of the theory of law, criminal liability should occur because of the crime, the main guarantee of the effectiveness of criminal responsibility is its inevitability. Criminal law comes from the fact that the perpetrator should be punished. When it avoids sanctions under the so-called "active repentance" is an exception, largely inconsistent with the general rule.

This shortcoming of the proposed amendments to the Criminal Code is aggravated by the fact that the RF Code of Administrative Offenses, which establishes administrative liability for a tax crime for officials of organizations, generally do not contain any sanctions for tax evasion, breach of duties of a tax agent and concealment of property from taxation. It is responsible for the violation of the term registration with the tax authority, the violation of the deadline for submission of information on opening and closing bank accounts and other procedural violations of tax laws. However, similarly to Art. 122, 123 and 125 of the Tax Code there are no (as well as unique art. 198-199.2 of the Criminal Code) violations in the Code of Administrative Offenses.

This means that the head of the organization, to evade criminal liability for tax evasion or failure to perform duties of a tax agent, no personal liability shall not be at all. This means that the head of the organization who escaped criminal responsibility for tax evasion or failure to comply with tax agent is not criminally liable at all.

From a practical point of view, the possibility of "active repentance" for tax crimes seriously discourages fiscal discipline. When the taxpayer is confident that he will not be held criminally liable in case of detection of large arrears in force of «active repentance", tax evasion is preferable for him. In our opinion, the possibility of involving the tax liability in the absence of risk of criminal or even administrative penalties does not create sufficient incentives for the payment of taxes, since the probability of detection of the arrears was relatively small, and the maximum amount of tax penalties makes only 40% of the amount in arrears

It should be noted that the negative practice of using “active repentance" in Russia is already available. In the form in which the authors of this Article draft propose to enter this legal

act, it has already been used in criminal legislation from 1998[1] to 2003[2], after which the legislators have rejected it.

From 1998 to 2003, Art. 198 of the RF Criminal Code contained a note 2, which indicated that the person who committed a crime under this Article, as well as Art. 194 or 199[3] shall be exempt from liability, provided that it "helped to solve the crime and fully repair the damage caused. It applies both to "tax" and to "customs" of crimes.

Other Articles of the RF Criminal Code describe under the "contribution to the exposure" crime a voluntary cessation of a continuing offense and active promotion of the investigation in its disclosure. However, given that in the Art. 198 the notion of "contribution to the exposure" crimes are not revealed, it allows exemption from criminal responsibility not only to individuals who voluntarily declared that they have committed tax crimes, but also those whose tax crimes were uncovered in the course of a field tax audit.

In practice, application of this provision has led to the fact that only those taxpayers who could not repay the arrears, additionally accrued as a result of verification of tax payments. Thus, at the expense of "active repentance", criminal liability under tax Articles of the RF Criminal Code was used not only for the actual punishment of the taxpayer, but to collect tax debts. i.e., essentially played the role of the Institute of Tax Administration. The practice of this rule application has shown that it stimulates serious tax crimes, since the risk of punishment for these acts is minimal.

The negative impact of this rule on the conduct of the taxpayer is exacerbated by the fact that it could be applied as a relapse. While the Article included a disclaimer that it applies only to the entities who "committed a tax crime for the first time", in fact it could be used an unlimited number of times, as a matter of law, a person who has no criminal record, is considered to be the first prosecuted.

This lack of 'old' practice of "active repentance" is fully repeated in the new law, adopted in late 2009. It uses the wording that copies the entire logic of the RF Criminal Code of 1998: "The entity, who first called to criminal responsibility for crimes covered by this Article, as well as Art. 199.1 of this Code, shall be exempt from criminal liability, if it is to the end of the preliminary investigation of the case has fully paid the amount in arrears and the corresponding penalties, as well as the amount of penalty in the amount determined in accordance with the RF Tax Code."

However, despite all the shortcomings of the Institute of "active repentance", the amendments made to the RF Code and the Code and RF Criminal Procedure, have one significant advantage - they bring criminal law into line with the logic of tax law.

The RF Tax Code has actually recognized the possibility of "actual repentance" from 2006. If before 2006, Item 3, Article 32 of the RF Tax Code required the tax authority to report to law enforcement agencies of all identified major arrears, whether paid or not, after the amend-

[1] Art. 199 "Evasion from taxes or insurance premiums to the state budget and Non-Governmental Funds" and Art. 194 of the Criminal Code "Evasion from Customs Duties" (in the version of Federal Act No.92-FZ of June 25, 1998).

[2] Art. 199 "Evasion from taxes or insurance premiums to the state budget and Non-Governmental Funds" (in the version of Federal Act No.162-FZ of December 8, 2003).

[3] Art. 199 "Evasion from taxes or insurance premiums to the state budget and Non-Governmental Funds" and Art. 194 of the Criminal Code "Evasion from Customs Duties" (in the version of Federal Act No.92-FZ of June 25, 1998).

ments made by the Federal law No. 137-FZ of July 27, 2006, the tax authorities are required to report only on the major outstanding arrears.

The possibility of non-disclosure to law enforcement agencies the information about major redeemed arrears created conditions for a taxpayer to avoid criminal responsibility by itself, regardless of how it was formulated in criminal legal provisions.

Given the above, one can make the following *conclusions.*

The idea of decriminalization of tax crimes is in itself worth of serious attention. In the circumstances where the results of tax audits revealed large arrears of more than 90% of the taxpayers[1], criminal liability can not be total. This means that the principle of inevitability of criminal liability in respect of tax crimes under the existing system of sanctions involving the deprivation of liberty can not be realized in practice.

Analysis of the practice of the "tax" Articles of the RF Criminal Code indicates that the main type of sanctions applied by the courts in relation to the entities who have committed tax crimes are fines and conditional sentences. That is, the only practical difference between the criminal liability from the administration responsibility in most cases is the fact of conviction, rather than the nature of the sanctions applied to it[2]. This situation, no doubt, reveals the relevance of the reform in terms of criminal responsibility for tax evasion.

Unfortunately, the attempt to "decriminalize" tax crimes, undertaken by the authors of the new law is not consistent and contains a number of "old" legal errors that previously led to the abandonment of the use "of repentance" of the taxpayer.

In our opinion, there are two options to address the issue related to the reform of the system of liability for tax crimes.

The first option is based on the finalization of the adopted law and preservation of "active repentance" of the taxpayer set forth by the new law. As shown above, the new law has many advantages, because it improves the existing legislation by bringing into line the rules of the RF Criminal Code and the RF Tax Code. Previously, Item 3, Article. 32 of the RF Tax Code, was in contrast to the logic of the RF Criminal Code, based on the principle of inevitability of punishment.

Also, major improvements are the waiver of detention of persons suspected of committing tax offenses, custody and detailed procedural order of execution of decisions about their involvement in tax liability.

At the same time maintaining a principle approach to the issue of "decriminalization" of tax evasion can make any number of a technical amendments.

In particular, it is reasonable to:

- establish a system of annual indexation of "large" and "very large" amount of tax arrears. For this purpose, one can be use, for example, an index-deflator, used to index the "threshold" values of the transition to special tax regimes;
- make symmetrical changes to the Art. 194 of the RF Criminal Code, establishing responsibility for "evasion of customs duties levied on an organization or individual" It should be noted that the RF Customs Code includes in the customs duties VAT and excise duties

[1] See official data on the results of tax audits http://www.nalog.ru/index.php?topic=nal_statistik

[2] For details, see: A.Zolotareva,A. Kireev, N.Kornienko - Tax Administration. The main outcomes of the reform, Ed. S.G. Sinelnikova-Muryleva and I.V. Trunina. In 3 vols. Institute for Economy in Transition. Moscow: IET, 2008.

paid by importers. Therefore, in the current situation, a taxpayer who has paid arrears on VAT and excise tax not related with the import of goods should be exempted from criminal responsibility, and the taxpayer-importer in a similar situation should be sentenced under Art. 194 of the Criminal Code. It looks illogical;

- establish administrative penalties for officials of organizations which are exempt from criminal liability in connection with the repayment of arrears, penalties and fines

Replacement of criminal responsibility for the administrative tax evasion charges would make it possible to apply at least the material sanctions (without incurring a criminal record) in relation to persons convicted of tax evasion.

At the same time bringing those guilty in tax evasion to administrative charges will make law enforcement authorities free from proving the direct intent to commit a violation, because the RF Administrative Code requires no form of guilt. The difficulty of establishing direct intent to commit tax crime is the main argument in favor of moving the offence to the category of administrative offenses.

However, this option has several disadvantages. Thus, the replacement of the prosecution of tax evaders, the administrative penalty may, as "active repentance", discourage fiscal discipline.

In addition, the denial of criminal responsibility for tax crimes is contrary to international practice.

Another most appropriate option, in our opinion, is to abandon the practice of "active repentance" as such. Accordingly, the amendments made by the new law to the Criminal Code and the Code of Criminal Procedure of the introduction of "active repentance" of the taxpayer should be abandoned. Instead, in order to humanize the criminal penalties for tax crimes should be replaced with all kinds of sanctions set forth in Art. 198-199.2 of the Criminal Code, fines.

Such a solution to the question has several advantages, including:

- criminal responsibility for "tax evasion / avoidance of responsibilities tax agent / concealment of property from taxation" will be maintained The actual replacement of those offenses by the "evasion of payment of debts" does not occur;
- responsibility for tax crimes would be consistent with the principle of inevitability of criminal punishment for their crimes, as the possibility of release will be excluded;
- sanctions system based on fines, will sharply limit the pressure on the business on the part of law enforcement and judicial corruption (currently there is too much discretion in the courts on the issue of what sanctions should be applied if the person is guilty of tax evasion, penalties range from minor fines to six years' imprisonment);
- the use of penalties not involving deprivation of liberty, is fully consistent with the policy to humanize the criminal prosecution system, as well as "unloading" of prisons.

Virtually the only drawback of this option is a low probability of its political implementation. Since the legislators chose the "active repentance" of the taxpayer, it is unlikely in the near future they will change this approach to the opposite.

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